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State of the Pakistan Economy Estimates of Annual Growth in Pakistan: Financial Year 2023

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Abstract

The Lahore School of Economics macro model forecasts a marginal GDP growth of 0.05% for Pakistan's fiscal year 2023. This minimal expansion is attributed to a combination of supply and demand shocks. Supply shocks include flood damage and import constraints arising from a balance-of-payments crisis. Demand shocks stem from reduced income due to supply shocks and a persistent current account deficit. Inflation, reaching 33.3%, is primarily driven by exchange rate depreciation, with the fiscal deficit and global commodity prices playing secondary roles. The model projects a modest GDP growth of 2.71% for FY 2024, contingent on mitigating supply and demand shocks. However, Pakistan faces significant challenges, including low foreign exchange reserves, a looming current account deficit, and the urgent need for fiscal and monetary policy reforms to address these issues.

Introduction

This report on the state of the Pakistan economy initiates the proceedings of this annual conference on management of the Pakistan economy. It makes for sombre reading at this juncture of the economy in May 2023, with the economy stalled and inflation continuing on the boil. It also comes with a persisting vulnerability in the balance of payments (BOPs), dragging down the country's reserves to rock bottom, necessitating another program of borrowing from the International

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Monetary Fund (IMF). While the last Extended Fund Facility (EFF) has been the 23rd, it has still left reserves parlous, requiring a short-term Stand-By-Agreement (SBA) for nine months, indicating a dependency on these programs.

Growth does not factor into the Fund programs of lending conditionalities. However domestic growth appears to be constrained, apart from one off black swan events like flooding of agriculture, by the external factor of weak BOPs and dwindling reserves. The manufacturing sector particularly, has a high import coefficient, and yet fully liberalizing the current account (CA) by opening all Letters of Credit (LCs) for imports would drain out the last reserves, as the finance minister rightly fears.

The reserves are being exhausted by another factor, on the side of the capital account (KA) outflows. Complementary research at the Lahore School estimates an alarming increase in the capital outflows and shows a strong causality with depreciation of the exchange rate. To facilitate growth through the CA, reserves will need to be propped up by some capital controls, to reduce capital outflows.

The fiscal year FY 2023 also witnessed the highest-ever inflation rate for Pakistan, the overwhelming driver of which, has been the massive depreciation of the exchange rate. As this depreciation is expected to follow some easing during the upcoming FY 2024, inflation is also expected to follow a downward trajectory. While monetary policy is the primary instrument to control this raging inflation, the depreciation of exchange rate needs to be arrested urgently, however, within the working of a market equilibrium—without lowering GDP growth.

Estimates of Annual Growth in Pakistan: Fiscal Year 2023

The Lahore School of Economics macro model for the Pakistan economy projects that GDP growth over the fiscal year FY 2023 (July 2022 – June 2023) will be 0.05% (see Table 1). This flatline estimation for the annual growth rate of GDP for FY 2023 has been due to successive quarters of falling GDP growth in FY 2023. The year-on-year estimation of GDP growth makes it globally comparable to most estimation. Table 1 shows that output in FY 2023 gives an annual GDP growth 0.05% for Pakistan, as compared to FY 2022.

Table 1: Estimates for GDP Growth Rate FY 2023

FY 2022		FY 2023
GDP (\$ bn)	369.01	369.21
C (\$ bn)		266.67
I (\$ bn)		59.92
G (\$ bn)		46.62
NXn (\$ bn)		-2.56
Growth Rate (%)		0.05

Source: Lahore School Modeling Lab Estimate (LSML), 2023

Our estimation of GDP growth is comparable to the estimate of the Government of Pakistan (GOP) of 0.3% for FY 2023 (see Table 2). IMF has a lower estimate of -0.5% for FY 2023. The Asian Development Bank and the World Bank have higher estimates of 0.6% and 0.4% respectively, for FY 2023.

Table 2: Comparable Growth Rate Estimates FY 2023

GOP	0.3%
IMF (April, 2023)	-0.5%
World Bank (June, 2023)	0.4%
Asian Development Bank(April, 2023)	0.6%

Source: WEO, IMF (July, 2023), Global Economic Prospects, World Bank (June, 2023), Asian Development Outlook (ADO)

Our estimates are based on supply and demand shocks, which have interacted to flatline output.

Supply shocks

There have been two supply shocks, flood damage, and import constraints resulting in economic uncertainty.

Impact of the Floods on Agriculture

The first negative supply shock observed over Q1 of FY 2023 has been the impact of floods on agriculture. Our estimates show that the flood damage to lives, livelihoods, and incomes, over the first quarter (Q1) of FY 2023, from July 2022 to September 2022, has taken a devastating toll on overall growth.

GOP has estimated the total loss to agriculture at \$30 billion, annualized over the whole of FY 2023, while the World Bank reports that agricultural output has actually contracted over FY 2023 for the first time in two decades. Despite these estimates of loss, GOP still gives the agricultural sector a positive growth rate of 1.6%, as seen in Table 3. Albeit, this has been much lowered from the agricultural sector's growth rate of 4.4% in FY 2022.

Table 3: Sectoral Growth Rates

	FY 2022	FY 2023
Agriculture	4.4%	1.55%
Industry	7.19%	-2.90%
LSM	10.4%	-9.40%
Services	6.19%	0.90%

Source: Ministry of Finance, 2023

Impact of an Import Constraint on Manufacturing

The supply shock to agriculture, was followed in the rest of the year (quarters two, three and four of FY 2023) by a supply shock to manufacturing growth, which was further hit by import constraints and economic uncertainty. A balance-of-payments (BOP) crisis, with a depreciating exchange rate, and falling reserves for the State Bank of Pakistan (SBP), has imposed these import constraints, especially weakening manufacturing growth. This is primarily due to a significantly high coefficient of the import content of capital goods, intermediate goods, and energy—contributing to value added in manufacturing.

Monthly imports peaked at \$6.9 billion in August 2022, which is Q1 of FY 2023. Over the next seven months of FY 2023, they dropped significantly to an average of \$5.2 billion huge decline of \$1.7 billion. This represents a nearly 25% reduction in imports over the course of FY 2023 (Table 4).

This decline in imports over FY 2023 appears to be a direct result of an import constraint, necessitated by the dwindling reserves of SBP. SBP reserves plummeted drastically from \$8.8 billion in August 2022 to \$5.6 billion by December 2022, and further to \$3.1 billion by January 2023. To prevent further depletion of reserves, the SBP imposed restrictions on letters of credit (LCs) for imports. Without these restrictions, SBP reserves would have been exhausted at a much faster rate.

Our model estimates a significantly high coefficient of 0.52 for the share of capital goods, intermediate goods, and energy imports in total imports. This high import coefficient for these goods then feeds into the total value-added in the economy as a second coefficient. Consequently, the 25% drop in imports passes through both coefficients, resulting in a drop in value added in industry of up to 13%.

The impact of this approximately 13% drop can be seen on Large Scale Manufacturing (LSM) in Table 3—showing that LSM growth dropped from 10.4% in FY 2022, to a contraction of -9.4% in FY 2023. This import shock constitutes the second negative supply shock in Q2 of FY 2023, following on the heels of the first negative supply shock of flood damage in Q1 of FY 2023.

Demand Shocks

The demand side of GDP estimation is predicated on two shocks: first, the reduced income stemming from the supply shock, which subsequently feeds into a demand shock; and second, a continued decline in the current account (CA) balance. The CA deficit is primarily attributed to a fall in demand for exports, with the first seven months of the fiscal year showing successive deficits, ranging between \$0.2 billion and \$1.2 billion. Despite the downward trajectory of imports, the CA still ran a deficit. Only in the last five months of FY 2023 did the CA break even or run a surplus, but proved insufficient to offset the cumulative deficit of \$2.56 billion for the entire fiscal year FY 2023.

Table 4: Current Account Balance, FY 2023

Million US\$	Jul-22	Aug-22	Sep-22	Oct-22	Nov-22	Dec-22	Jan-23	Feb-23	Mar-23	Apr-23	May-23	June-23	FY 2023
Exports-Goods	2,295	2,812	2,501	2,281	2,238	2,306	2,219	2,210	2,438	2,112	2,603	1,896	27,911
Exports-Services	530	575	565	621	650	735	610	569	610	486	607	741	7,299
Primary Income	57	76	124	68	65	85	125	88	44	85	34	61	860
Credit													
Total Exports	2,882	3,463	3,190	2,935	2,956	3,106	2,914	2,904	3,136	2,642	3,244	2,698	36,070
Imports-Goods	5,385	5,749	4,821	4,653	4,263	4,236	3,929	3,933	3,991	3,769	3,769	3,558	51,994
Imports-Services	789	936	738	701	715	649	592	600	635	667	809	188	8,019
Primary Income	503	248	488	542	612	634	594	557	515	514	581	841	6,579
Debit													
Total Imports	6,677	6,933	6,047	5,896	5,619	5,519	5,115	5,090	5,141	4,950	5,159	4,587	66,592
Exports-Imports	-3,795	-3,470	-	-	-2,514	-	-	-	-	-2,329	-1,915	-1,889	-30,522
Remittances	2,547	2,558	2,451	2,112	2,320	2,223	1,971	2,017	2,775	2,347	2,400	2,026	27,965
Current Account	-1,200	-676	-316	-849	-276	-290	-230	-36	750	18	485	63	-2,557
Balance													
Foreign	8,395	8,805	7,859	8,759	7,722	5,585	3,086	3,864	4,208	4,458.3	3,679.1	4,466.5	4,466.5
Exchange													
Reserves													

Source: LSML, 2023; SBP, 2023.

These twin demand shocks—reduced income and continued current account deficits due to falling export demand—combined with the twin supply shocks of floods and import constraints, contribute to a flatlining of our estimated GDP growth for FY 2023.

Inflation for the Fiscal Year 2023

Year-on-year inflation for FY 2023 is estimated at 33.3%, compared to FY 2022 (See Table 5). This estimate is quite comparable to GOP's estimate of 29.0% for FY 2023.

Our model estimates inflation as being driven by four factors: an output gap, the budget deficit, depreciation of the exchange rate, and global commodity prices.

Table 5: Price Model Estimated for FY 2019, FY 2020, FY 2021, FY 2022, and FY 2023

Time Period	Output Gap	Budget Deficit (% of GDP)	Exchange Rate Depreciation	Commodity Prices (Growth Rate %)	Inflation (Model Estimate) (%)	CPI (GOP estimate) (%)
FY 2019	-1.40	7.60	4.44	-1.74	10.30	10.30
FY 2020	-1.70	6.40	0.88	-2.00	5.28	9.30
FY 2021	-1.80	5.20	-0.78	9.07	13.49	8.20
FY 2022	0	7.00	3.59	7.696	15.88	11.00
FY 2023	0	5.00	26.26	2.04	33.30	29.0

Source: LSML Estimations, 2023; State Bank of Pakistan, 2023

Table 5 shows that for FY 2023, the most significant driver of inflation was the massive depreciation of the exchange rate, which amounted to 51% over the four quarters of the fiscal year. This depreciation alone is responsible for contributing nearly three quarters (26.26%) of the year-on-year inflation rate of 33.3% for FY 2023.

The second major driver of inflation for FY 2023 has been the fiscal deficit, estimated at 5.0%. The third driver of inflation, global commodity prices, has eased significantly over FY 2023, growing at just 2.04%. Lastly, the output gap has been disinflationary over the previous three fiscal years (FY 2020, FY 2021, and FY 2022), on account of the Covid-19 pandemic lockdowns. This post-pandemic output gap is estimated to have a neutral impact on inflation, neither disinflationary nor inflationary.

GDP Growth Projections for FY 2024

Our model projects GDP growth for FY 2024, to be 2.71%. This is based on easing some of the supply and demand shocks observed over FY 2024.

The first supply shock observed during FY 2023 was in agriculture, which is expected to ease in FY 2024. The black swan event of flooding in Q1 of FY 2023, is not anticipated to recur, therefore, agriculture is expected to return to its long-run trend growth, approximating 4% per annum. The second supply shock observed during FY 2023 was in manufacturing, which is anticipated to moderate in FY 2024.

The demand shock observed over FY 2023 was for the current account, which is expected to moderate in FY 2024. The current account deficit is anticipated to persist at approximately the same level in FY 2024, but with foreign exchange reserves permitting a higher level of imports to avoid constraining manufacturing.

Therefore, easing of these supply and demand shocks during FY 2024, allow us to project a GDP growth rate of 2.71% for FY 2024. Our model also forecasts that inflation will moderate somewhat in FY 2024, reaching 25.39%, largely attributed to the anticipated easing of exchange rate depreciation.

GOP Emergency Economic Policy over FY 2023

The cusps of economic regimes in Pakistan repeatedly generate the twin whammies of fiscal sustainability and current account sustainability. This time around, a third whammy, stagflation, has been added—plummeting GDP growth and spiraling inflation. Both of these are fueled by the fourth whammy of a viciously depreciating exchange rate.

Therefore, GOP faces a flatlined growth rate of 0.05% over FY 2023. Its foreign exchange reserves have dwindled to approximately \$4.5 billion, providing barely a month's worth of imports. The ninth review of the IMF's Extended Fund Facility for the remaining \$6 billion deal signed in 2019 lapsed. Instead, GOP is to secure \$3 billion through a shorter-term, nine-month Stand-By-Facility (SBF). GOP's immediate fiscal stance to regenerate GDP growth and provide additional welfare is severely limited, in abiding with the terms of this agreement with IMF. A riskily high-projected budget deficit of 6.5% of GDP for FY 2024, has not survived renegotiations with IMF, nor can it survive a possible corner solution of restructuring of debt with bilateral lenders in the future.

The alternative of fiscal reforms, such as raising taxation above 12% of GDP and capping spiraling energy leakages that have been increasing expenditures, is the elephant in the policy room. The current economic regime has not addressed these comprehensive reforms in the budget for FY 2024. A succeeding economic regime will likely need to implement them to achieve fiscal sustainability. So, absencing fiscal reforms have only left GOP with the monetary policy to generate growth and support welfare. Monetary policy, however, is primarily occupied with controlling inflation, raging at 33.3% per annum, primarily through the demand-side policy instrument of the interest rate. Table 6 shows the interest rate

rose from 13.75% to peak at 21% from May 2022 to May 2023, but there is no visible impact on inflation, which rose from 13.8% to peak at 38%, during the same period.

Table 6: Interest Rates and Inflation Rates (May 2022 to May 2023)

	May -22	June -22	Jul- 22	Aug- 22	Sep- 22	Oct- 22	Nov- 22	Dec- 22	Jan- 23	Feb- 23	Mar- 23	Apr- 23	May -23
CPI (%)	13.8	21.3	24.9	27.3	23.2	26.6	23.8	24.5	27.6	31.5	35.4	36.4	38.0
Interest Rate (%)	13.7	13.7	15.0	15.0	15.0	15.0	16.0	16.0	17.0	17.0	20.0	21.0	21.0

Source: State Bank of Pakistan, 2023

This does not render the demand-side policy instrument of interest rates unnecessary, but it does demonstrate its insufficiency. As we have shown, three-quarters of the inflation rate can be attributed to the massive supply-side cost push of exchange rate depreciation.

Furthermore, research at the Lahore School demonstrates that exchange rate depreciation sets depreciatory expectations in place, leading to increased capital outflows (Mahmood & Chaudry, 2020). Pakistan's weak current and capital accounts (KA), coupled with a weak investment rate of 16% of GDP can ill afford that. This presents GOP with two immediate, almost existential policy objectives, but with tight constraints on the policy instruments it may use.

First, to arrest the depreciation of the exchange rate urgently, but within the working of a market equilibrium. This means avoiding the use of import controls, as agreed with IMF, and which are shown to lower GDP growth. Moreover, it should be done without intervening in the exchange rate market to prop up the rupee, for which the SBP has no reserves left to draw down in open market operations, in any case.

Second, the maintenance and increase of the SBP's reserves, above the current rock-bottom levels of \$4.5 billion. This should be achieved implementing port controls or significantly raising the interest rate above the already prohibitive cost of borrowing of 22%. Otherwise, GDP growth would likely remain flatlined in FY 2024.

The only short-run policy solution to reduce capital outflows on the KA is to tighten capital controls. This would circumvent the need for intervening in the CA through import controls. IMF also anticipates that developing countries will resort to capital controls on account of increased capital flight. Given the rising in interest rates in Advanced Economies (AEs)¹, a surge in capital flight from developing countries is expected as investors seek higher yields. Therefore, GOP could explore this policy option of capital controls while remaining within the ambit of the SBA.

¹ For the record, the IMF has countenanced capital controls since the Asian Financial Crisis.