Growth remained strong in fiscal 2022, and a larger fiscal deficit pushed up inflation despite tighter monetary policy. A substantial rise in imports widened the current account deficit, and international currency reserves plunged. Growth is projected to slow substantially in fiscal 2023, reflecting the impact of floods and a foreign exchange crisis, with currency depreciation and supply disruption doubling inflation. Fiscal and current account deficits should narrow nevertheless. Pakistan urgently needs to adapt to climate change.

**Economic Performance**

**Accommodative policies last year supported strong growth.** Growth edged up to 6.0% in fiscal year 2022 (FY2022, ended 30 June 2022) from 5.7% in FY2021, driven by rapidly rising domestic demand (Figure 2.20.1). Demand rose thanks to major fiscal stimulus that featured fuel and electricity subsidies higher than originally budgeted, tax exemptions, a tax amnesty for real estate, increased public wages and pensions, and a late response from the State Bank of Pakistan, the central bank, to overheating. Growth in private consumption accelerated from 9.3% in FY2021 to 10.0%. However, private investment reversed 2.5% growth in FY2021 with 0.5% contraction, slowing growth in total investment and reflecting declining business confidence as political tensions and economic vulnerabilities intensified in the second half of FY2022.

**On the supply side, growth reflected gains across sectors.** Expansion in agriculture rose from 3.5% in FY2021 to 4.4% in FY2022 as crop production accelerated from 6.0% growth in FY2021 to 6.6% thanks to better weather, improved availability of seed and other inputs, increased credit, and attractive prices. Growth in livestock production rose from 2.4% in FY2021 to 3.3%. Industrial output remained strong, rising by 7.2% in FY2022 because of higher domestic and external demand, with growth in large-scale manufacturing up from 11.2% in FY2021 to 11.7%. Strong consumer demand lifted growth in services slightly, from 6.0% in FY2021 to 6.2%, as wholesale and retail trade expanded by 10.0% and strong economic activity boosted transportation and storage by 5.4%.

**Headline inflation accelerated from 8.9% in FY2021 to 12.2%, reflecting currency depreciation, high global prices, and strong demand.** (Figure 2.20.2). Food prices rose by 13.4% in urban areas and 13.0% in rural as prices rose for agricultural inputs and imported food, and as the local currency depreciated. Energy

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prices rose even faster, by 25.5% in urban areas and 24.7% in rural, reflecting higher global fuel prices, delayed implementation of FY2020 and FY2021 quarterly tariff adjustments for electricity, and the abandonment in May 2022 of a 4-month freeze on fuel prices, which more than doubled domestic petroleum prices. Core inflation, excluding food and energy, accelerated from 6.0% in FY2021 to 8.1% in urban areas and from 7.6% to 9.0% in rural, largely reflecting currency depreciation and rising domestic demand.

The central bank moved slowly to contain inflation. It increased the policy rate by a cumulative 800 basis points from September 2021 to reach 15% by the end of FY2022 (Figure 2.20.3). However, with inflation above the policy rate, the real rate remained negative throughout FY2022. Growth in private sector credit almost doubled from 11.8% in FY2021 to 22.7% in FY2022, propelled by strong economic growth, negative real interest rates, and concessionary central bank finance schemes.

Loose fiscal policy contributed to rising macroeconomic imbalances. The consolidated fiscal deficit of the federal and provincial governments widened from the equivalent of 6.1% of GDP in FY2021 to 7.9% (Figure 2.20.4). Revenue dropped in FY2022 by 0.4 percentage points to 12.0% of GDP as a large decline in nontax revenue outweighed strong tax collection. Tax revenue rose from 9.5% of GDP in FY2021 to 10.1%, mainly from higher collection of direct taxes and sales tax on goods, reflecting strong domestic economic activity, higher prices, and increased imports. Nontax revenue slipped from 2.9% of GDP in FY2021 to 1.9%, reflecting smaller transfers of central bank profits and the government’s suspension of the petroleum development levy to alleviate inflation, plunging receipts from the levy to their lowest since 2015. Expenditure rose from
18.5% of GDP in FY2021 to 19.9%, driven mainly by a substantial rise in current spending caused by fuel and electricity subsidies, higher interest payments as domestic interest rates rose, and currency depreciation. The primary deficit almost tripled from 1.2% of GDP in FY2021 to 3.1% in FY2022, with 59% of budget financing from banks, 18.6% from nonbank sources, and 22.4% from foreign borrowing (Figure 2.20.5).

The current account deficit soared from $2.8 billion in FY2021 to $17.3 billion, driven by a larger trade deficit. As a percentage of GDP, it widened sharply from 0.8% to 4.6% (Figure 2.20.6). The merchandise trade deficit expanded from 8.2% of GDP in FY2021 to 10.5% as 32.8% growth in imports exceeded 26.6% expansion for exports, reflecting strong recovery in domestic demand and higher prices, especially global energy and food prices (Figure 2.20.7). The service deficit more than doubled to equal 1.4% of GDP, reflecting higher financial service payments, freight charges for imports, and the normalization of travel post-pandemic. While official remittances remained strong at 8.4% of GDP, remittance growth year on year slowed from 27.0% in FY2021 to 7.1% in FY2022 (Figure 2.20.8). Net central bank foreign exchange reserves plunged from $17.3 billion at the end of FY2021 to $9.8 billion a year later, cover for only to 1.4 months of imports, after debt repayment and frequent central bank intervention to mitigate exchange rate pressures. The Pakistan rupee depreciated by 23.6% in FY2022 against the US dollar, reflecting worsening external conditions and a persistently high import bill, among other factors (Figure 2.20.9).

The current account deficit widened, driven by a larger trade deficit.

Figure 2.20.6 Current Account Components

The current account deficit widened, driven by a larger trade deficit.

Figure 2.20.7 Trade Balance

The merchandise trade deficit widened as imports grew faster than exports.
Economic Prospects

The International Monetary Fund (IMF) recently concluded talks with Pakistan on the pending ninth review of its extended fund facility. The arrangement would release $1.18 billion to Pakistan. An IMF mission to Pakistan in February 2023 discussed policies to restore domestic and external sustainability, including strengthening Pakistan’s fiscal position durably while supporting the vulnerable and those affected by floods; restoring the viability of the electric power sector and reversing the continued accumulation of circular debt from subsidies and unpaid bills; and restoring the proper functioning of the foreign exchange market so that a realistic exchange rate can attract sufficient foreign exchange. Virtual discussions continue toward finalizing details on these policies. Their timely and decisive implementation are critical for Pakistan to regain macroeconomic stability, as is securing financial support from other development partners. At the end of February 2023, items pending included a higher petroleum development levy, electricity tariff increases, and the withdrawal of electricity subsidies to export industries and agriculture. The government must also identify financing sources to fill the external financing gap.

Growth is projected to slow substantially, with significant risks to the outlook. Growth is projected to decelerate to 0.6% in FY2023 (Figure 2.20.10). Weighing on economic activity are the difficult political situation, economic losses and devastation from flooding, the ongoing foreign exchange crisis, tighter macroeconomic policies, and the challenging external environment. High inflation will affect purchasing power and thus restrain domestic demand. Increased government spending to support relief, recovery, and rehabilitation in the aftermath of the floods is expected to compensate for some of the damage and disruption to economic activity during the first half of the fiscal year. Growth is forecast to improve to 2.0% in FY2024, assuming sustained macroeconomic policies, reform implementation, recovery from supply shocks caused by flooding, and improving external conditions. A return to political stability with the formation of a new government after scheduled general elections would improve business sentiment.

Figure 2.20.8 Remittances
Remittance growth slowed in 2022 and continued to decline in the first half of 2023.

![Remittances graph]

Note: Years are fiscal years ending on 30 June of that year.

Figure 2.20.9 Gross Official Reserves and Exchange Rate
Reserves declined as the Pakistan rupee depreciated sharply in 2022.

![Gross official reserves and exchange rate graph]


Figure 2.20.10 GDP Growth
Growth is expected to slow in 2023 before recovering somewhat in 2024.

GDP = gross domestic product.
Notes: Years are fiscal years ending on 30 June of that year.
Economic trends and prospects in developing Asia: South Asia

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Agriculture will likely contract in FY2023 for the first time in 2 decades. This follows massive losses to cotton, wheat, and rice crops caused by flooding, as well as loss of livestock. Some 4,410 million acres of agriculture land was affected, affecting 40% of the cotton crop. Improved input availability from incentives announced in the Kissan Package 2022 for farmers may boost agricultural productivity and enhance crop production in the winter season, partly offsetting losses to summer crops.

A flood-induced supply shock severely affects industry and services. The production of textiles, which are normally 25% of industrial output and about 60% of export goods, is expected to plunge because prices for imported cotton to replace domestic supply are driven up by the foreign exchange crisis. The decline in food and livestock production will reduce slaughtering and food processing. Industry faces additional pressures as higher inflation and an expected tightening of fiscal and monetary policies curb domestic demand. Moreover, liquidity shortages caused by depleted foreign currency reserves are disrupting supply chains and making it harder to import essential raw materials, intermediate goods, and machinery for industry. Consequently, many factories have either closed temporarily or operate below capacity. Output from large manufacturers fell by 3.6% from July to November 2022, with output dropping in 19 of 25 categories. In November, output from large manufacturers plunged by 5.5% year on year. Industry is thus expected to contract in FY2023 but, as demand and supply shocks dissipate, expand in FY2024. Growth in services is projected to slow as contraction in agriculture and industry drag down wholesale and transportation services, which are half of the sector. Further weakening of economic activity overall is expected from continued supply disruption caused by the loss to flooding of critical transportation infrastructure.

Average inflation is projected to more than double from 12.2% in FY2022 to 27.5% (Figure 2.20.11). Headline consumer inflation jumped to 25.4% in the first 7 months of the fiscal year on higher domestic energy prices, a weaker currency, flood-related supply disruption, and restraint on imports caused by a serious crisis in the balance of payments. Core inflation in rural areas escalated to 17.7% year on year in the first 7 months of FY2023 from 9.0% a year earlier, while urban core inflation averaged 14.3% in this period, up from 8.1%. Headline inflation is expected to decrease to 15.0% in FY2024 as global energy prices decline and flood-induced supply constraints are resolved, as well as from a high base effect. The central bank tightened monetary policy further in response to rising inflation and external imbalances, raising the policy rate by another 200 basis points in the first half of FY2023 to 17.0% in January 2023, which was still below the inflation rate. On 2 March 2023, the central bank increased its policy rate by a further 300 basis points to 20.0% to tackle inflation.

The fiscal deficit is projected to narrow slightly to the equivalent of 6.9% of GDP in FY2023. If the IMF program remains on track, it will likely continue to shrink over the medium term as revenue mobilization

![Figure 2.20.11 Inflation](image-url)

Notes: Years are fiscal years ending on 30 June of that year. Source: State Bank of Pakistan, Monthly Inflation Snapshot; Asian Development Bank estimates.
measures gain momentum, including general sales tax harmonization and personal income tax reform. The fiscal deficit stood at 2.0% of GDP during July–December 2022, remaining stable from the same period of 2021, while the primary surplus rose from 0.1% of GDP to 1.1%. Domestic tax collection declined slightly by 0.4% in the first half of the current fiscal year.

The current account deficit is projected to narrow to 2.0% in FY2023 (Figure 2.20.12). In the first half of FY2023, the current account deficit fell from $9.1 billion a year earlier to $3.7 billion, mainly from a 26% drop in the merchandise trade deficit. In the period, merchandise exports declined by 6.8% because of flood damage to the rice and cotton crops and industry shutdowns. Merchandise imports plunged by 18.2% as import restraints were imposed to slow the drain on international reserves. Workers’ remittances have also declined in FY2023, with average monthly remittances in the first half falling from $2.6 billion a year earlier to $2.3 billion.

Figure 2.20.12 Current Account Balance

The current account deficit will narrow in 2023 and slightly widen in 2024.

Risks to the outlook and program implementation are high, tilting to the downside because of challenges both domestic and external. Macroeconomic conditions have deteriorated seriously in the current fiscal year, and Pakistan is at dire risk because international reserves have reached critical lows. The economic outlook appears weak, with substantial risks from slower global growth or any further increases in world energy and food prices caused by the ongoing Russian invasion of Ukraine. Bilateral and multilateral sources of affordable external financing would be hampered by higher international interest rates, weaker market sentiment, or tighter global financing conditions. The stalled IMF program must be resumed to buttress falling reserves and ease the balance of payments crisis, in part by catalyzing financing from other sources.

Policy Challenge—Adapting to Climate Change

Climate change poses a grave challenge to economic, social, and environmental development in Pakistan. For the past 20 years, the Global Climate Risk Index has consistently ranked Pakistan among the 10 most vulnerable countries, with thousands of fatalities caused by climate-induced extreme weather, as well as colossal losses to agriculture, infrastructure, and the economy. In 2022, Pakistan endured devastating drought and flooding that decimated assets, lives, and livelihoods on a massive scale. A post-disaster needs assessment following the 2022 floods estimated damage exceeding $14.9 billion, in addition to the total economic losses of $15.2 billion, requiring $16.5 billion for recovery and rehabilitation. As the likelihood of such devastating shocks continues to rise, so do their impacts on Pakistani people and their livelihoods, and on ecosystems and the economy, worsening poverty and food insecurity and risking conflict over water and other resources.

Improving consistency and continuity in climate policies, budgets, and programs, will help implementing Pakistan’s climate agenda. Further, a clear gap exists between policy direction and implementation mechanisms. Pakistan’s Ministry of Climate Change is responsible for climate change policy-making at the national level. With improved capacity and sufficient resources, it can better influence outcomes. In recent years, however, the government has taken a more proactive stance toward climate change. In 2021, it revised its National Climate Change Policy (NCCP) to link climate action and economic growth by integrating climate concerns with other national policies. The updated NCCP incorporates measures for disaster preparedness, capacity building, institutional strengthening,
technology transfer, and international cooperation. In line with the NCCP, several new sectoral policies supporting decarbonization have been adopted. The Alternative and Renewable Energy Policy, 2019 aims to create a framework for sustainable growth in Pakistan’s alternative and renewable energy industry. The Strategic Plan for Energy Efficiency and Conservation, 2020–2023 supports energy efficiency and conservation, and the National Electric Vehicle Policy, 2020–2025 promotes a stronger transport supply chain and the use of electric vehicles. These innovations signal new momentum toward addressing climate challenges.

**Urgent and collective action climate action must align with global climate measures.** Such measures are needed to steer Pakistan toward climate-compatible development. The country needs to transform its system of managing agriculture, food, and water to become more inclusive, sustainable, climate-smart, and resilient. It also needs to support the development of clean, green, and livable cities and accelerate the transition to sustainable energy and low-emission transportation.

**Climate change actions should be introduced into sectoral policies through planning and development departments.** Climate considerations should be incorporated into project and program development when preparing annual development plans and the budgetary framework. Decentralization can promote provincial and local ownership of climate policies. In recent years, several provincial governments have developed policies, strategies, and action plans to address climate change. These developments show that provincial commitment can help overcome institutional constraints and propel the implementation of environmental action.