The World Bank Pakistan Development Update (PDU) provides an update on the Pakistani economy, its economic outlook, together with the development challenges it faces and the structural reforms that should be considered.

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<tr>
<td>BISP</td>
<td>Benazir Income Support Program</td>
</tr>
<tr>
<td>BPM6</td>
<td>Balance of Payments Manual 6</td>
</tr>
<tr>
<td>CAD</td>
<td>Current Account Deficit</td>
</tr>
<tr>
<td>CAR</td>
<td>Capital Adequacy Ratio</td>
</tr>
<tr>
<td>CDS</td>
<td>Credit Default Swap</td>
</tr>
<tr>
<td>COICOP</td>
<td>Classification of Individual Consumption According to Purpose</td>
</tr>
<tr>
<td>CPI</td>
<td>Consumer Price Index</td>
</tr>
<tr>
<td>CRR</td>
<td>Cash Reserve Requirement,</td>
</tr>
<tr>
<td>EFS</td>
<td>Export Finance Scheme</td>
</tr>
<tr>
<td>FBR</td>
<td>Federal Board of Revenue</td>
</tr>
<tr>
<td>FDI</td>
<td>Foreign Direct Investment</td>
</tr>
<tr>
<td>GDP</td>
<td>Gross Domestic Product</td>
</tr>
<tr>
<td>HIES</td>
<td>Household Integrated Economic Survey</td>
</tr>
<tr>
<td>HIICS</td>
<td>Household Integrated Income and Consumption Survey</td>
</tr>
<tr>
<td>IMF-EFF</td>
<td>International monetary Fund-Extended Fund Facility</td>
</tr>
<tr>
<td>IPL</td>
<td>International Poverty Line</td>
</tr>
<tr>
<td>IPPs</td>
<td>Independent Power Producers</td>
</tr>
<tr>
<td>LTFF</td>
<td>Long-Term Financing Facility</td>
</tr>
<tr>
<td>LSM</td>
<td>Large-scale manufacturing</td>
</tr>
<tr>
<td>NDMA</td>
<td>National Disaster Management Agency.</td>
</tr>
<tr>
<td>NEPRA</td>
<td>National Electric Power Regulatory Authority</td>
</tr>
<tr>
<td>NPL</td>
<td>Non-Performing Loan</td>
</tr>
<tr>
<td>PBS</td>
<td>Pakistan Bureau of Statistics</td>
</tr>
<tr>
<td>PPP</td>
<td>Purchasing Power Parities</td>
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<tr>
<td>PSDP</td>
<td>Public Sector Development Program</td>
</tr>
<tr>
<td>PTI</td>
<td>Pakistan Tehreek-e-Insaf</td>
</tr>
<tr>
<td>QTA</td>
<td>Quarterly Tariff Adjustments</td>
</tr>
<tr>
<td>RWA</td>
<td>Risk Weighted Assets</td>
</tr>
<tr>
<td>SBP</td>
<td>State Bank of Pakistan</td>
</tr>
<tr>
<td>SCRR</td>
<td>Special Cash Reserve Requirement.</td>
</tr>
<tr>
<td>SME</td>
<td>Small Medium Enterprise</td>
</tr>
<tr>
<td>SPI</td>
<td>Sensitive Price Indicator</td>
</tr>
<tr>
<td>TERF</td>
<td>Temporary Economic Refinance Facility</td>
</tr>
<tr>
<td>UAE</td>
<td>United Arab Emirate</td>
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<tr>
<td>USDA</td>
<td>The United States Department of Agriculture</td>
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</table>
1. Executive Summary

In the context of persistent imbalances, recent flooding has compounded macroeconomic risks. Supported by accommodative macroeconomic policy, Pakistan’s economy saw robust growth in FY22, at the cost of growing economic imbalances. The Government has begun to further tighten policy to constrain aggregate demand. However, the catastrophic flooding is likely to disrupt activity and may lead to delays in the required fiscal consolidation. In the context of high macroeconomic risks and large financing needs, the outlook is sensitive to market perceptions and sentiment. The Government should adhere to sound economic management and carefully communicate a clear strategy for economic recovery, while judiciously targeting any new expenditures and maintaining progress on critical structural reforms, including those in the energy sector.

Economic growth in FY22 was robust and broad-based. Growth of real GDP at constant 2015–16 factor prices for FY22 was estimated at 6.0 percent (Table ES.1). Agricultural output growth increased significantly on larger crop production, in line with overall better weather conditions and stronger livestock output. Growth in the industry and services sectors remained strong, but some industries, such as food and textiles, weakened in line with the deteriorating macro conditions.

Strong domestic demand helped widen the current account deficit to a 4-year high. On the external front, strong domestic demand and high global commodity prices led to a current account deficit (CAD) of 4.6 percent of GDP in FY22, the largest in 4 years. The large CAD, higher debt service, together with ongoing political and policy uncertainty, weakened investor confidence and the currency depreciated 23.1 percent against the U.S. dollar in FY22. Foreign reserves dwindled to 1.5 months of import cover at end-FY22.

Inflation rose to an 11-year high due to the weaker currency and the overheating economy. The weaker Rupee, high commodity prices, and the overheating economy pushed up inflation, which reached an average of 12.2 percent in FY22, an 11-year high. Accordingly, the State Bank of Pakistan (SBP) tightened monetary policy and raised the policy rate by a cumulative 800 bps beginning September 2021. However, with the policy rate at 15 percent, the real interest rate remained negative.

The Government had begun to tighten fiscal policy to tame aggregate demand and mitigate domestic and external imbalances. Partly due to energy price subsidies, the FY22 fiscal deficit (excluding grants) widened to 7.9 percent of GDP and public debt rose to 78.0 percent of GDP. The banking sector’s sovereign exposure continued to increase, with lending to the public sector accounting for nearly 70 percent of all bank credit at end-June 2022. Considering the mounting risks, rating agencies downgraded Pakistan’s government bonds, while bond yields remained high and the overheating economy pushed up inflation, which reached an average of 12.2 percent in FY22, an 11-year high. Accordingly, the State Bank of Pakistan (SBP) tightened monetary policy and raised the policy rate by a cumulative 800 bps beginning September 2021. However, with the policy rate at 15 percent, the real interest rate remained negative.

The economic outlook has deteriorated significantly with the catastrophic floods. The economic outlook and prospects for overdue adjustment have been significantly affected by the floods. Agricultural output is expected to decline sharply, with losses to cotton, date, wheat, rice crops and livestock. Cotton losses are expected to weigh on the domestic textile, wholesale, and transportation service industries. Public relief and recovery efforts are expected to partially offset the loss in activity. Real GDP growth is therefore expected to slow to 2.0 percent in FY23, but recover to 3.2 percent by FY24.
supported by a rebound in agricultural production, reconstruction efforts, and projected lower global inflationary pressures.

**Consumer price inflation is expected to surge further in FY23 partly due to flood disruptions**

Due to higher domestic energy prices, flood disruptions, and the weaker Rupee, inflation is projected to rise to 23.0 percent in FY23 but moderate to 9.5 percent in FY24 with declining international energy prices and resolution of flood-related supply constraints. Despite flood-associated effects, the CAD is expected to narrow slightly to 4.3 percent of GDP in FY23, partly due to stronger remittance inflows and is projected to shrink further in FY24 as exports recover from flood impacts.

**The fiscal deficit is expected to narrow slightly on fiscal consolidation efforts, despite flood impacts**

In line with fiscal consolidation efforts and lower subsidy expenditures, the primary deficit (excluding grants) is forecast to narrow from 3.1 percent of GDP in FY22 to 3.0 percent in FY23, despite negative impacts to revenue bases and increased expenditure needs due to the floods. Similarly, the fiscal deficit is projected to contract by one percentage point to 6.9 percent of GDP in FY23 and expected to gradually narrow over the medium term as revenue mobilization measures take hold, particularly GST harmonization and personal income tax reform. With rapid nominal GDP growth, public debt as a share of GDP is projected to decline gradually over the forecast period, despite continued primary deficits. The macroeconomic outlook is predicated on the IMF EFF program remaining on track.

**The floods have heightened macroeconomic risks**

Continued policy tightening has become more challenging on account of the floods. The Government will face challenges in implementing the planned fiscal consolidation, given the extensive relief and recovery needs. Additional downside risks include unexpected damages resulting from the still-evolving flooding situation that could further reduce output and worsen economic imbalances; political pressures that undermine the implementation of a coherent and prudent macroeconomic policy mix; unanticipated deterioration of external conditions; and risks associated with large fiscal and external financing needs. To manage these uncertainties, the Government should adhere to sound economic management, while carefully targeting any new expenditures to the poor and maintaining progress on critical structural reforms, including in the energy sector.

**As a direct consequence of the floods, several million people could fall into poverty**

The devastating floods will have adverse effects on poverty reduction. The floods will impact households through at least four channels that includes: (i) reduced income due to lost harvests and livestock, or loss of livelihood; (ii) loss of assets, such as homes, livestock, productive equipment, and household durables; (iii) shortages of food due to lost food stocks, poor harvests and rising food prices; and (iv) loss of human capital, due to disease, food shortages and prolonged school closures. Preliminary estimates suggest that as a direct consequence of the floods, the national poverty rate can increase by 2.5 to 4.0 percentage points, pushing between 5.8 and 9.0 million people into poverty. Reversing these negative socio-economic effects is likely to take considerable time, and some losses, such as those to human capital and land productivity, can lead to more sustained declines in welfare and will warrant specific policy attention.

**The recent bout of inflation has had disproportionately adverse impacts on the poor**

Given the recent spikes in inflation, this report examines the impact of inflation on household welfare and reviews policy options to cushion the effects of rising prices on the poor. By accounting for differences in consumption patterns and in price trends across various goods and services, this report identifies the differential impact of inflation across income groups. The analysis shows that the recent bout of inflation has had disproportionately adverse impacts on the poor. More specifically, the analysis shows that the poorest households, on average, experienced inflation rates that were one percentage point higher than the wealthiest households.

**Policy should aim to contain inflationary pressures, while targeting support to the poor**

Apart from a sound macroeconomic policy mix, sectorial policies with sustainable fiscal costs that largely benefit poor households, like reducing import duties on sensitive food products, could help to reduce inflationary pressures. These policies could be complemented with well targeted temporary expansions of social protection programs to mitigate the impact of higher inflation on poor households. Over the medium term, enhancing economy-wide productivity growth through reforms in the agriculture and energy sectors could further ease inflationary pressures.
2. Recent Economic Developments

a. Context

Supported by accommodative macroeconomic policy, Pakistan’s economy expanded at a robust pace in FY21 and FY22. However, low productivity growth, high world commodity prices, and the global economic slowdown have all contributed to high trade and CAD, exerting significant pressures on domestic prices, the exchange rate, and foreign reserves. Market sentiment deteriorated, the Rupee depreciated sharply, and bond yields hiked over late FY22 and early FY23, reflecting heightened macroeconomic risks. The Government has begun implementing policies to constrain aggregate demand, including a tight monetary stance, a contractionary fiscal budget, and increases in administered energy prices. However, implementation faces mounting risks due to the unprecedented large-scale flooding, political instability, and upcoming elections. The ongoing pandemic and unanticipated surges in global commodity prices pose additional risks to the outlook.

The IMF Board approved the combined 7th and 8th reviews of the Extended Fund Facility (EFF) Program for Pakistan on 29 August 2022. The review focused on fiscal consolidation measures to reduce government borrowing needs, tightening monetary policy, and expanding and strengthening social safety nets to protect the poor. The approval will allow the authorities to draw the equivalent of SDR894 million (about USD1.2 billion) bringing totalEFF disbursements to USD4.2 billion. The Staff Level Agreement (SLA) also included an extension of the EFF until end-June 2023 and increases access by SDR720 million to a total of about USD7 billion. The agreed program is fully funded, following the IMF’s recent receipt of financing assurances for US$6 billion from bilateral and multilateral partners.

The EFF reform program focuses on reforms in the energy and financial sectors, and fiscal measures. The EFF structural reform program maintains focus on energy sector reforms, while also including financial sector and fiscal measures. Energy sector reforms focus on implementation of tariff rebasing, subsidy reform and adjustments to reduce circular debt and fiscal costs. Financial sector reforms focus on strengthening resilience through recapitalization of two undercapitalized banks and improvements to bank resolution and crisis management arrangements; and establishment of a new development finance institution to allow the phasing out of refinancing schemes and improve monetary transmission. Fiscal measures include avoidance of new tax exemptions and personal income tax reforms. The program also supports an increasing floor on social protection expenditures to alleviate poverty impacts of price increases and tariff reforms.

b. Real Sector

Growth

Real GDP growth remained strong for a second consecutive year. Growth of real GDP at factor cost strengthened to an estimated 6.0 percent in FY22 from 5.7 percent in FY21. Private consumption increased, supported by robust remittance inflows and cash transfers under the Ehsaas Emergency Cash Programme (Table 2.1).1 In contrast, growth in investment slowed on account of a modest contraction in private investment reflecting higher interest rates and declining sentiment mainly in H2 FY22. Simultaneously, public investment strengthened as the Government increased development spending. Government consumption contracted as recurrent spending was reprioritized towards financing higher debt servicing costs. The external sector was marked by high growth in both imports and exports, although import growth almost doubled that of exports, in line with strong domestic demand and a weakening global economy.

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Favorable weather conditions and higher livestock output supported growth in the agriculture sector…

On the production side, the agriculture sector’s growth increased from 3.5 percent in FY21 to 4.4 percent in FY22, the highest in 17 years. Supported by favorable weather conditions, a decline in wheat production was offset by higher output of other important crops, including rice, cotton, sugarcane, and maize, as well as some minor crops. In addition, livestock output, which constitutes around 60 percent of the agriculture sector’s value addition, also increased in FY22.¹

…while large-scale manufacturing recorded double-digit growth

In line with expansionary fiscal and monetary policy, industrial sector growth reached 7.2 percent in FY22, lower than last year’s growth of 7.8 percent. This was supported by higher production in the manufacturing sector and electricity, gas, and water supply, whereas output from mining and quarrying contracted. Large-scale manufacturing (LSM), which constitutes approximately half of industrial sector output, grew by 11.7 percent in FY22, up from 11.2 percent in FY21. However, some industries, including cement and textiles, showed signs of weakening production in line with deteriorating domestic and global economic conditions.²

Strong growth in agriculture, manufacturing, and imports supported services sector expansion

With support from a booming economy and strong consumer demand, services sector growth rose to a 16-year high of 6.2 percent in FY22, up from 6.0 percent in FY21. Wholesale and retail trade, as the largest sub-sector, constituting one-third of services, benefited from higher agriculture and manufacturing output and increasing imports.³ Similarly, the second largest sub-sector, transport and storage, saw consumer demand surge for transport services as well as for storage services in line with strengthening economic activity. However, as macroeconomic conditions deteriorated, business sentiment gradually declined to the lowest levels seen in two years by the end of FY22, reflecting dimmer prospects for growth.

Table 2.1: Real GDP growth (y-o-y, percent)

<table>
<thead>
<tr>
<th>Source</th>
<th>FY18</th>
<th>FY19</th>
<th>FY20</th>
<th>FY21</th>
<th>FY22</th>
</tr>
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<tbody>
<tr>
<td>Real GDP growth (at market price)</td>
<td>6.2</td>
<td>2.5</td>
<td>-1.3</td>
<td>6.5</td>
<td>6.2</td>
</tr>
<tr>
<td>Government consumption</td>
<td>5.2</td>
<td>5.6</td>
<td>-2.8</td>
<td>9.3</td>
<td>10.0</td>
</tr>
<tr>
<td>Private consumption</td>
<td>-1.6</td>
<td>-3.4</td>
<td>-8.3</td>
<td>1.8</td>
<td>-3.4</td>
</tr>
<tr>
<td>Investment</td>
<td>0.0</td>
<td>2.8</td>
<td>-6.1</td>
<td>4.2</td>
<td>2.5</td>
</tr>
<tr>
<td>Gross fixed capital formation</td>
<td>10.3</td>
<td>-11.1</td>
<td>-6.7</td>
<td>4.8</td>
<td>5.2</td>
</tr>
<tr>
<td>Public</td>
<td>18.5</td>
<td>33.0</td>
<td>-12.9</td>
<td>11.9</td>
<td>12.7</td>
</tr>
<tr>
<td>Private</td>
<td>7.1</td>
<td>1.7</td>
<td>4.9</td>
<td>2.5</td>
<td>-0.5</td>
</tr>
<tr>
<td>Exports of goods and non-factor services</td>
<td>10.0</td>
<td>13.2</td>
<td>1.3</td>
<td>6.3</td>
<td>8.4</td>
</tr>
<tr>
<td>Imports of goods and non-factor services</td>
<td>15.7</td>
<td>7.6</td>
<td>-5.1</td>
<td>14.5</td>
<td>15.6</td>
</tr>
<tr>
<td>GDP growth (at factor cost)</td>
<td>6.1</td>
<td>3.1</td>
<td>-0.9</td>
<td>5.7</td>
<td>6.0</td>
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<td>Agriculture</td>
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<td>3.0</td>
<td>3.3</td>
<td>4.4</td>
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<tr>
<td>Industry</td>
<td>0.2</td>
<td>-5.7</td>
<td>7.8</td>
<td>7.2</td>
<td>7.2</td>
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<tr>
<td>Services</td>
<td>6.0</td>
<td>5.0</td>
<td>1.2</td>
<td>6.0</td>
<td>6.2</td>
</tr>
</tbody>
</table>

Note: FY18 corresponds to fiscal year 2017-18 which runs from July 01, 2017, to June 30, 2018.

Source: Pakistan Bureau of Statistics

Inflation

Average headline inflation increased in FY22…

Average consumer price index (CPI) inflation reached an eleven-year high of 12.2 percent y-o-y in FY22, up from 8.9 percent during FY21, due to increases in government-administered energy prices, surging global commodity prices, and a weaker exchange rate. All product categories within the CPI basket saw higher y-o-y average inflation during

³ The agriculture sector’s growth was further supported by a double-digit increase in the sale of farm tractors (Pakistan Automotive Manufacturers Association) and a modest increase in agriculture credit disbursement from July to May FY22. (Monthly Economic Update & Outlook: August 2022. Government of Pakistan. Finance Division). However, fertilizer off-take was lower due to significant increase in prices (The domestic price of DAP increased by 88.7 percent while that of urea increased by 10.4 percent. See: Pakistan Economic Survey 2021–22.)
⁵ The growth in value-addition of wholesale and retail trade linked to agriculture, industry, and imports was at 4.0 percent, 9.8 percent, and 19.8 percent, respectively. See: Pakistan Economic Survey 2021–22.
Inflation and the Poor

Pakistan Development Update

October 2022

The World Bank

FY22 except for alcoholic beverages and tobacco and miscellaneous goods and services. The FY22 average headline inflation in Pakistan was the second highest in South Asia after Sri Lanka, with the regional average at 8.7 percent in FY22.6

…driven in large part by higher energy prices

In line with sharp increases in global fuel prices, domestic energy inflation reached 25.5 percent y-o-y in urban areas and 24.7 percent in rural areas during FY22, compared to 4.6 percent in urban areas and 6.8 percent in rural areas in FY21 (Figure 2.1 and Figure 2.2).7 Higher electricity prices reflected the rising cost of fuel for power generation8 and the delayed implementation of FY20 and FY21 quarterly tariff adjustments (QTA). For petroleum products, rising global oil prices and a weaker exchange rate translated into higher domestic prices.9,10 By the end of the FY, the domestic prices of petroleum products had more than doubled.

Food inflation remained elevated

In urban areas, food inflation rose to 13.4 percent in FY22 from 12.5 percent in FY21, while in rural areas, it slowed slightly to 13.0 percent in FY22 from 13.2 percent in FY21. Higher food inflation was partly due to higher agricultural input costs, including for transport, fertilizer, and animal feed. In addition, the rise in global food prices combined with a weaker exchange rate increased the domestic prices of items for which Pakistan is a net importer, including pulses, edible oil, and oilseeds.

Core inflation continued rising

Urban core inflation reached 8.1 percent in FY22 compared to 6.0 percent in FY21, while rural core inflation rose to 9.0 percent in FY22 from 7.6 percent in FY21, with larger price increases for product categories such as clothing & footwear and furnishing & household equipment. The increase was partly due to the depreciation of the exchange rate and the buildup in domestic demand pressures, while factors such as the oil price hike also impacted input costs for a range of businesses.

Flood disruptions have contributed to recent spikes in inflation

More recently, headline CPI inflation jumped 27.3 percent y-o-y in August 2022, up from 24.9 percent in July, partly due to hikes in fuel prices and tariff adjustments on electricity pricing, and flood disruptions. Energy price inflation soared to 80.7 percent in urban areas and 67.8 percent in rural areas. Food and core inflation also reached record highs, with food inflation close to 30 percent in both rural and urban areas and core inflation at 13.8

6 World Bank staff calculations based on data from the CEIC, Bhutan National Statistics Bureau, and Afghanistan National Statistical and Information Authority.
7 Energy price inflation consists of electricity charges, gas prices, liquified hydrocarbons, solid fuel, and motor fuel.
8 The average fuel cost for power generation rose by 93.6 percent y-o-y in FY22, reaching PKR9.34/kWh. Source: Arif Habib Limited Research, based on NEPRA’s data.
9 During FY22, the average crude oil prices rose by 59.4 percent. Source: World Bank Pink Sheet.
10 During FY22, the Rupee depreciated by 23.0 percent against the USD.
percent in urban areas and 16.5 percent in rural areas in August 2022. Similarly, the wholesale price index (WPI) leaped by 41.2 percent y-o-y in August, after increasing by 38.5 percent in July, partly reflecting flood related shortages and transportation challenges.

### Poverty

#### In FY22, poverty is estimated to have decreased

High GDP growth led to a decrease in the projected poverty headcount, measured at the lower-middle income class line of USD 3.65 PPP 2017 per day, from 39.1 in FY21 to 36.4 percent in FY22.\(^\text{11}\)

#### Survey data from January 2022 suggests continued economic hardship

A phone survey conducted by the World Bank in January 2022 suggests that Pakistan’s economic recovery remains fragile.\(^\text{12}\) During the COVID lockdowns, many respondents had left the labor market and are now searching for employment, driving up the unemployment rate. More recently, rising inflation has reduced the real purchasing power of households, with adverse welfare implications especially among the poor and vulnerable (Section 3). Economic hardship remains high, with over half of respondents having concerns about running out of food in the next week, and 44 percent of households who rent are struggling to make payments. The survey also records a decrease in school enrollment rates, as parents can no longer afford school fees.

#### Targeted cash transfers seek to alleviate the effects of rising prices on the poor and vulnerable

The Government has sought to bolster the social protection program through a horizontal expansion of the flagship Benazir Income Support Program (BISP). The number of beneficiary households increased from 4.9 million to 8 million between December 2021 and June 2022. Further, to compensate poor and vulnerable households against rising energy prices, the Government rolled out a new Sasta Petrol/Sasta Diesel Scheme in June 2022. The intent is to disburse Rs 2,000 to an estimated 14 million households earning less than Rs 40,000 a month, with the cash intended to provide a buffer against rising energy prices.\(^\text{13}\)

### c. Monetary and financial sector

#### Monetary

The SBP has been tightening its monetary policy to contain surging inflation and the Rupee’s rapid depreciation. Since September 2021, the central bank has increased the policy rate by a cumulative 800 bps to reach 15 percent, the highest rate since the 2008 global financial crisis. However, with the June through August 2022 inflation rates exceeding 20 percent, real interest rates are still negative. Additionally, to strengthen monetary policy transmission, the SBP has linked the interest rates on concessionary schemes with the policy rate; interest rates for the Export Finance Scheme (EFS) and Long-Term Financing Facility (LTFF) are being maintained at a fixed 500 bps below the policy rate. Therefore, while moving in tandem with the policy rates, the EFS and the LTFF interest rates are still discounted, providing some incentive to the export sector.\(^\text{14}\)

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\(^\text{11}\) Following the publication of new purchasing power parities (PPP) for the 2017 reference year, the World Bank has revised its global poverty lines so they are expressed in its reference year. With the new PPPs, the international poverty line (IPL) — which is used to measure extreme poverty — changes from USD 1.90 (2011 PPP) to USD 2.15 per day (2017 PPP). The higher poverty lines typically used to measure poverty in lower-middle- and upper-middle-income countries have been updated from USD 3.20 (2011 PPP) to USD 3.65 per day (2017 PPP) and from USD 5.50 (2011 PPP) to USD 6.85 per day (2017 PPP).

\(^\text{12}\) The World Bank conducted a region wide survey in response to COVID 19, in order to track the effect of the crisis and subsequent recovery trajectories. The first round in Pakistan was conducted from November to March 2021, and the second round from November to January 2022. A total of 8157 respondents were interviewed in the first round using random digit dialing, and 3,824 were reached in the second round. Sampling weights were used to adjust for attrition.

\(^\text{13}\) The Sasta Petrol/Diesel scheme targets 8 million households registered under the Benazir Income Support Program (BISP) and an additional 6 million household who are invited to verify their eligibility via SMS. Eligible beneficiaries may withdraw their payments through biometric ATMs at designated financial institutions.

Financial Sector

Credit to the private sector continued to grow but remained concentrated in the corporate sector.

Bank lending to the private sector grew by a five-year high of 22.7 percent y-o-y in FY22, up from an increase of 11.8 percent in FY21, driven by negative real interest rates, strong economic growth, and SBP's concessionary finance schemes, including the Temporary Economic Refinance Facility. However, growth was not homogenous across sectors and segments, with credit to the corporate sector growing at a significantly higher rate (23.3 percent) than that to the SME sector (8.9 percent as of June 2022). In contrast, credit to the sovereign, which constitutes nearly 70 percent of total outstanding bank credit, posted a 23.1 percent growth in FY22. Although slightly lower than the 24.3 percent growth in FY21, this growth bolstered the bank–sovereign nexus, with government borrowing further crowding out credit to the private sector.

Banks' traditional financial buffers remain strong but the sector faces mounting risks

At 16.1 percent in June 2022, banks’ Capital Adequacy Ratio (CAR) is well above the minimum regulatory requirement of 11.5 percent. However, CAR has declined by 2.2 percentage points since June 2021, primarily driven by an increase in the banks’ risk-weighted assets (RWA) due to strong growth in private sector credit. Notably, CAR computations accord zero risk weight to loans to the Government. The non-performing loan (NPL) ratio of the banking sector also improved, declining 1.4 percentage points from June 2021 to 7.5 percent in June 2022, while the provisioning coverage ratio improved from 88.8 percent to 91.6 percent over the same period. The significant increase in interest rates poses substantial risks to the outlook for NPLs. Higher NPLs can weigh on banking sector profitability and potentially also on the CAR, with potential negative impacts on credit to the private sector.

Low investor confidence continued to drive capital outflows from equity and bond markets

Low investor confidence on account of the deteriorating macroeconomic environment and political uncertainty were the major causes of volatility in the equity and bond market. Total portfolio investment from Pakistan saw outflows of USD $54 million in FY22 compared to the net inflow of US$D 2.7 billion in FY21. However, net outflow from the securities traded on the stock exchange in Pakistan was significantly higher. Compared to the USD$ 368 million net outflow in FY21, there was a net outflow of amounted to USD US$1.2 billion in FY22, of which 56 percent was mostly from the government securities and the rest from the equity market. The KSE-100 index also dropped by approximately 12 percent in FY22 compared to an increase of 21.4 percent in FY21.

d. External sector

The CAD widened sharply in FY22

The current account recorded a deficit of USD 17.3 billion (4.6 percent of GDP) in FY22, much wider than the CAD of USD 2.8 billion (0.8 percent of GDP) in FY21 (Figure 2.3). The deterioration of the CAD was led by a wider total trade deficit, driven by both domestic and global factors. Rebounding domestic demand, due to more benign COVID conditions and accommodative macroeconomic policies, strengthened imports. Price effects, including higher energy prices, played the dominant role, with more than three fourths of the goods import growth in FY22 driven by price increases. A record level of official remittance inflows helped to finance 80 percent of the trade gap.

The trade deficit reached a record high

Both goods exports and imports reached record highs in FY22. The total trade deficit increased by 43.5 percent y-o-y to reach a record-high of USD 44.8 billion in FY22 (Figure 2.4). While the growth of goods exports doubled to 26.6 percent in FY22, goods imports rose even faster at 32.7 percent, leading to a record goods trade deficit of USD 39.6 billion in FY22. Meanwhile, goods export receipts reached a record high of USD 32.5 billion,

15 As reflected in the SBP report on the Special Convertible Rupee Account which shows international capitals flows in securities listed on the stock exchange in Pakistan (including Equity, PIBs, T-bills, etc.)
17 During FY22, on average, brent crude oil prices increased by 68.3 percent from USD 54.1/barrel to USD 91.1/barrel. Source: World Bank commodity prices data (The Pink Sheet).
18 During FY22, on an overall basis 83 percent of the change in the value of imports is being contributed by the rising prices; for the items with both volume and value data available. Source: Pakistan Bureau of Statistics, World Bank staff calculations,
partly due to strong increases in textile and food product exports. In particular, textile exports grew by 27.8 percent partly due to higher cotton prices.\textsuperscript{19} Meanwhile, the goods import bill also reached a record high of USD 72.0 billion during FY22, with broad-based growth and significant contributions from petroleum, agriculture & other chemical, machinery, metal, and transport. Petroleum imports, which account for a quarter of goods imports, nearly doubled to an all-time high of USD 18.7 billion. Likewise, the services trade deficit more than doubled, partly due to the impact of higher fuel prices on service costs.

### The income account surplus narrowed, partly due to the resumption of interest payments

The income account surplus narrowed to USD 27.4 billion during FY22 from USD 28.3 billion in FY21, with an increase in the primary income deficit reinforced by a slight narrowing of the secondary account surplus. The primary income deficit rose on rising interest payments on external debt, partly due to the resumption of interest payments to bilateral creditors, which were deferred under DSSI last FY.\textsuperscript{20} Under secondary income, worker remittance inflows reached a historic level of USD 31.2 billion. After reaching 27.3 percent in FY21, remittance growth decelerated to 6.1 percent in FY22, reflecting slowing inflows from the UAE and Saudi Arabia\textsuperscript{21} and moderation after benefiting from a COVID-induced transition to formal channels in FY21.

### The financial account surplus rose in FY22 due to greater financing from multilateral and bilateral creditors

Net inflows increased to USD 11.0 billion in FY22 from USD 8.8 billion in FY21, in part due to an IMF SDR allocation of USD 2.8 billion, net issuance of Sukuk/Eurobond of USD 1.0 billion, Saudi Fund for Development time deposits (SFD) of USD 3.0 billion, and a refinancing of the Chinese syndicate/commercial loan of USD 2.2 billion.\textsuperscript{22} Net foreign direct investment (FDI) remained unchanged at USD 1.6 billion due to the slowdown in global growth and higher borrowing costs. Net portfolio investment flows were negative in FY22, partly because of the maturing of the USD 1.0 billion Sukuk bond repayment.

### A larger CAD increase swung the

In line with the sharp widening of the CAD, the balance of payments recorded an overall deficit of USD 6.3 billion in FY22, compared to a surplus of USD 5.6 billion in FY21.

\textsuperscript{19} On average, international cotton prices increased by 56.7 percent during FY22. Cotton, A index (USD/kg) Source: World Bank commodity prices data (The Pink Sheet).

\textsuperscript{20} Source: Economic Survey of Pakistan FY22, external debt chapter.

\textsuperscript{21} Both countries have a combined share of 44 percent in remittances. Inflows from the UAE decreased marginally (USD 323 million), down by 5.2 percent, whereas inflow from Saudi Arabia was almost flat, with a muted growth of just 0.2 percent. Remittances touched a record high base last year due to government efforts to divert the remittances to formal channels and other air travel-related restrictions due to COVID.

\textsuperscript{22} The Government raised USD 2 billion through international bond issuance (USD 1 billion Eurobonds in July 2021 and USD 1 billion Sukuk in January 2022) and repaid USD 1 billion against maturing Sukuk. Refinancing of the Chinese loan facility against CNB 15 billion Term Facility Agreement (USD 2240.31 million) was signed with the Finance Division in June 2022. Source: Foreign Economic Assistance, Monthly Bulletin June 2022, Economic Affairs Division, Government of Pakistan, and Economic Survey of Pakistan FY22.
balance of payments into deficit in FY22, exerting pressures on the Rupee and foreign reserves

SBP’s gross reserves, including the Cash Reserve Requirement and cash holdings, decreased to USD 11.1 billion, equivalent to only 1.5 months of imports at end-June 2022, the lowest since FY18.23 After appreciating by 6.9 percent in FY21, the Pakistani Rupee in FY22 depreciated by 23.6 percent against the USD, 7.1 percent against the Yen, and 12.9 percent against the euro (Figure 2.3). The widening CAD and deteriorating sentiment partly drove the PKR depreciation.

Recently, the CAD has narrowed largely due to reduction in the overall trade deficit

During Jul–Aug 2022, the CAD narrowed to USD 1.9 billion from USD 2.4 billion in Jul–Aug 2021, largely due to the reduction in the overall trade deficit by 11.1 percent y-o-y. Goods export grew by 11.3 percent on account of rice and ready-made garments. In contrast, goods imports declined by 2.1 percent, in line with the temporary administrative measures taken in recent months to soften growth and to contain luxury imports.

e. Fiscal and Debt Sustainability

Pakistan’s fiscal deficit widened significantly on account of higher subsidy expenditure

The fiscal deficit reached a record high of PKR5,260 billion (7.9 percent of GDP) in FY22, up from PKR3,403 billion (6.1 percent of GDP) in FY21 (Figure 2.5). Substantial growth in expenditures, particularly on energy subsidies and debt servicing payments, outweighed revenue growth. As non-interest expenditure rose, the primary deficit increased to PKR2,077 billion (3.1 percent of GDP) – over three times the primary deficit in the previous year.

![Figure 2.5: Consolidated Fiscal and Primary Balance (excluding grants) (percent of GDP)](image)

![Figure 2.6: Public and Publicly Guaranteed Debt (percent of GDP)](image)

Source: Ministry of Finance, World Bank staff Calculations
Note: Other federal current expenditure includes subsidies.

Strong economic activity, inflation, and higher imports drove the increase in revenue

Total revenue increased to PKR8,035 billion (12.0 percent of GDP) in FY22 from PKR6,903 billion (12.4 percent of GDP) in FY21, as tax revenue increased to 10.4 percent of GDP. The main drivers of the tax revenue increase were direct taxes and sales tax on goods, in line with strong domestic economic activity, higher prices, and higher imports.24 According to provisional estimates, almost three-fourths of sales tax on goods was sourced from imports.25 Meanwhile, Petroleum Development Levy (PDL) revenues in FY22 fell to their lowest levels since 2015, as the Government reduced taxes on petroleum products to mitigate inflationary pressures.26 Non-tax revenue declined to 1.6 percent of

23 Based on the next 12 months’ projected imports of goods and services.
24 Supported by robust domestic demand and higher global commodity prices, goods imports increased by 32.7 percent in FY22.
25 The FBR has not yet published a breakdown of tax revenue by domestic sources and import. The estimates given here are based on the expected collection projected by the FBR based on realized data from July 2021 to April 2022. See: Evidence based revenue forecasting FY2022-23. Federal Board of Revenue.
26 The PDL was maintained at zero from July to August 2021 and then gradually increased to almost PKR18 per liter from September 2021 to February 2022. From March to June 2022, PDL was maintained at zero. The Government now considers tax on petroleum products as part of non-tax revenue; however, for consistency against historical years, these are included in tax revenue.
GDP, largely due to a 27.2-percent decrease in the profits of the SBP, with lending to the Government capped in line with reforms to improve central bank independence.

**Subsidies on electricity and petroleum prices significantly increased current expenditure**

Total expenditure increased to PKR13,295 billion (19.9 percent of GDP) in FY22 from PKR10,307 billion (18.5 percent of GDP) in FY21. Expenditure increases were driven primarily by a 26.8 percent increase in current spending, including subsidy expenditure. Increasing domestic interest rates and PKR depreciation led to higher domestic and foreign interest payments. Simultaneously, the federal grants rose by almost 38 percent in FY22 on the back of higher social protection expenditure and COVID-19 vaccine procurement, while provincial current spending rose by 12.3 percent.

**Development spending also rose in line with an expansionary fiscal stance**

Overall development expenditure and net lending rose by 26.0 percent. Although federal spending under the Public Sector Development Program contracted by 9.2 percent, the provincial Public Sector Development Program spending surged by 58.0 percent, supported by higher provincial own-source tax revenue and federal transfers.

**Public debt increased on account of larger financing needs and the weaker Rupee**

Almost 60 percent of the fiscal deficit was financed through domestic banks, amid a contraction of almost 12.0 percent in external inflows. Increased deficit financing needs and large revaluation losses due to the weakening of the domestic currency contributed to the rise in public debt. At the end of FY22, public and publicly guaranteed debt had increased to PKR52,214 billion (78.0 percent of GDP) from PKR42,199 billion (75.6 percent of GDP) at end-FY21 (Figure 2.6). The new debt was largely sourced through long-term domestic debt instruments carrying variable interest rates, which improved the overall maturity profile but also increased debt servicing costs and interest rate risks. Of the total public debt, the share of external debt was 37.6 percent at end-FY22, whereas short-term debt was 13.6 percent.

**Catastrophic flooding has exacerbated macroeconomic risks**

Amid the worsening external liquidity position and tight financing conditions, global credit rating agencies, including Fitch Ratings, Moody’s Investor Service, and S&P Global, downgraded Pakistan’s outlook to “negative” from “stable” over late FY22 and early FY23. Macroeconomic risks have further heightened due to flood impacts. On September 15, 2022, the yields on Pakistan’s 5- and 10-year Eurobonds were recorded at 26.8 percent and 19.9 percent, respectively, compared to 15.4 percent on the 5-year Eurobond and 14.2 percent on the 10-year Eurobond on June 1, 2022. Pakistan’s 5-year Credit Default Swap spread also rose to 2,291.3 bps on September 15, up from 1,300 bps at the start of June 2022. Elevated financing needs and the expected wider trade deficit due to the historic floods exerted further pressures on the Rupee, which depreciated by 14.7 percent against the U.S. dollar since end-June 2022. SBP’s gross reserves (including CRR and cash holdings) were recorded at USD 9.6 billion on September 5, 2022, equivalent to only 1.4 months of imports of goods and services.

### f. Medium-Term Outlook

**The economic outlook has deteriorated significantly with the catastrophic floods**

The economic outlook has deteriorated with the floods. Real GDP growth is expected to slow from 6.0 percent y-o-y in FY22 to around 2.0 percent in FY23, on high-base effects, flood-related damages and disruptions, a tight monetary stance, high inflation, and a less conducive global environment (Table 2.2). Public spending for significant public relief, recovery, and rehabilitation efforts are expected to partially offset the loss in economic performance.

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27 The Government, in an attempt to contain inflationary pressures, reduced the prices of petrol and HSD by PKR10 per liter at the end of February 2022 and maintained these lower prices from March to end-May 2022. Simultaneously, the Government from March to June 2022 also implemented a subsidy of PKR5 per unit on the base price of electricity.

28 The policy rate was increased by 675 basis points in FY22, increasing from 7.0 percent to 13.75 percent as the Government tightened monetary policy. The PKR depreciated by 23.0 percent against the USD in FY22.


30 Federal transfers to provinces surged by 30.9 percent in FY22, after a very low increase of 9.5 percent in FY21. Simultaneously, provincial tax revenue rose by 20.5 percent — slightly lower than the growth of 22.9 percent in FY21.


32 The PKR/USD exchange rate was 239.7 on September 21, 2022.
activity over the fiscal year. Economic growth is projected to recover to 3.2 percent in FY24, supported by a recovery in agricultural production, reconstruction efforts, projected lower global inflationary pressures, and improved confidence from the continued implementation of macroeconomic stabilization measures. However, flooding is expected to impose a lingering drag on output in the medium term through the loss of livelihoods and human capital, disruption to crop cycles, infrastructure damage, and possible financial sector impacts.

**Table 2.2: Pakistan Macroeconomic Outlook (FY23-24)**

(Annual percent change unless indicated otherwise)

<table>
<thead>
<tr>
<th></th>
<th>FY19</th>
<th>FY20</th>
<th>FY21</th>
<th>FY22e</th>
<th>FY23f</th>
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<tr>
<td>Real GDP Growth, at constant factor prices</td>
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<tr>
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<td></td>
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<tr>
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<td>6.2</td>
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<td>Government Consumption</td>
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<td>9.3</td>
<td>10.0</td>
<td>3.1</td>
<td>3.3</td>
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<td>Gross Fixed Capital Formation</td>
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<td>1.8</td>
<td>3.4</td>
<td>7.0</td>
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<tr>
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<td>Inflation (Consumer Price Index)</td>
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<td>12.2</td>
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<td>-0.8</td>
<td>-4.6</td>
<td>-4.3</td>
<td>-3.3</td>
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<tr>
<td>Fiscal Balance (excluding grants, % of GDP)</td>
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<td>0.4</td>
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<tr>
<td>Debt (% of GDP)</td>
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<td>78.0</td>
<td>71.7</td>
<td>71.9</td>
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<td>-1.2</td>
<td>-3.1</td>
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<td>-2.1</td>
</tr>
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</table>

Notes: FY19 corresponds to fiscal year 2018-19 which runs from July 01, 2018, to June 30, 2019.  
1 This macroeconomic outlook uses the re-based national accounts data at 2015–16 prices. It was prepared by World Bank staff and differs from that of the Government.

**Flood-related damages in the agriculture sector are expected to spillover into the industry and services sectors**

In line with the preliminary damage estimates, the agriculture sector is projected to contract for the first time in more than two decades, with flood losses to cotton, date, wheat, and rice crops. More than a million livestock are estimated to have perished. Furthermore, damages in the agricultural sector are expected to have spillover effects on the industry and services sectors (Box 2.1). Flood-related cotton losses are expected to weigh on the domestic textile industry, as local cotton constitutes about half of the industry’s required cotton input. Textiles account for around a quarter of total industry output and more than half of goods exports. Similarly, the local food processing and slaughtering industries will be negatively impacted by the expected reduction in food harvests and reduced supply of livestock. Lower agricultural and industrial activity is likely to weigh on wholesale and transportation services activities, which account for 50 percent of service sector output. Transportation challenges arising from the loss of critical infrastructure, such as roads and bridges, are expected to disrupt supply and further dampen overall economic activity (Box 2.2).

**The macroeconomic outlook is predicated on a strong fiscal response**

The above growth outlook assumes that substantial public spending on flood relief, recovery, and rehabilitation will partially offset the adverse macroeconomic impacts of the floods. The Government is already taking fiscal measures in response to the floods. A flood relief cash transfers scheme is underway, through which 1.1 million targeted

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33 Preliminary estimates indicate that agriculture is the worst-affected sector by the floods, accounting for around half of total direct damages. Infrastructure and non-residential structures constitute around 30 percent of damages, while residential housing constitutes around 20 percent of direct damages.

The fiscal deficit is expected to narrow on fiscal consolidation efforts, despite flood impacts

In line with fiscal consolidation efforts and lower subsidy expenditures as a share of GDP, the primary deficit (excluding grants) is forecast to narrow from 3.1 percent of GDP in FY22 to 3.0 percent in FY23, despite negative impacts to revenue bases and increased expenditure needs due to the floods. Similarly, the fiscal deficit is projected to contract by one percentage point to 6.9 percent of GDP in FY23 and expected to gradually narrow over the medium term as revenue mobilization measures take hold, particularly GST harmonization and personal income tax reform. In the context of high inflation and rapid nominal GDP growth, public debt as a share of GDP is projected to gradually decline over the forecast period, despite continued primary deficits. The macroeconomic outlook is predicated on the IMF-EFF program remaining on track.

Inflation is expected to remain high in FY23 partly due to flood disruptions

With WPI inflation exceeding CPI inflation by around 50 percent, monthly y-o-y CPI inflation has yet to peak. Overall, due to higher domestic energy prices, flood disruptions, and the weaker Rupee, CPI inflation is projected to rise to an average of 23.0 percent in FY23 from 12.2 percent in FY22. Inflation is expected to moderate over the forecast horizon due to high base effects, declining global energy prices, and the resolution of flood-related supply constraints.

CAD will narrow slightly from FY22 on slower activity

Flooding is expected to lead to higher goods imports, reflecting domestic demand for food and cotton, while exports, particularly rice and textiles, are expected to decrease. Despite flood-associated effects, the CAD is expected to narrow slightly to around 4.3 percent of GDP in FY23 from 4.6 percent in FY22, in line with stronger remittance inflows. The CAD is projected to shrink further in FY24 as exports recover from flood impacts.

As a direct consequence of the floods, several million people could fall into poverty

The devastating floods will have an adverse impact on poverty. The immediate impact on household welfare will come through at least four channels: (i) loss of household income due to destroyed harvest, killed livestock, or inactivity of businesses; (ii) loss of assets, such as homes, livestock, productive equipment, and household durables; (iii) shortages of food due to lost food stocks, poor harvests and rising food prices; and (iv) loss of human capital, given significant threat of disease outbreaks and food shortages, and prolonged school closures, with attendant learning losses. Preliminary estimates suggest that as a direct consequence of the floods, the national poverty rate could increase by 2.5 to 4.0 percentage points, pushing between 5.8 and 9.0 million people into poverty. The size and duration of shocks will vary across locations and households depending on the intensity of the flooding as well as the quality of relief and reconstruction efforts. Even in the best case, reversing these negative shocks to household welfare will take considerable time, and some losses, such as losses to human capital and loss of land productivity could set in motion more sustained declines in welfare and will need specific policy attention.

g. Risks and Priorities

The floods have heightened macroeconomic risks

The floods are expected to have a substantial negative impact on Pakistan’s economy. Prior to the floods, the economy was already facing a difficult adjustment to regain macroeconomic and fiscal stability. Implementation of government plans for fiscal consolidation is likely to become more challenging, given extensive relief and recovery spending needs, and slower growth of tax bases due to weaker economic activity. While relief measures are needed to cushion the human and economic impacts of flooding, delays in fiscal consolidation will heighten risks to macroeconomic and fiscal stability, in the context of high inflation and fiscal and current account deficits.
The full impacts of flooding are not yet known

The full economic impact of the floods is highly uncertain, and the situation is still evolving. Large areas remain inundated, hindering on-the-ground damage assessments. Estimates of flood impacts could therefore worsen, as more information becomes available from previously inaccessible areas, or through further crop and livestock losses due to shortages of animal feed, disease or impacts on the next planting season. Economic challenges would intensify with worsening flood impacts, and with delayed or inadequate response efforts.

The financial sector is exposed to risks from higher interest rates and flood impacts

Given the large exposure to government securities, the health of the financial sector is intertwined with the fiscal resilience of the Government. Per regulations, bank holdings of government papers need to be “marked-to-market” or revalued daily in response to changes in interest rates in the secondary markets. As interest rates have been increasing, banks are exposed to interest rate risks on their government securities and have started to incur sizeable losses on their government investment portfolios. Flood-related losses have also exposed the microfinance sector to significant downside risks both in terms of profitability and stability, in the immediate to medium term. In addition, unanticipated fiscal financing needs are expected to be met mostly from domestic borrowing, possibility contributing to further crowding-out of private sector financing, increasing debt servicing costs, and strengthening the sovereign-financial nexus and associated risks.

External conditions still pose substantial risks to the outlook

Pakistan remains exposed to external conditions, with the macroeconomic outlook sensitive to global commodity prices and financing conditions. Higher interest rates, deteriorations in market sentiment, and tighter global financing conditions would pose challenges to accessing affordable external financing. Similarly, Pakistan’s economic outlook faces substantial risks from further potential increases in world energy and food prices due to the ongoing Ukraine–Russia conflict and slower global growth due to rising inflation.

In the short-term, it will be critical to progress with the necessary adjustment

To manage short-term risks, the Government needs to strike a delicate balance between progressing on the required fiscal consolidation and meeting relief and recovery needs. In the context of high domestic and external financing needs, ongoing political uncertainties, and upcoming elections, maintaining market confidence will be critical. Clearly articulating and effectively implementing an economic recovery could help manage market perceptions. It will be critical to maintain a tight monetary policy stance; pursue fiscal consolidation to the extent possible, including through the tight targeting and prioritization of any new expenditures; and proceed with planned structural reforms, including in the energy sector.

Structural reforms are critical to medium-term economic growth and resilience

Historically low levels of physical and human capital accumulation and exports lead to muted productivity growth, which limits Pakistan’s growth prospects, contributing to frequent macroeconomic crises. As such, the recent record-high trade deficit due to elevated aggregate demand pressures is symptomatic of the longstanding structural issues associated with low potential growth. To achieve higher, sustained growth, reforms should target the maintenance of macroeconomic stability, improving resilience to natural disasters, increasing domestic revenue mobilization, supporting private sector investment, raising export competitiveness, and improving the financial viability of the energy sector.

Box 2.1: Direct macroeconomic impacts of the 2022 floods – A Summary

Floods have been unprecedentedly severe and are expected to affect Pakistan’s economy through multiple channels. This box summarizes the main expected macroeconomic effects.

The agriculture sector is projected to contract for the first time since FY01 due to the floods. An estimated 9.4 million acres of crops are affected with significant losses to cotton, date, wheat, and rice crops. More than a million livestock are also estimated to have been lost.

Industrial activity is expected to slow. Damages in the agricultural sector are expected to spillover onto the industry sector. Cotton losses are expected to result in shortages, hindering the domestic textile industry’s production. Textiles and apparel constitute around a quarter of total industry output and more than half of goods exports. Similarly, local food
processing and slaughtering industries will be negatively impacted by the expected reduction in food harvests and reduced supply of livestock.

**The services sector is also forecast to be adversely affected.** Lower agricultural and industrial activity is likely to weigh on wholesale and transportation services activities, which account for 50 percent of service sector output. Transportation challenges arising from the loss of critical connectivity infrastructure, such as roads and bridges, are expected to disrupt supply and further dampen overall economic activity.

**Inflation is projected to increase.** The floods have resulted in lower crop and livestock production, leading to temporary food shortages and transitory spikes in food prices. Transportation difficulties have exacerbated these shortages and disrupted domestic supply chains contributing to broader inflationary pressures and production challenges.

**Current account and trade deficits are expected increase.** Flooding is expected to lead to higher goods imports to mitigate temporary shortages of domestically produced goods, such as food and cotton, while exports, particularly rice and textiles, are expected to decrease.\(^1\)

**The fiscal deficit is expected to widen.** Fiscal expenditures are likely to increase with flood relief and recovery and rehabilitation efforts, while revenues are expected to be dampened by a contracting tax bases, suspension of some food import duties, and slower activity overall.\(^2\)

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1. Despite the direct flood effects, the current account deficit is projected to narrow in FY23 after considering slower economic activity and the import management measures.

2. The fiscal deficit is estimated to contract in FY23 when accounting for fiscal consolidation efforts in light of the current economic imbalances.

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**Box 2.2: The 2022 floods and Pakistan’s exports – Anecdotal Evidence**

**Pakistan’s exports are likely to be significantly impacted by the floods.** The catastrophic floods are expected to negatively impact Pakistan’s exports through two main channels: the destruction of crops and of connectivity infrastructure. The destruction of crops reduces the supply of rice—which is a key agriculture export—and decreases the availability of cotton, which is a key input into textiles, another major export. In addition, the floods have also led to the destruction of connectivity infrastructure, increasing production costs for exporters and curtailing production. The potential foreign exchange losses resulting from the floods may therefore be substantial, with agriculture accounting for almost a quarter of goods exports, and with textiles and apparel (nearly all cotton-based) accounting for around half of goods exports. In addition, there may be persistent adverse effects on export competitiveness associated with loss of global market shares.

**Effects through the destruction of crops**

**Rice.** Exports of rice had reached a historical record of USD2.5 billion in FY22, up 23 percent with respect to FY21, driven by a 32 percent increase in export quantities. Although the major sowing area for Basmati is Southern Punjab, which is not as severely affected by the floods as Sindh, estimates from the Rice Exporters Association of Pakistan place the rice production losses due to the floods at about 20 percent,\(^1\) contributing to lower rice exports.

**Cotton.** The estimates on the flood related cotton crop losses range from 11 percent\(^2\) to up to 36 percent.\(^3\) Given current trends in global demand for textiles, the sector can expect to import close to 5 to 5.8 million bales of cotton, an increase in a range from 11 to 28 percent, to mitigate the domestic shortfall. However, smaller-sized mills are particularly reliant on domestic supplies and unable to fully substitute with imports.\(^2\) Accordingly, overall textile production may decline, consequently contributing to lower textile exports.

**Effects through destruction of connectivity infrastructure**

The floods have also severely affected infrastructure linking the Karachi port to the spinning mills in Punjab, disrupting textile production. With about 70 percent of the spinning mills located in Punjab, and a substantial portion of cotton inputs being imported via the Karachi port, the roads linking the port and the spinning mills are important for the efficient transportation of cotton. The floods have damaged portions of the routes connecting Karachi with Hyderabad, Sukkur, and Lahore. Anecdotal evidence indicates that transportation time is now 4 to 5 times longer with implications both on transport costs and on truck availability. Interviews with key industry players reveal that a up to half of Faisalabad’s spinning mills are currently closed due to a combination of factors that include a lack of inputs to process, alleged challenges to obtaining open letters of credit to import machinery or parts, and a reduction in orders.\(^3\)

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1. Foregone export revenues are expected to be partially offset by higher global rice prices. The Government of India recently imposed a ban on exports of broken rice and introduced a 20 percent export tax on other varieties. These policy changes are expected to put upward pressure on international rice prices, given that India accounts for 40 percent of the world’s rice exports.


3. Inflation and the Poor

a. Introduction

Pakistan experienced high rates of inflation recently. This was driven by difficult external conditions, including rising global prices for food and energy, and domestic factors including an overheating economy and the phasing out of energy price relief measures. Going forward, inflationary pressures are likely to continue in the context of the recent floods, which are expected to disrupt the supply of critical household and agricultural goods, disproportionately impacting the most vulnerable. This Special Topic Section examines the drivers of inflation in Pakistan, describes the impact of inflation on households of different income levels, and discusses policy response options.

Box 3.1: Analytical Findings and Policy Summary

Our analysis shows that the recent bout of inflation has imposed a disproportionate burden on poorer households, or equivalently, households towards the lower end of the income distribution. Due to differences in consumption patterns, relatively poorer households have been more exposed to food inflation, whereas better-off households have been more exposed to energy inflation. As a result, poorer households have experienced more rapid inflation of their overall consumption basket. Additionally, poorer households tend to have less savings to mitigate the impact of rising prices, which often forces poorer households to cut back on the level of consumption or to substitute for lower-quality products. Over the medium term, this may have a detrimental impact to human development outcomes.

The recent catastrophic floods have exerted further upward pressures on inflation, particularly through food prices, disproportionately affecting poorer households. Policy measures to manage overall inflation, while also protecting poor and vulnerable households from the resulting adverse welfare impact, are critical. To this end, the following policy measures can be considered:

**Maintaining macroeconomic policies that contain inflationary pressures.**
- Maintaining the independence of the State Bank of Pakistan (SBP), combined with proactive and data-driven monetary policymaking to support price stability objectives.
- Sustaining overall fiscal discipline to prevent excessive aggregate demand pressures that drive up prices.

**Avoiding measures that impose unsustainable fiscal costs and largely benefit households with higher incomes.**
- Maintaining progress with the removal of energy price relief measures, including implementing delayed power tariff adjustments towards cost-recovery and removing energy tax exemptions.
- Avoiding other general reductions in taxes that deprive the Government of much-needed revenues, while providing relief to all, including the most affluent households.

**Introducing targeted measures to protect poorer households.**
- Expanding existing programs or introducing additional ones with clear targeting criteria, to protect poor and vulnerable households through temporary transfers based on a shock-responsive social safety net.
- Adjusting the benefit levels of social protection programs regularly through indexation can prevent declines in their value in real terms.
- Reducing import tariffs on sensitive food items consumed heavily by the poor or trade facilitation measures to reduce the cost of imports can also help protect the poor.

Over the medium term, these policies should be complemented by a broader set of reforms to enhance economy-wide productivity, particularly by removing distortions to enhance the efficiency in the allocation of capital and labor, which will contribute to higher economic growth and real incomes.

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35 Income is a proxy for household welfare. In developing countries, including Pakistan, welfare is proxied using consumption expenditure.
36 Supply-driven domestic food price shocks tend to raise median core inflation in low-income countries, but the effects are short-lived, fading within six months of the shock. (World Bank, 2019).
b. Inflation Trends and Drivers

Inflation in Pakistan rose rapidly over the past year, breaking from past trends

In line with global trends, inflation was relatively stable in Pakistan prior to 2019 (Figure 3.1). However, since then, inflation has been higher and more volatile, driven by global commodity price trends, expansionary fiscal and monetary policies, and distortionary agricultural policies that increased food prices, detailed in subsequent discussions. In particular, monthly y-o-y inflation has risen sharply over the past 12 months, with the national headline CPI inflation tripling from 9.0 percent in September 2021 to 27.3 percent in August 2022.

Figure 3.1: Pakistan National Headline Inflation

Figure 3.2: Average Contribution to Monthly y-o-y headline Inflation in Rural and Urban Areas in Pakistan (percentage points, y-o-y)

Higher food and energy prices underpinned increases in inflation

Food and energy prices contributed most to increase in inflation (Figure 3.2), partly reflecting flood-related shortages and transportation challenges. Food inflation rose to record-highs in August; 30.2 percent y-o-y in rural areas and 28.8 percent y-o-y in urban areas.37 Rising energy prices have also been a major contributor to inflation, reflecting higher global energy prices, a weaker Rupee, as well as much-needed upward adjustments to government-administered energy prices. With hikes in fuel prices and tariff adjustment on electricity pricing, energy price inflation surged in August 2022 to 80.7 percent in urban areas and 67.8 percent in rural areas (Section 2b).

External factors contributed to rising inflation, including global commodity price spikes

As the world began to recover from the COVID pandemic, demand for commodities rebounded while supply adjusted sluggishly, due to capacity constraints and supply bottlenecks. The war in Ukraine added further volatility and uncertainty, especially in markets where Russia and Ukraine are significant suppliers of agricultural products, fertilizers, and energy. Furthermore, a series of weather shocks in the world’s largest food-producing countries have exacerbated already high food prices. Reactions by producers to restrict exports of key food staples and fertilizers have worsened the effects of these global price shocks.

Domestic economic conditions and policy settings

In the context of Pakistan’s economy, expansionary fiscal policies and the delayed monetary policy response led to economic overheating, further contributing to inflationary pressures (Section 2b). Global financial market tightening as well as rising

37 The Consumer Price Index (CPI) is calculated as the weighted average of price changes for different categories of goods and services (see appendix). For rural areas, the weight for food items is higher than for urban areas. In consequence, the rural CPI is more sensitive to food price inflation.
Inflation and the Poor

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Exacerbated inflation trends

Imbalances also contributed to a marked depreciation of the Rupee, which further exacerbated inflationary pressures. More recently, energy prices increased rapidly as the Government phased out subsidies and reduced energy tax exemptions, in an effort to contain the associated fiscal costs and curtail the further accumulation of energy sector debt.

The recent floods have exerted further upward pressures on inflation

The recent floods, which are the most severe since independence, have further exacerbated inflationary pressures. As a result of these floods, agricultural output is expected to be negatively impacted, resulting in significant losses to cotton, date, wheat, and rice crops. More than a million livestock are estimated to have perished. In addition, much of the cereals, seed, and animal feed stock have been destroyed, thereby wiping out the inputs needed for future crop and livestock production. Reduced agricultural production, disruptions to food processing and slaughtering, and disruptions to logistics have been placing upward pressures on local food prices. Accordingly, y-o-y increases in the Sensitive Price Indicator (SPI) for the lowest expenditure group exceeded 40 percent from mid-August to mid-September. Reduced exports combined with rising import demand may also drive further exchange rate depreciation, and higher prices for all imports.

c. Welfare and Distributional Impact of Inflation

High inflation adversely affects growth via investment and allocation decisions

Empirical studies covering a large number of countries have highlighted the adverse effects of inflation, and particularly of high inflation episodes, on economic growth. Inflation can: (i) discourage current investment decisions by creating uncertainty on future returns, leading to slower future growth; (ii) leads to investment in less efficient or unproductive assets, such as real estate and gold, also reflecting an erosion of trust in the national currency as store of value; and (iii) erode external competitiveness by appreciating the real exchange rate, making the country’s exports more expensive and imports relatively cheaper.

High inflation also erodes household welfare

The literature suggests negative implications of high inflation on household welfare through at least three channels: (i) declines in real purchasing power due to rising consumer prices; (ii) decreasing real income from labor markets, especially if wages or transfers are sticky and not adjusted frequently; and (iii) effects on asset prices, which depending on their net asset position—could lead to a redistribution between debtors and creditors. The extent to which each of these channels impacts household welfare depends on the characteristics of households, including their consumption patterns, employment profile, and asset positions. Moreover, the impact on household welfare depends on the ease with which shock-responsive social safety nets (both publicly and privately provided) can be expanded in times of crisis.

The CPI measure alone cannot be a basis for understanding the welfare impact of inflation across income groups

The standard indicator of inflation measures changes in the Consumer Price Index (CPI), and provides a high-level indicator to monitor changes of prices for goods and services. However, the indicator is calculated as the weighted average of price changes for different categories of goods and services, whereby the weights reflect the consumption patterns of a representative Pakistani household (see appendix). The Pakistan Bureau of Statistics (PBS) publishes a rural and an urban consumer price index separately, thus reflecting differences in consumption patterns across regions; however, the price index does not account for such differences in consumption patterns between poorer and richer households. To better understand the impact of inflation across households of different incomes based on their unique consumption patterns, data from the national household

39 In 31 out of 41 episodes of inflation above 40 percent, output losses were sharp (2.4 percent, on average), but they were not significant at lower inflation levels (Bruno and Easterly 1998). Lower inflation thresholds, typically below 20 percent, for a negative relationship between inflation and growth were also reported by a number of later studies based on large samples of countries stretching over multiple decades (Espinoza, Leon and Prasad 2012).
survey is used in conjunction with price changes in the various goods and services that the households consume.

Survey data shows that poorer households spend more on food while richer households spend more on housing and utilities. Consumption patterns differ across households from different income groups. The Household Integrated Economic Survey 2018–19 (HIES) reveals that households from the bottom of the income distribution spend more than two-thirds of their budget on food and housing and utilities. Table 3.1 shows that households in the first decile (10 percent poorest households) allocate around half of their budget for food and non-alcoholic beverages. The top decile (10 percent richest households), in contrast, spends less than one third on food and non-alcoholic beverages. In contrast, the budget shares for housing and utilities and transport increase across deciles. The top decile’s spending on transport is more than double (9 percent) that of the lowest decile (4.2 percent). Overall, the poorest families (decile 1) spend 72 percent of their budget on basic necessities such as food, housing, health, and education.

Table 3.1: Decile-Wise Budget Shares of COICOP Categories

<table>
<thead>
<tr>
<th>COICOP Categories</th>
<th>D1 poorest</th>
<th>D2</th>
<th>D3</th>
<th>D4</th>
<th>D5</th>
<th>D6</th>
<th>D7</th>
<th>D8</th>
<th>D9</th>
<th>D10 richest</th>
</tr>
</thead>
<tbody>
<tr>
<td>Food and Non-Alcoholic Beverages</td>
<td>49.2</td>
<td>46.9</td>
<td>46.0</td>
<td>44.6</td>
<td>43.5</td>
<td>42.3</td>
<td>40.7</td>
<td>38.5</td>
<td>35.3</td>
<td>28.4</td>
</tr>
<tr>
<td>Alcoholic Beverages and Tobacco</td>
<td>1.6</td>
<td>1.5</td>
<td>1.4</td>
<td>1.3</td>
<td>1.3</td>
<td>1.2</td>
<td>1.1</td>
<td>1.0</td>
<td>0.9</td>
<td>0.6</td>
</tr>
<tr>
<td>Clothing and Footwear</td>
<td>9.4</td>
<td>9.1</td>
<td>9.0</td>
<td>8.8</td>
<td>8.6</td>
<td>8.3</td>
<td>8.1</td>
<td>7.8</td>
<td>7.5</td>
<td>6.6</td>
</tr>
<tr>
<td>Housing, water, electricity, gas, etc.</td>
<td>18.4</td>
<td>19.0</td>
<td>19.4</td>
<td>20.4</td>
<td>20.7</td>
<td>21.2</td>
<td>22.0</td>
<td>23.5</td>
<td>24.6</td>
<td>27.4</td>
</tr>
<tr>
<td>Furnishing, household equipment, etc.</td>
<td>3.2</td>
<td>3.4</td>
<td>3.4</td>
<td>3.4</td>
<td>3.4</td>
<td>3.4</td>
<td>3.3</td>
<td>3.4</td>
<td>3.5</td>
<td>4.0</td>
</tr>
<tr>
<td>Health</td>
<td>3.7</td>
<td>3.7</td>
<td>3.5</td>
<td>3.5</td>
<td>3.5</td>
<td>3.5</td>
<td>3.5</td>
<td>3.5</td>
<td>3.3</td>
<td>3.4</td>
</tr>
<tr>
<td>Transport</td>
<td>4.2</td>
<td>4.8</td>
<td>5.5</td>
<td>5.8</td>
<td>6.2</td>
<td>6.6</td>
<td>7.0</td>
<td>7.3</td>
<td>8.0</td>
<td>9.0</td>
</tr>
<tr>
<td>Communication</td>
<td>1.5</td>
<td>1.6</td>
<td>1.6</td>
<td>1.7</td>
<td>1.7</td>
<td>1.7</td>
<td>1.8</td>
<td>1.8</td>
<td>2.1</td>
<td>2.4</td>
</tr>
<tr>
<td>Recreation and Culture</td>
<td>1.1</td>
<td>1.4</td>
<td>1.5</td>
<td>1.5</td>
<td>1.5</td>
<td>1.6</td>
<td>1.6</td>
<td>1.6</td>
<td>1.6</td>
<td>1.5</td>
</tr>
<tr>
<td>Education</td>
<td>0.7</td>
<td>1.1</td>
<td>1.3</td>
<td>1.7</td>
<td>2.0</td>
<td>2.5</td>
<td>3.1</td>
<td>3.8</td>
<td>4.5</td>
<td>7.3</td>
</tr>
<tr>
<td>Restaurants and Hotels</td>
<td>1.7</td>
<td>2.0</td>
<td>2.0</td>
<td>2.0</td>
<td>2.1</td>
<td>2.3</td>
<td>2.4</td>
<td>2.5</td>
<td>2.9</td>
<td>3.8</td>
</tr>
<tr>
<td>Miscellaneous</td>
<td>5.2</td>
<td>5.4</td>
<td>5.4</td>
<td>5.4</td>
<td>5.5</td>
<td>5.4</td>
<td>5.4</td>
<td>5.6</td>
<td>5.6</td>
<td>6.0</td>
</tr>
<tr>
<td>Total</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
</tbody>
</table>


Notes: (i) COICOP: The classification of individual consumption by purpose is a classification used to classify both individual consumption expenditure and actual individual consumption. (ii) D=Decile equivalent to 10 percent of households, with D1 being the poorest 10 percent of households, and D10, the richest 10 percent. Deciles calculated using per-adult equivalent household consumption expenditure.

Over recent years, food inflation exceeded overall inflation, leading to poorer households experiencing higher inflation rates. Because of the differences in consumption patterns highlighted above, rising food prices are a bigger contributor to inflation among the poor compared to the rich (Figure 3.3). In contrast, inflation driven by energy prices, especially fuel prices, affects richer households relatively more. Figure 3.4 reflects the divergence in trends between food and energy prices, and shows that between November 2018 and August 2022, the poorest households (decile 1) on average experienced a one-percentage-point higher inflation rate than the richest households (decile 10).

Inflation reduces the real purchasing power for all households, but welfare losses will be higher among poorer households. Even if more recently inflation rates did not differ substantially between the poorest and the richest households, the poor will experience disproportionate losses in household welfare. This is because the poor have limited savings, and higher prices imply that poor households will either need to reduce their total consumption or switch to lower-quality and less expensive products. In addition to immediate losses of household welfare, inadequate access to food, proper nutrition, and energy can have long-term impacts on human capital, with sustained losses in productivity, greater poverty, and inequality. In this context, the following section discusses policy options with a particular focus on protecting poor and most vulnerable households that are likely to be disproportionately affected by higher inflation and have limited own-capacity to cope with the shock.

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41 The literature on poverty and inequality traditionally assumes a utility maximizing household; hence, household's total consumption expenditure is used as a proxy for money metric utility and household welfare. Beyond monetary welfare, the literature also highlights non-monetary aspects of household welfare, including the health status and educational status of household members.
Inflation and the Poor

Policy should aim to contain inflationary pressures, while protecting the poor and most vulnerable

Inflation has a particularly negative welfare impact on poorer households in Pakistan. However, previous policy responses to rising inflation have emphasized reducing energy prices through delays in energy price adjustment and introduction of energy tax exemptions and direct government interventions in agricultural markets. This has been suboptimal for several reasons. Firstly, subsidies and tax exemptions have contributed to pro-cyclical fiscal expansion, fueling inflation, and feeding into medium-term fiscal sustainability challenges. Secondly, providing subsidies and tax relief on fuel and electricity have been heavily regressive, with better-off households benefiting disproportionately. Lastly, distortionary agricultural and energy policies (including subsidies, public procurement, and price caps for agricultural goods and high import duties) have undermined efficient resource allocation and price signals. Policy measures could instead focus on managing overall inflationary pressures, while protecting the poor and most vulnerable.

Coherent and sound monetary and fiscal policy measures should be used to maintain price stability and manage inflation

Monetary policy. Going forward, maintaining an appropriate monetary policy stance and minimizing interest rate volatility, guided by the primary goal of safeguarding price stability, can help reduce inflationary pressures, anchor inflationary expectations, and address external imbalances. To this end, implementation of the amendments to the Central Bank Act from earlier in the year, combined with proactive and data-driven monetary policymaking can further strengthen the SBP’s independence, governance, and mandate to support price stability objectives.

Maintaining fiscal restraint. On the expenditure side, progress should be maintained towards achieving cost-recovery in energy prices and removing tax exemptions on energy prices. This will curtail a highly regressive drain on fiscal resources, while supporting effective management of aggregate demand and reducing inflationary pressures. On the revenue side, broad-based reductions in taxes—such as on fuel—should be avoided. Provision of such exemptions implies providing relief to all including the most affluent households, and results in the loss of significant fiscal resources that could be better used to provide targeted support to those most in need.

Reductions in import duties and trade facilitation measures can reduce, in the

Trade policies can help to reduce the prices of sensitive food products.

- Reducing import duties on sensitive food products can help reduce food prices at a relatively low cost. This is especially relevant in the current context where higher
food prices are driven by flood-related disruptions. Removing distortions that artificially increase the prices of goods that are heavily consumed by poorer households can help to mitigate short-term impact while supporting medium-term growth.\footnote{The potential medium-term impact of import tariff reforms on growth are detailed in “From Swimming in Sand to High and Sustainable Growth” A Country Economic Memorandum for Pakistan (World Bank Group, 2022).} For example, import duties can add up to 18 percent on the price of sensitive food items. The foregone import duty revenue associated with a six-month elimination of import duties on selected sensitive food items is relatively minor, estimated at 7 billion PKR (less than 0.06 percent of the estimated total expenditure in FY2022).

- Trade facilitation measures can also help. For example, ensuring thorough, efficient sanitary and phytosanitary controls at the border, by deploying Plant Protection teams at key border points, can help reduce food trade costs and prices. Policies such as export bans, however, should be avoided, as they can affect exporters’ performance through negative reputation effects, while also driving up global commodity prices.

- Consider opening trade routes with India to source key food products and cotton, to reduce the excess demand the floods will likely generate. India could be a low-cost supplier of these goods given its production patterns and proximity.

**Over the medium term, a broader set of agriculture and energy sector reforms can help slow inflation**

**Reforms to agriculture and energy sector.** Given the significance of food and energy as drivers of inflation in Pakistan, measures to improve the sustainability and efficiency of agriculture, food and energy production are critical to ensure price stability over the medium term.

- In the energy sector, reducing the cost of generating and enhancing both demand- and supply-side efficiency will be key. The cost of generation can be reduced through (re)negotiations with independent power producers to help reduce capacity payments and circular debt. Improving demand-side efficiency and promoting energy conservation—such as by incentivizing households to switch to more energy-efficient utilities—can help alleviate the energy cost burden to consumers, including the poor households. Improving supply-side efficiencies, such as through reducing inefficiencies in electricity distribution and transitioning toward a renewable energy-dominant power generation mix can be a route to cheaper power, lower reliance on fossil fuel imports, and a more sustainable energy sector.

- To transform the agri-food system, changes will be needed to correct incentives and enhance climate resilience. To this end, phasing out environmentally damaging and distortionary subsidies could help improve efficiencies and optimize production decisions in the short term. Reducing market intervention such as in the areas of wheat procurement and increasing the competitiveness of the sugar markets could also help, including in reducing price volatility. Over the medium term, agricultural policies should be repurposed toward enhancing agriculture research and extension, creating an enabling business environment for private-sector participation and...
quality upgradation, adopting climate-smart crop and livestock management practices, modernization of irrigation, and improved management of and allocation rules for water resources.

These can be complemented by broader efforts to improve economy-wide productivity, such as by removing distortions to improve efficiency in the allocation of capital. Enhancing economy-wide productivity. In terms of enhancing economy-wide productivity, the focus could be on improving incentives for more efficient allocation of capital and labor. Distortions, including through taxes, subsidies, size-dependent industrial policy, trade restrictions, and gender norms can create incentives for firms and households to allocate resources in suboptimal ways, while also discouraging innovation and productivity upgrading. Avenues to enhance economy-wide productivity over the medium term can involve supporting firms to become more productive over time, such as by enhancing their export orientation through trade policy reforms; or supporting households through policies to enhance human capital and female labor-force participation. Preserving a market-determined exchange rate also remains key to absorbing external shocks and maintaining competitiveness.

Technical Annex 1 - Data

Estimating decile-level inflation rates requires combining data on consumer prices with information from household expenditure surveys. The monthly data to produce the Consumer Price Index (CPI) are collected and compiled by the Pakistan Bureau of Statistics (PBS). The PBS also conducts the Household Integrated Economic Survey (HIES) to collect data on household expenditure.

The urban CPI aggregates price data on 356 items, whereas the rural CPI covers 244 items. The Laspeyres formula is used to compute urban and rural CPIs using weights from the Household Integrated Income and Consumption Survey 2015/16 (HIICS). The weights for commodity groups obtained from the HIICS are different for rural and urban CPIs. These regional CPIs are then used to compile the national CPI. For instance, the urban CPI assumes that on average urban household spends 40.87 percent of its budget on food and non-alcoholic beverages, whereas the rural CPI assumes this to be 30.42 percent for rural households (the weighted national average would be 34.58 percent).

The latest HIES was conducted in 2018–19 and collects information on 283 expenditure items. These items are grouped into 12 main categories according to the Classification of Individual Consumption According to Purpose (COICOP) and include Food and Non-Alcoholic Beverages (98); Alcoholic Beverages and Tobacco (8); Clothing and Footwear (13); Housing, Water, Electricity, Gas and other Fuels (24); Furnishing, Household Equipment and Routine Maintenance (41); Health (6); Transport (14); Communication (5); Recreation and Culture (14); Education (3); Restaurants and Hotels (29); Miscellaneous Goods and Services (28). Both CPI and HIES use the same COICOP categories.

Technical Annex 2 - Methodology

The household-specific inflation rate for each month is calculated as the weighted sum of the monthly y-o-y inflation rate of the goods and services the household consumes, grouped into 12 COICOP categories. Specifically,

43 “From Swimming in Sand to High and Sustainable Growth” A Country Economic Memorandum for Pakistan (World Bank Group, 2022) highlights some of the distortions. For example, distortions in the form of differences in direct tax rates tend to make it more profitable to invest in real estate relative to manufacturing or tradable services. And because the size of the tradable sector tends to be associated with growth, this reduces growth potential. Within tradables, high import duties make it more profitable for firms to sell domestically rather than exporting. For example, in Pakistan, a 10 percent import duty on a given product increases profits of selling domestically relative to exporting by 40 percent on average. Firms that decide to embark upon export-oriented manufacturing despite these adverse incentives face a further distortion: if they want to innovate, they miss out on export subsidies. It is 18 times more likely for a potential exporter that decides to export a traditional product (e.g., apparel) to be eligible for an export subsidy, than for one that decides to innovate and export a new product. This is because export subsidy schemes target mostly well-established, unsophisticated export products and can provide up to a 30 to 35 percent boost in profits.

\[ \pi_{hmt} = \sum_{c=1}^{12} S_{hcmt} \pi_{cmt} \tag{1} \]

where \( \pi_{hmt} \) is the y-o-y inflation rate for household \( h \), in month \( m \) and year \( t \). \( C (=1\ldots12) \) represents the 12 COICOP categories, and \( S \) is the share of each COICOP category for household \( h \) in a particular month and year. These shares are estimated from the unit-level records collected for each household through the HIES (2018-19). Furthermore, \( \pi_{cmt} \) is the y-o-y inflation for the corresponding month \( m \) and year \( t \).

The decile-specific inflation rate for each month is calculated as the weighted average of household-specific inflation rates for all households in that decile. Households are sorted in their specific decile constructed based on per adult equivalent household’s consumption expenditures. The deciles are also adjusted for population sample weights. Specifically,

\[ \pi_{dhmt} = \frac{\sum \pi_{hmt}}{N} \tag{2} \]

where \( d (=1\ldots10) \) represents deciles, and \( N \) is the total number of households in each decile.

Finally, the decile-specific inflation rate for a specific COICOP category is calculated using formula (2) while only accounting for goods and services within that COICOP category.

**Calculations of decile-wise inflation rates are based on certain assumptions.** For instance, it is assumed that the composition of the consumption basket and therefore the shares of COICOP categories remained constant during this period. Similarly, the analysis does not differentiate between purchased and home-produced consumption items. With this assumption it is possible that the estimated inflation rates for the bottom of the welfare distribution is overestimated, as they often live in rural areas and are therefore more likely to consume home-produced items. Finally, the calculations assume a zero elasticity between consumption and income growth, which implies that the composition of household consumption expenditure remains unchanged as incomes rise or decline.
References

Executive Summary and Section 2


Arif Habib Limited Research, based on NEPRA’s data.

Blogs World Bank. May 02, 2022. How do the 2017 PPPs change our understanding of global and regional poverty?


Section 3 - Focus Topic


### Annex Table 1: Balance of payments summary

US$ million unless mentioned otherwise

<table>
<thead>
<tr>
<th>FY18</th>
<th>FY19</th>
<th>FY20</th>
<th>FY21</th>
<th>FY22</th>
<th>FY21 Share of GDP (percent)</th>
<th>FY22 Share of GDP (percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>i. Current account (A+B+C+D)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>A. Goods trade balance</td>
<td>-30903</td>
<td>-27612</td>
<td>-21109</td>
<td>-28634</td>
<td>-39576</td>
<td>-8.2</td>
</tr>
<tr>
<td>Goods exports</td>
<td>24768</td>
<td>24257</td>
<td>22536</td>
<td>25639</td>
<td>32467</td>
<td>7.4</td>
</tr>
<tr>
<td>Goods imports</td>
<td>55671</td>
<td>51869</td>
<td>43645</td>
<td>54273</td>
<td>72043</td>
<td>15.6</td>
</tr>
<tr>
<td>B. Services trade balance</td>
<td>-6426</td>
<td>-4970</td>
<td>-3316</td>
<td>-2516</td>
<td>-5130</td>
<td>-0.7</td>
</tr>
<tr>
<td>Services Exports</td>
<td>5851</td>
<td>5966</td>
<td>5437</td>
<td>5945</td>
<td>6957</td>
<td>1.7</td>
</tr>
<tr>
<td>Services Imports</td>
<td>12277</td>
<td>10936</td>
<td>8753</td>
<td>8461</td>
<td>12087</td>
<td>2.4</td>
</tr>
<tr>
<td>Trade Balance</td>
<td>-37329</td>
<td>-32582</td>
<td>-24425</td>
<td>-31150</td>
<td>-44706</td>
<td>-8.9</td>
</tr>
<tr>
<td>C. Balance on primary income</td>
<td>-5437</td>
<td>-5610</td>
<td>-5459</td>
<td>-4400</td>
<td>-5258</td>
<td>-1.3</td>
</tr>
<tr>
<td>D. Balance on secondary income</td>
<td>23571</td>
<td>24758</td>
<td>25435</td>
<td>32730</td>
<td>32646</td>
<td>9.4</td>
</tr>
<tr>
<td>of which, remittances</td>
<td>19914</td>
<td>21740</td>
<td>23131</td>
<td>29450</td>
<td>31238</td>
<td>8.5</td>
</tr>
<tr>
<td>ii. Capital account</td>
<td>376</td>
<td>229</td>
<td>285</td>
<td>224</td>
<td>206</td>
<td>0.1</td>
</tr>
<tr>
<td>1. Balance from current and capital accounts (i+ii)</td>
<td>-18819</td>
<td>-13205</td>
<td>-4164</td>
<td>-2596</td>
<td>-17112</td>
<td>-0.7</td>
</tr>
<tr>
<td>2. Financial accounts</td>
<td>-13611</td>
<td>-11759</td>
<td>-9313</td>
<td>-8768</td>
<td>-10985</td>
<td>-2.5</td>
</tr>
<tr>
<td>of which:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Direct investment</td>
<td>-2772</td>
<td>-1436</td>
<td>-2652</td>
<td>-1648</td>
<td>-1620</td>
<td>-0.5</td>
</tr>
<tr>
<td>Portfolio investment</td>
<td>-2257</td>
<td>1274</td>
<td>409</td>
<td>-2774</td>
<td>54</td>
<td>-0.8</td>
</tr>
<tr>
<td>Net acquisition of financial assets</td>
<td>273</td>
<td>-67</td>
<td>-127</td>
<td>1345</td>
<td>2588</td>
<td>0.4</td>
</tr>
<tr>
<td>Net incurrence of financial liabilities</td>
<td>8855</td>
<td>11530</td>
<td>6935</td>
<td>5691</td>
<td>12006</td>
<td>1.6</td>
</tr>
<tr>
<td>3. Errors and omissions</td>
<td>-933</td>
<td>-58</td>
<td>150</td>
<td>-619</td>
<td>-189</td>
<td>-0.2</td>
</tr>
<tr>
<td>Overall balance (-1+2-3)</td>
<td>6141</td>
<td>1504</td>
<td>-5299</td>
<td>-5553</td>
<td>6316</td>
<td>-1.6</td>
</tr>
<tr>
<td>Gross SBP reserves (incl. CRR, SCRR)</td>
<td>11341</td>
<td>9301</td>
<td>13724</td>
<td>18716</td>
<td>11092</td>
<td>1.7</td>
</tr>
</tbody>
</table>

**Memorandum items**

| GDP (US$ million) | 356128 | 320909 | 300426 | 348263 | 376525 |
| Export growth (percent, y-o-y) | 12.6 | -2.1 | -7.1 | 13.8 | 26.6 |
| Import growth (percent, y-o-y) | 16.0 | -6.8 | -15.9 | 24.4 | 32.7 |
| Remittance growth (percent, y-o-y) | 2.9 | 9.2 | 6.4 | 27.3 | 6.1 |

**Source:** State Bank of Pakistan, World Bank Staff calculations

**Notes:**

1. As per Balance of Payments Manual 6 (BPM6).
2. In BPM6, the income account has been renamed “primary income” and current transfers, “secondary income.”
3. A negative balance shows that the economy is a net borrower from the rest of the world.
4. A negative balance highlights a net increase in the incurrence of foreign liabilities.
5. CRR: Cash Reserve Requirement, SCRR: Special Cash Reserve Requirement.
## Annex Table 2: Summary of Pakistan's Fiscal Operations

<table>
<thead>
<tr>
<th></th>
<th>FY18</th>
<th>FY19</th>
<th>FY20</th>
<th>FY21</th>
<th>FY22</th>
<th>FY21 Share of GDP (percent)</th>
<th>FY22 Share of GDP (percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total revenue</strong></td>
<td>5228</td>
<td>4901</td>
<td>6272</td>
<td>6903</td>
<td>8035</td>
<td>12.4</td>
<td>12.0</td>
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<tr>
<td><strong>Tax revenue</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Federal</td>
<td>4469</td>
<td>4477</td>
<td>4751</td>
<td>5760</td>
<td>6947</td>
<td>10.3</td>
<td>10.4</td>
</tr>
<tr>
<td>Provincial</td>
<td>401</td>
<td>402</td>
<td>414</td>
<td>508</td>
<td>612</td>
<td>0.9</td>
<td>0.9</td>
</tr>
<tr>
<td><strong>Non-tax revenue</strong></td>
<td>759</td>
<td>424</td>
<td>1521</td>
<td>1144</td>
<td>1088</td>
<td>2.0</td>
<td>1.6</td>
</tr>
<tr>
<td>Federal</td>
<td>612</td>
<td>337</td>
<td>1419</td>
<td>993</td>
<td>960</td>
<td>1.8</td>
<td>1.4</td>
</tr>
<tr>
<td>Provincial</td>
<td>147</td>
<td>86</td>
<td>102</td>
<td>150</td>
<td>128</td>
<td>0.3</td>
<td>0.2</td>
</tr>
<tr>
<td><strong>Total expenditure</strong></td>
<td>7488</td>
<td>8346</td>
<td>9648</td>
<td>10307</td>
<td>13295</td>
<td>18.5</td>
<td>19.9</td>
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<tr>
<td><strong>Current expenditure</strong></td>
<td>5854</td>
<td>7104</td>
<td>8532</td>
<td>9084</td>
<td>11521</td>
<td>16.3</td>
<td>17.2</td>
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<td><strong>of which</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Interest</td>
<td>1500</td>
<td>2091</td>
<td>2620</td>
<td>2750</td>
<td>3182</td>
<td>4.9</td>
<td>4.8</td>
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<tr>
<td>Defense</td>
<td>1030</td>
<td>1147</td>
<td>1213</td>
<td>1316</td>
<td>1412</td>
<td>2.4</td>
<td>2.1</td>
</tr>
<tr>
<td><strong>Development expenditure and net lending</strong></td>
<td>1622</td>
<td>1219</td>
<td>1204</td>
<td>1316</td>
<td>1657</td>
<td>2.4</td>
<td>2.5</td>
</tr>
<tr>
<td><strong>of which</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Total PSDP2</td>
<td>1456</td>
<td>1008</td>
<td>1090</td>
<td>1211</td>
<td>1617</td>
<td>2.2</td>
<td>2.4</td>
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<tr>
<td>Other development expenditure</td>
<td>128</td>
<td>170</td>
<td>65</td>
<td>27</td>
<td>0</td>
<td>0.0</td>
<td>0.0</td>
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<tr>
<td>Net lending</td>
<td>38</td>
<td>41</td>
<td>49</td>
<td>77</td>
<td>40</td>
<td>0.1</td>
<td>0.1</td>
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<tr>
<td><strong>Statistical discrepancy</strong></td>
<td>12</td>
<td>22</td>
<td>-87</td>
<td>-93</td>
<td>116</td>
<td></td>
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<tr>
<td><strong>Memorandum items</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>GDP (PKR billion)</td>
<td>39190</td>
<td>43798</td>
<td>47540</td>
<td>55796</td>
<td>66950</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Ministry of Finance, World Bank Staff calculations

Note:
1From FY21 onwards, the Ministry of Finance has included revenue from Gas Infrastructure Development Cess, natural gas development surcharge and petroleum levy in non-tax revenue. For consistency of analysis across years, these taxes have been included in tax revenue.
2Public Sector Development Programme