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The State of Pakistan's Economy 2023-24

TRIALS AND TURMOIL

Navigating the Interconnected Challenges of Politics, Economy, and Climate Change

Editor
Asma Hyder

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IBA Press

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Editor

Asma Hyder
Dean, School of Economics and Social Sciences
Institute of Business Administration, Karachi

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List of Abbreviations

ADP	Annual Development Plan
BCI	Business Confidence Index
BCS	Business Confidence Surveys
CBCI	Current Business Confidence index
CEI	Current Employment Index
CERC	Contingent Emergent Response Component
CPEC	China Pakistan Economic Corridor
CPI	Consumer Price Index
CPPA	Central Power Purchasing Agency
DI	Diffusion Index
DISCOs	Distribution companies
EBCI	Expected Business Confidence Index
EEI	Expected Employment Index
EU	European Union
FBR	Federal Board of Revenue
FED	Federal Excise Duty
FREHP	Flood Response Emergency Housing Project
FY	Fiscal Year
GDP	Gross Domestic Product
GRR	Gross Revenue Receipts
HDI	Human Development Index
IBA	Institute of Business Administration
IEI	Inflation Expectations Index
IMF	International Monetary Fund
IPPs	Independent Power Producers
KIBOR	Karachi Interbank Offered Rate
LBOD	Left Bank Outfall Drain
LSMI	Large Scale Manufacturing Index
MW	MegaWatt
NAC	National Accounts Committee
NDMA	National Disaster Management Authority
NEPRA	National Electric Power Regulatory Authority
NFPP	National Flood Protection Plan

NRR	Net Revenue Receipts
OMOs	Open Market Operations
PBS	Pakistan Bureau of Statistics
PKR	Pakistani Rupee
PMI	Purchasing Manager Index
PPP	Public Private Partnerships
PSDP	Public Sector Development Program
PV	PhotoVoltaic
RBOD	Right Bank Outfall Drain
RCA	Revealed Comparative Advantage
RLNG	Regasified Liquefied Natural Gas
SBP	State Bank of Pakistan
SCARP	Salinity Control & Reclamation Project
SECP	Securities and Exchange Commission of Pakistan
SESS	School of Economics and Social Sciences
SFERP	Sindh Flood Emergency Rehabilitation Project
SPI	Special Price Index
SWAT	Sindh Water and Agricultural Transformation
UNESCAP	United Nations Economic and Social Commission for Asia and the Pacific
WITS	World Integration Trade Solution

Foreword

Pakistan is facing the most serious economic crisis since its independence.

Unfortunately, Pakistan is no stranger to booms and busts. These have forced us to approach the IMF 23 times in our history, making us the Fund's most loyal customer. However, the current crisis is fundamentally different.

Not only are the macroeconomic imbalances more acute than ever before—as manifested in record inflation, ballooning public debt, pervasive import controls, an abysmally low level of foreign exchange reserves, and unprecedented concerns about external default—but they are coinciding with political dysfunction that has paralyzed economic policymaking. Against this fractured backdrop and the short-termism that it breeds, Pakistan's ability to manage the existential challenge of climate change that was brought home so vividly by last summer's devastating floods will be seriously tested.

It is evident that these three issues—politics, economics and the climate—can no longer be viewed in isolation. For Pakistan to finally embark on a sustainable high growth path, we will need a holistic strategy that brings these elements together. We will need a new social contract that reconnects the elite and the people. We will need bold economic reforms to re-orient the structure of the economy towards investment and exports, while safeguarding macroeconomic stability through prudent fiscal and monetary policies. And we will need to do all of this within an environmentally friendly paradigm that ensures the welfare of our future generations, including an enlightened energy policy and climate-resilient infrastructure. Successful countries respond to crises by building a new social consensus and charting a new direction. We too must not let this crisis go to waste.

The interesting essays compiled in this timely book, 'Trials and Turmoil: Navigating the Interconnected Challenges of Politics, Economy, and Climate Change in 2023-24', shed light on these overlapping challenges, consider what might lie ahead and propose innovative solutions. Successful countries encourage ideas and debate. I am hopeful that all stakeholders including policymakers, parliamentarians, academics, development practitioners, researchers, civil society activists, and the business community will deliberate on the insightful analysis presented in this book.

Murtaza Syed
Former Deputy Governor, State Bank of Pakistan
Head of Ecosystem, Asian Infrastructure Investment Bank (AIIB)

1. Introduction

Asma Hyder

The report discusses three persistent issues, including political turmoil, an unstable economy, and devastating floods in the current economic context. These have been long standing issues, but their severity reached an unprecedented level in the FY 22-23. On the political front, Pakistan has experienced a series of transitions of power, with frequent changes in government, and the elite continue to polarize, amassing wealth, power, and privilege, resulting in the same situation we experienced multiple times, although with more intensity this time. Removing Imran Khan from Prime Minister's office through a Vote of No Confidence and establishing a new incumbent government raised serious concerns and sent mixed signals to different segments of society. However, it is important to note that political dynamics in Pakistan are complex, influenced by regional and ethnic interests, ideological differences, and is governed by a power struggle between military and political parties. The future of the country depends upon the current government's ability to navigate these complexities, forge alliances, and effectively implement policies that address the needs and aspirations of the Pakistani people. At this juncture, when tough measures are required to improve the economic trajectory, the current government is restrained from doing so because of the upcoming elections. Most of the decisions to improve the country's economic health will significantly affect voting outcomes. Considering the complex situation this year, it was decided that the report would open with a discussion on the political economy of the country. In the first chapter, S Akbar Zaidi explains the recent events and their consequences, the new geopolitical situation, and the historical perspective.

The Federal Budget 2023-24 announced various relief measures and a significant increase in expenditures, which is a clear indication of moving towards an alarming and unsustainable fiscal deficit. The *Economic Growth and Forecasting Lab* at the School of Economics and Social Sciences (SESS) at IBA Karachi, headed by Dr Wali Ullah, is getting recognition because of its researchers' expertise in forecasting. At SESS, using a macroeconomic model designed by the lab, we predict macroeconomic indicators and provide policy guidelines and advisory remarks to the relevant departments. The third chapter of this report provides econometric projections of key macroeconomic indicators, including GDP growth rate and inflation, for the coming years based on three scenarios presented with detail in the chapter.

In the last one year, Pakistan's economy went through multiple trials with three finance ministers changing within this short time span, each from a different school of thought. Pakistan is also facing serious obstacles including high inflation, a sizeable undocumented economy, income inequality, and a significant proportion of the population living below the poverty line. The grim situation of the economy is reflected in the national Consumer Price Index (CPI) as recorded in April 2023 at 36.40 percent (y-o-y), with Sensitive Price Index (SPI) touching 46% in the same month. These two indices, along with other variables, significantly affect an ordinary citizen's daily life and are a matter of serious concern. The country is struggling with a fiscal deficit, a reliance on external loans, and a need for structural reforms to promote sustainable growth. Consistent and drastic devaluation of the rupee has heightened the inflationary pressures and led to a huge trade deficit. This devaluation of our currency against the dollar and rising global energy prices contributed to higher energy costs. Inflationary pressures have further been exaggerated by the sluggish adaptation of supply to meet the resurging demand for commodities, as well as capacity limitations and supply obstacles. The ongoing conflicts, like the war in Ukraine, have introduced volatility and uncertainty into markets. In this situation, we cannot avoid the uncertainty and possibility of multiple scenarios. We dedicate the second, third, and fourth chapters to the economy, budget, and macroeconomic policies. The faculty from the economics department, including Wail Ullah, Muhammad Sabir, and Muhammad Nasir, authored these chapters and provided professional opinions on these matters.

Pakistan is constantly facing significant challenges in increasing exports. Dr. Aadil Nakhoda, an expert in international trade, has regularly been providing feedback and recommendations on these issues, especially in the last three years through this annual report. One of the biggest crises, the balance of payments crisis that repeats every few years, is driven by the trade deficit, which many experts believe arises due to the lack of exports. This time, Aadil Nakhoda and Qazi Masood Ahmed suggest a rather different area to explore as a policy option. They recommend that negotiating duty-free access to the US and China, although for a limited number of goods, can help increase Pakistan’s exports. They also analyze the most recent outcomes of the Business Confidence Index. The political turmoil in June 2022, coupled with uncertainty regarding IMF financing, led to a decline in business confidence, and this chapter discusses the situation in detail.

One chapter of this book, authored by Amir Jahan Khan, explains the circular debt and viability of the energy sector. The circular debt issue primarily stems from consistent losses during the transmission and distribution of electricity, delayed recoveries, underutilization of assets, non-payment by defaulters, and delays in the disbursement of subsidies. Efforts to address these issues require a comprehensive approach that tackles the root causes of revenue collection improvement, energy conversation promotion, efficient governance, and fostering a sustainable energy ecosystem for Pakistan’s long-term economic growth and development.

As mentioned at the beginning of the introduction, during 2022-23, we faced three significant crises: political turmoil, economic crisis, and devastating floods that affected people's lives. The widespread flooding caused extensive damage to infrastructure including roads, bridges, and irrigation systems, disrupting transportation networks, and hindering agricultural productivity. Moreover, the floods displaced many people, resulting in the loss of homes and livelihoods and putting additional strain on government resources for rehabilitation and humanitarian assistance. The economic repercussions of the floods were felt across various sectors, leading to reduced economic growth and increased unemployment. They heightened fiscal challenges for the government as it worked towards recovery and reconstruction efforts. Because of this reason, we dedicated the last chapter to building resilient communities against floods. Arooj Dar and Junaid Alam authored this chapter. They emphasize that climate-resilient infrastructure is vital to the sustainable development of those living in and around the Indus Basin.

These small pieces in different but important dimensions of the economy provide significant insights into our complex systems and their structural problems. As an academic institution, we aim to continue providing feedback and food for thought to the academia government and policymakers for improving systems and the betterment of society.

2. The Current Crises are the Permanent Crises of the Ruling Classes

S Akbar Zaidi

The fact that Pakistan has been in crisis mode, of every dispensation – economic, political, democratic, of the state, or of the environment – has in many ways normalised the notion and sense of crisis with regard to Pakistan. If all institutions and sectors are in a continuous and almost permanent state of crisis, can we still call Pakistan's 'State of Being' to be in a crisis mode? Have the repeat and recurring crises in Pakistan nullified the notion of crisis and internalised the manifestation into a new normal, a new equilibrium? Do we call recurring events which apparently destabilise the status quo a 'crisis', or have the institutions, sectors, and the people at large, adapted to such disruptions taking them in their stride without having to take resource to mitigating factors which crises call forth?

The political economy and the political history of the last few decades will help answer such questions, where the evidence clearly suggests that there have been multiple, simultaneous and regular 'crises' of numerous manifestations. In many ways, Pakistan continues to be in permanent crisis, 'a failed state', and the apparent appellation imposed on Pakistan that it is (using a contentious and possibly derogatory compliment) 'resilient' – both its state and its people – might simply be a way of acknowledging the ability to accept and 'move on' from one crisis to another. Analytically, if we regard each new event as a 'crisis', even though it may be a similar manifestation of an earlier event, we often react to the latest event-as-crisis. The last many months of Pakistan's political economy provide an example and are instructive in finding responses to how to examine such recurring happenings.

Recent Events

Any examination of the public discourse for the last fourteen months, will highlight the fact that Pakistan's political state and economy, have been in a state of 'crisis'. There seems to be a considerable consensus on this one fact. Nevertheless, there is much disagreement if the current crises are new or have a recent history which implies that the present crises have pre-existed antecedents which suggest that the present crises are merely a continuation of earlier, and continuing, ones.

The removal of Imran Khan as Prime Minister by a fair and constitutional mechanism, the Vote of No Confidence against him and his government, was passed through Parliament as per legislative and constitutional norms and means. For those who support the party of Imran Khan, this single event was the turning point which triggered Pakistan's current multiple crises. The economy is said to have hit a serious crisis and nosedived with the removal of his government, with inflation for fiscal year 2022-23 hitting an all-time high of close to 30 percent, the Rupee devalued by approximately 37 percent, and growth collapsed from 6 percent of GDP in FY 22 to 0.3 percent a year later. At a state level, from being on 'the same page' with Pakistan's military and with the Chief of Army Staff and other senior military officials, the former Prime Minister of Pakistan has been particularly vocal about how the same Generals and their military crafted and manipulated events to oust him from office, and today those same Generals and those who have replaced them, are seen as the state's (in the former Prime Minister's view) biggest adversaries and have become partisan in their visible support for the government in power. Similarly, an institution which was perceived to be just, fair, and impartial, the Supreme Court of Pakistan, might be facing its worst crisis (in the eyes of many), for it too is perceived to be partisan. This list can be extended easily.

Yet, the claim that Pakistan's latest crisis is merely one which emanates from the constitutional dismissal of the former Prime Minister, can easily be contested by citing a longer and prior series of events which preceded this event. For example, many observers have argued that the dismissal and subsequent barring of yet another former Prime Minister of Pakistan, Nawaz Sharif, was unconstitutional and unfair and that the Supreme Court of Pakistan allegedly followed on recommendations from Pakistan's military, to disqualify and de-bar a sitting Prime Minister. Moreover, there is now substantial evidence which shows that the 2018 elections which brought Imran Khan to power, were severely rigged and manipulated to ensure that his party, with some forced allies, could form government. Furthermore, the economic crisis which is being laid at the door of the incumbent government, can clearly be found in events and decisions that were taken (and not taken) in August 2018 when Imran Khan took over as Prime Minister. Clearly, one can find numerous examples where an apparent crisis today (often referred to as the 'worst crisis in Pakistan's history'), has antecedents and has causes which show a long continuum.

The Permanent Crisis of the Elite and Ruling Classes

If one takes a much longer view of the multiple and recurring crises which affect Pakistan, as many scholars and academics have done (see short reading list below), one gets a somewhat different sense of the crisis narrative in Pakistan, where the institutions and individuals might be the same and familiar ones, but where causes and processes run deeper and longer than through a mere few characters. For many scholars, Pakistan has been in a state of crisis because of its elite – the elite-capture argument popularised recently in the public domain – and its institutions, particularly the military, a view which has been held since at least 1958. While one can differentiate institutions based on their functions and composition, the simple framing of an 'elite capture' within and outside of these institutions is of a more pervasive and permanent nature.

The elite are a pervasive and evolving entity and have played progressive and developmental roles in dozens of countries through history, even in countries like Pakistan, but in the case of Pakistan, the performance and intrusion of the elite has also caused severe disruption and catastrophe. The military elite, for example, has disrupted popular movements and democratic processes on numerous occasions since 1958, often for decades. Having recourse to huge amounts of power, force, and weaponry, it has always had an unequal and unfair advantage over civilian elites. Civilian elites, when given the opportunity to do so have, on numerous occasions, proven that their developmental interventions are more conciliatory, inclusive, and considerate of those in whose name the rule. Yet, the civilian political elite have also proven time and again, that they are as susceptible to corruption and extremely poor governance, and the public has welcomed military intrusion. The judicial elite, best represented as the Supreme Court of Pakistan, often seen as a saviour and pillar of principles and basic human rights, has also been tainted by intrigue and compromise and corruption. The business elite pampered and protected, yet also persecuted many a time, has built its empires by making alliances with the military and political elite, ensuring that SROs, tax breaks and unethical and illegal practices are allowed to continue. One can recount similar stories and examples from other elements of our elite as well.

A secular decline in Pakistan's key social and economic indicators is a clear example of the damage done to Pakistan by its elite, military, civilian, political, all. Unlike other comparable countries, also ruled and misruled by their own elite, in many important ways, they have not only improved the social, economic, and developmental profile of their people, but have also out-shone Pakistan in key indices. Some examples will underscore this point.

In 2020, Pakistan was listed in the UNDP Global Human Development Index (HDI) as the 154th country out of 189, from where it slipped to 161st in 2021. From being placed in a group of countries which were in the medium level of human development, it has since been placed in a group of countries which are in the low level of human development. Pakistan has the lowest HDI Score and ranking amongst South Asian countries, even below Nepal and Bangladesh. The per capita growth rates, as well as the GDP and export-to-GDP growth rates for countries like India and Bangladesh, have risen much faster than that of Pakistan, surpassing Pakistan in most respects. Pakistan's income inequality has become noticeably worse, as a recent UNDP Report found that the richest 20 percent of Pakistanis now hold 49.6 percent of the national income, compared with the poorest 20 percent, who hold just 7 percent, amassing more wealth. Gender disparity in Pakistan remains amongst the worst in the world as Pakistan is third lowest amongst over 160 countries.

The UNDP Report mentioned above, shows that Pakistan's military is 'the largest conglomerate of business entities in Pakistan, besides being the country's biggest urban real estate developer and manager, with wide-ranging involvement in the construction of public projects, clearly underscoring that some elites matter more than others.

Conclusions

The debates amongst economists and other social scientists -- many of whom have contributed to this volume – have been based on what currently ails Pakistan and its economy. Questions like, whether Pakistan should go (back) to the IMF – it is until 30 June in its Programme; what sort of policy will help exports – despite huge devaluation Pakistan's exports have hardly risen, and have fallen as a percentage of the GDP; how inflation should be reduced – at a time when interest rates are 21 percent and utility prices are increased due to IMF Programme requirements; how Pakistan's dismal social and human development can be improved – at a time when there is a fiscal constraint and an increasing proportion of the population has been forced to shift on the variable private sector or charity handouts. These are critical ideas and suggestions and perhaps some might help in a situation which is noticeably getting from very bad to much worse.

However, these are mere palliative measures and very few interventions, given Pakistan's current political settlement and political and elite alignment, will address underlying structural issues. Even when Pakistan has not been dealing with a current crisis, when things are less 'crisis-like', perhaps less restrictive, with a freer hand for the elites to govern, Pakistan's economic, social, human and climate developments, have been unimpressive. It is difficult to expect new results and outcomes when the same elite continues to do what it has always done in the same way, essentially, amass wealth, power, privilege and proliferate. Pakistan's many failures are clearly the consequence of the behaviour and policy of Pakistan's elite. Tinkering on the margin will only bring in marginal changes. This is especially so when the previous geopolitical arrangement existent from 1979 and then again from 2001, has now ended. The three-decade political economy arrangements in which Pakistan played a critical role and also suffered, has now ended. Given these new geopolitical changes, dealing with the IMF, China, the US, or Saudi Arabia, needs to be undertaken very differently from the way they have in the past.

More importantly, the old structures of power have shown that they are unproductive and have not achieved what they had hoped to. The entire structure and nature of Pakistan's political economy needs a complete rehaul. Perhaps this is the only alternative which has not been tried yet.

Recommended readings

The following books and publications are recommended for those who want to understand some of the themes highlighted here.

Aasim Sajjad Akhtar, ***The Struggle for Hegemony in Pakistan: Fear, Desire and Revolutionary Horizons***, Pluto Press, London, 2022.

Aasim Sajjad Akhtar, ***The Politics of Common Sense: State, Society and Culture in Pakistan***, Cambridge University Press, Cambridge, 2017.

Matthew McCartney and S. Akbar Zaidi, ***New Perspectives on Pakistan's Political Economy: State, Class and Social Change***, Cambridge University Press, Cambridge, 2019

UNDP, ***Pakistan National Human Development Report on Inequality: The three Ps of inequality: Power, People, and Policy***, New York, 2021, ***https://www.undp.org/pakistan/publications/pakistan-national-human-development-report-inequality***

Muhammad Waseem, ***Political Conflict in Pakistan***, Hurst Publishers, London, 2022

Also see the collection of recent essays in: ***https://dissenttoday.net/opinion/pakistan-is-there-a-way-forward/***

3. Federal Budget 2023-24: A Reflection on Fiscal Performance and Outlook

Muhammad Sabir

The fiscal policy is one of the most pivotal policy tools at the disposal of the government, as it plays a crucial role in shaping economic conditions, promoting growth and stabilization, addressing societal needs, ensuring fiscal sustainability, and redistribution of resources. Simultaneously, macroeconomic conditions also impact budgetary aggregates. The current macroeconomic developments have significant implications for fiscal policy and its role in redistribution and paint a bleak picture. For instance, GDP growth in 2022-23 missed its target of 5% by a big margin and is now expected to be around 0.3%. The most notable deviation is seen in large-scale manufacturing, which against the target of 7.4% growth showed a negative growth of 8%. Moreover, the economy experienced an unprecedented rise in inflation that resulted in a substantial increase in nominal GDP growth. The estimate shows massive growth of more than 26.4% against the target of 16.8% in 2022-23. It was expected that this high growth in nominal GDP may have a significant impact on fiscal policy. It can lead to higher tax revenues for the government and can reduce the tax-to-GDP ratio and expenditure-to-GDP ratio, and fiscal deficit as a percentage of GDP.

The macroeconomic developments mentioned above also have implications for the direction fiscal policy takes in the future. It was anticipated that fiscal policy for 2023-24 will focus on measures to promote moderate GDP growth while offering concrete measures to halt prevailing high inflation, offering relief packages for marginalized groups in the society, lowering the tax rate on lower middle-class salaried persons, promote exports and attract remittances. Given that the Fiscal Year 2023-24 is an election year budget, it allocates funds to stimulate economic growth and create jobs through a massive development budget, and provisions for public sector wages in the form of increased salaries.

Against this backdrop, this section provides an overview of fiscal performance in FY 2022-23 and fiscal outlook for FY 2023-24. It covers resources mobilization strategy, priorities in current and development expenditures, highlights the size of fiscal deficit, and explores the un/sustainability of fiscal deficit. Finally, it provides insights into the financing of fiscal deficit and its possible implications on inflation.

Resource Mobilization Performance and Outlook

FY 2022-23 stands out as a unique period in terms of taxation. In addition to the discretionary changes introduced in July 2022 through the Finance Act 2023, three mini budgets were announced, resulting in upward revisions of various indirect tax rates. The most significant revision occurred on February 14, 2023, when the sales tax was raised from 17 percent to 18 percent along with substantial increases made to the Federal Excise Duty (FED) on cigarettes and other items.

Initially, it was expected that collection of direct taxes, sales tax, and FED would surpass their targets. These expectations were based not only on upward revisions in tax rates but also on other fiscal and macroeconomic developments. For example, the substantial increase in debt servicing payments was expected to lead to higher direct tax revenues, as a significant portion of domestic interest payments, at least 15%, is collected as income tax. Similarly, more than 50% of bank profits are collected as corporate tax. Additionally, the anticipation was that significant inflationary pressures would result in higher prices, thus contributing to increased sales tax collection.

On the contrary, customs duties were anticipated to encounter difficulties in achieving their target due to the implementation of various policy measures, including import restrictions and a ban on the import of non-essential goods. These measures resulted in a decrease in imports, which is expected to fall below the target of US$66 billion and reach approximately US$58 billion. The significant depreciation of the PKR played a crucial role in converting the negative growth in import volume into a growth of less than 1% in terms of the PKR value of imports. However, this growth in value of imports remains considerably lower than the targeted rate of 7.8 percent.

Table 3.1 shows the Federal Board of Revenue (FBR) collection target and revised estimates for FY 2022-23 and targets for FY 2023-24. According to revised estimates, the FBR is expected to fall short of its tax target of nearly PKR 7.5 trillion by over PKR 270 billion in FY 2022-23. Contradictory to expectations, upon examining the revised estimates of tax collection, a different scenario emerges. Both income tax and sales tax, the two major tax categories, experienced significant shortfalls of PKR 188 billion and PKR 268 billion respectively. The decline in income tax can be attributed to lower real GDP growth, but the reasons for the drop in sales tax collection remain unclear.

In contrast, customs duties exceeded their target by PKR 131 billion, despite a marginal increase of less than 1 percent in imports. This outcome was unexpected and demonstrated a noteworthy overachievement. On the other hand, federal excise duty (FED) was the only tax category that stayed on the projected trajectory, surpassing its target by PKR 55 billion.

The proposed tax measures outlined in the Finance Bill 2024 paint a less optimistic picture. Despite being labeled as a tax-free budget by the Finance Minister in his budget speech, the overall tax target for the FY 2023-24 stands at an ambitious PKR 9.2 trillion, representing a substantial growth rate of nearly 28% compared to the revised estimates for FY 2022-23. The income tax measures introduced by the federal government for the FY 2023-24 appear to be relatively lenient, but they are accompanied by an ambitious target of 32% growth in income tax. Achieving such a significant increase in income tax seems overly ambitious. Similarly, the target for indirect tax collection indicates a massive 25% growth rate without any major tax measures, which also appears overly ambitious considering the performance of the current fiscal year. It appears that the government's tax collection strategy heavily relies on inflation and the growth of nominal GDP.

Table 3.1: Federal Resource Overview (PKR Billions)

	2022-23			2023-24		
	Target	Revised	Growth	Target	Growth	Share in GRR
A. FBR Tax Revenue	**7,470.0**	**7,199.8**	**-3.6%**	**9,199.9**	**27.8%**	**75.6%**
Direct Taxes	**3,039.0**	**2,850.8**	**-6.2%**	**3,758.9**	**31.9%**	**30.9%**
Indirect Taxes	**4,431.0**	**4,349.0**	**-1.9%**	**5,441.0**	**25.1%**	**44.7%**
Custom Duties	953.0	1,084.0	13.7%	1,178.0	8.7%	9.7%
Sales Tax	3,076.0	2,808.0	-8.7%	3,538.0	26.0%	29.1%
Federal Excise	402.0	457.0	13.7%	725.0	58.6%	6.0%
B. Non-Tax Revenues	**1,934.9**	**1,618.2**	**-16.4%**	**2,963.2**	**83.1%**	**24.4%**
Income from Property and Enterprise	279.6	305.4	9.2%	398.1	30.3%	3.3%
Petroleum Development Levy	855.0	542.0	-36.6%	869.0	60.3%	7.1%
SBP Pro its	300.0	371.2	23.7%	1,113.0	199.8%	9.2%
Others	500.2	399.6	-20.1%	583.1	45.9%	4.8%
Gross Revenue Receipts (GRR) (A+B)	**9404.9**	**8818.0**	**-6.2%**	**12163.1**	**37.9%**	**100.0%**
Transfers to Provinces	4,372.6	4,129.0	-5.6%	5,276.0	27.8%	43.4%
Net Revenue Receipts (NRR)	**5032.3**	**4689.0**	**-6.8%**	**6887.1**	**46.9%**	**56.6%**

Source: Federal Budget in Brief 2023-24

A disappointing aspect of the resource mobilization performance is the significant decrease in the overall tax-to-GDP ratio. Despite a target of 9.6 percent, it is expected to fall short by 1.1 percentage points, resulting in a total of only 8.5 percent. Regrettably, both direct and indirect taxes failed to meet their respective tax-to-GDP targets of 3.9 percent and 5.7 percent, with actual figures reaching only 3.4 percent and 5.1 percent, respectively. This outcome highlights a compromise on equity and progressivity, as there has been a heavy reliance on indirect taxes.

In the upcoming FY 2023-24, the tax-to-GDP ratio target has been set at 8.7 percent. However, considering the historical trend of the FBR falling short of tax-to-GDP targets and the presence of over-ambitious tax targets, there is a concern that the actual tax-to-GDP ratio might even dip below this target, potentially reaching a record-low level. There is an urgent need to reassess the tax structure, address existing loopholes, introduce automatic stabilizers, and enhance the effectiveness of the tax implementation mechanism. This serves as a critical call to action, highlighting the importance of comprehensive reforms in the tax system.

Relying heavily on indirect taxes has placed a significant burden on the country's population, particularly in the form of inflation tax. This burden is regressive and exacerbates income distribution disparities. As a result, concerns arise regarding equity and fairness within the tax system.

The shortfall in tax revenue not only presents challenges to fiscal sustainability but also raises questions about the effectiveness of the tax system in achieving equitable outcomes. Addressing these issues becomes crucial to ensure a fair and progressive taxation framework that promotes economic growth while reducing inequalities.

The non-tax revenues of the federal government make up less than one-fourth of its total collected revenues. These revenues are primarily generated from a few specific sources, including the petroleum levy, State Bank of Pakistan (SBP) profit, dividends from public enterprises, markup on federal loans, and various fees and fines. However, the revised estimates for federal non-tax revenues in FY 2022-23 reveal a significant decline of over PKR 300 billion compared to the targeted amount. In this fiscal year, the non-tax revenues for the federal government amounted to PKR 1.6 trillion, falling short of the intended target of PKR 1.9 trillion. This underperformance can be mainly attributed to a substantial decrease in petroleum development levy revenues, which only amounted to PKR 542 billion, significantly lower than the targeted PKR 855 billion.

The non-tax revenue target for the FY 2023-24 reflects a significant growth of over 83% compared to the revised estimates for FY 2022-23. However, based on our assessments, the target of PKR 2.9 trillion appears attainable, primarily due to heavy reliance on SBP profits. This profit indicates the government's fiscal deficit financing strategy, which involves monetizing the fiscal deficit by more than PKR 3.5 trillion.

Mis/management of Current Expenditures

Table 3.2 provides an overview of the federal government's current expenditure budget and revised estimates for FY 2022-23, and budget estimates for FY 2023-24. The anticipated current expenditures for FY 2022-23 are estimated to reach PKR 10.5 trillion, significantly surpassing the target of PKR 8.7 trillion by a substantial PKR 1.8 trillion. This notable deviation can be attributed to a significant increase in subsidies, with a budgetary adjustment of PKR 439 billion deviating from the targeted amount. Additionally, defence expenditures experienced a slight deviation of PKR 24 billion. However, it is the markup payments that demonstrate the most substantial deviation, exceeding the target by a staggering PKR 1.5 trillion. The markup payments for 2022-23 amounted to PKR 5.5 trillion, accounting for over half of the current expenditures.

These variations in current expenditure estimates reflect the complexities and challenges involved in managing public finances. It is crucial for policymakers to closely examine the factors contributing to these deviations and ensure the effective allocation and utilization of resources. Implementing strategies aimed at optimizing subsidy programs, evaluating defence spending priorities, and adopting prudent debt management practices can help mitigate these deviations and achieve a more sustainable fiscal position.

By carefully analyzing and addressing these expenditure patterns, the government can strive for greater fiscal discipline, enhance efficiency in resource allocation, and establish a more balanced budgetary framework that aligns with national priorities and long-term financial sustainability.

Table 3.2: Priorities in Current Expenditures (PKR Billions)

	2022-23			2023-24		
	Budget	Revised	Growth	Budget	Growth	Share
Markup Payments	**3,950.1**	**5,520.5**	**39.8%**	**7,302.5**	**32.3%**	**54.8%**
Domestic Debt	3,439.1	4,795.1	39.4%	6,430.3		48.3%
Foreign Debt	511.0	725.4	42.0%	872.2	20.2%	6.5%
Defence	**1,563.0**	**1,586.9**	**1.5%**	**1,804.0**	**13.7%**	**13.5%**
Pensions	**609.0**	**609.0**	**0.0%**	**761.0**	**25.0%**	**5.7%**
Transfers and Grants	**1,174.5**	**1,155.2**	**-1.6%**	**1,463.7**	**26.7%**	**11.0%**
Grants to Provinces	***82.0***	***82.0***	***0.0%***	***92.4***	***12.7%***	***0.7%***
Grants to Others	***1,092.5***	***1,073.2***	***-1.8%***	***1,371.3***	***27.8%***	***10.3%***
BISP	360.0	408.0	13.3%	450.0	10.3%	3.4%
Contingent Liabilities	291.0	235.0	-19.2%	280.0		2.1%
Others	441.5	430.2	-2.6%	641.3	49.1%	4.8%
Subsidies	**664.0**	**1,103.1**	**66.1%**	**1,074.3**	**-2.6%**	**8.1%**
Subsidies to WAPDA	455.0	677.0	48.8%	579.1	-14.5%	4.3%
Subsidies to KE	80.0	193.0	141.3%	315.0	63.2%	2.4%
Petroleum Subsidies	71.0	102.0	43.7%	53.6	-47.5%	0.4%
Others	58.0	131.1	126.0%	126.6	-3.4%	1.0%
Health	**19.6**	**22.5**	**14.7%**	**24.2**	**7.8%**	**0.2%**
Education	**90.6**	**91.8**	**1.3%**	**97.1**	**5.8%**	**0.7%**
Others	**637.9**	**438.8**	**-31.2%**	**792.6**	**80.6%**	**6.0%**
CURRENT EXPENDITURE	**8708.5**	**10527.6**	**20.9%**	**13319.4**	**26.5%**	**100.0%**

Source: Federal Budget in Brief 2023-24

Despite the resource crunch resulting from a lack of revenue buoyancy and a declining tax-to-GDP ratio, it was expected that the federal government will implement stringent measures to control the upward trajectory of current expenditures. However, outlook for FY 2023-24 presents a different narrative. The budget estimates for current expenditure indicate a significant increase of over 26.5%. This surge is primarily fueled by the rapid growth in debt servicing, a substantial rise of 30% to 35% in salaries, an 11% growth in grants and transfers, and a lack of emphasis on fiscal austerity. These growth rates underscore the fact that the FY 2023-24 budget is influenced by the upcoming elections, with substantial salary hikes for government employees, a significant boost in grants and transfers, and a considerable allocation for consumption subsidies in the fuel and electricity sectors.

Priorities in Federal Development Expenditure

In contrast to past practices where a significant decline was often observed, the revised estimates for federal development expenditure, and the revised estimates for FY 2022-23 indicate a notable increase of 8.3% in development expenditures compared to budget allocations. Despite the massive rise in current expenditures, focus on development has been maintained.

Table 3.3: Priorities in PSDP (PKR Billions)

	2022-23			2023-24		
	Budget	Revised	Growth	Budget	Growth	Share
Federal Ministries/Divisions	**565.0**	**562.2**	**-0.5%**	**653.0**	**16.1%**	**56.8 %**
Water Resources Division	103.5	90.6	-12.5%	99.6	9.9%	8.7%
Cabinet Division	46.2	64.0		70.1	9.5%	6.1%
Special Areas (AJK & GB)	0.0	0.0		52.6		4.6%
Higher Education Commission	42.5	26.3	-38.0%	44.2		3.8%
Merged Districts of Khyber Pakhtunkhwa	0.0	0.0		50.2		4.4%
Provincial Projects	0.0	0.0		33.0		2.9%
Housing & Works Division	24.2	14.3	-40.8%	14.0	-2.4%	1.2%
Railways Division	30.0	17.8	-40.6%	32.6		2.8%
Pakistan Atomic Energy Commission	27.0	18.9	-30.0%	26.0		2.3%
Planning, Development & Spl. Initiatives Division	19.2	6.6	-65.6%	42.2		3.7%
National Health Services, Regulations & Coordination Division	21.7	12.6	-42.0%	12.7	0.4%	1.1%
Other Federal Ministries	250.7	311.0	24.1%	175.8	-43.5%	15.3%
Corporations	**161.5**	**151.5**	**-6.2%**	**212.1**	**40%**	**18.4 %**
National Highway Authority	118.4	101.4	-14.4%	157.5		13.7%
NTDC / PEPCO	43.1	50.1	16.2%	54.6	8.8%	4.7%
ERRA and Others	**0.5**	**0.5**	**0.0%**	**5.0**	**900%**	**0.4%**
PM Initiatives	**0.0**	**0.0**		**80.0**		**7.0%**
VGF for PPP Projects	**0.0**	**73.0**		**200.0**	**174%**	**17.4 %**
Total Federal PSDP	**727.0**	**787.2**	**8.3%**	**1150.0**	**46.1%**	**100.0%**

The initial budget estimates for the Public Sector Development Program (PSDP) stood at PKR 727 billion. However, the revised estimates now reflect a higher allocation of PKR 787 billion, including an additional PKR 73 billion designated for the Viability Gap Funding (VGF) of Public-Private Partnership (PPP) projects. Moreover, the development expenditure under the Cabinet Division has experienced remarkable growth, surpassing budgetary estimates by over 58%. This exceptional expansion signifies the importance of the Cabinet Division in driving the development priorities.

Despite the prevailing resource constraints, the PSDP allocations for 2023-24 exhibit a significant growth rate of 46%. However, the pattern of expenditure growth suggests that the federal government is prioritizing election-related concerns rather than addressing economic imbalances. Notably, infrastructure allocations witness a substantial growth of 40%, with the construction of national highways being the top priority, commanding a share of over 13% in the PSDP and experiencing a remarkable growth rate of 55% compared to the revised estimates of 2022-23. Additionally, FY 2023-24 allocation includes a new allocation of PKR 80 billion for Prime Minister's initiatives. Furthermore, the PSDP allocation for Cabinet divisions has increased to PKR 70 billion, compared to PKR 46 billion budgeted in 2022-23. Taken together, these figures reflect the expansionary nature of an election-year budget.

Unsustainable Federal Fiscal Deficit

The preceding analysis brings to light several concerning issues in the financial situation of the federal government. Firstly, the actual net revenues have fallen short of expectations, while both current and development expenditures have exceeded the budgetary estimates. As a result, there has been a significant and worrisome increase in the fiscal deficit, surpassing PKR 1.85 trillion or 2.2 percent of GDP compared to the budget estimates. Official estimates indicate a staggering federal budget deficit of PKR 6.4 trillion in FY 2022-23, while our own estimates indicate a slightly higher deficit of PKR 6.6 trillion (See Table 3.4).

Of particular concern is the fact that the net revenue receipts of the federal government amount to only PKR 4.6 trillion, which is significantly lower than the total expenditure depicted in Table 3.4. This clearly illustrates that the revised federal expenditures for the year FY 2022-23 account for 237 percent of the net revenue receipts. This alarming situation implies that even the net revenue receipts are inadequate to cover the markup payments, necessitating additional borrowing to finance the remaining federal expenditure.

Moreover, it is important to note that the non-mark-up expenditures also exceed the net revenue receipts, indicating a primary deficit and underscoring the unsustainability of the current fiscal policy.

Looking ahead to FY 2023-24, the fiscal outlook reflects a scenario influenced by an election year, resulting in a larger federal budget deficit. Given the federal government's tendency to underestimate current expenditures and overestimate revenues, the projected deficit of PKR 6.9 trillion is susceptible to further slippage.

Table 3.4: Computation of Overall Budget Deficit, (PKR Billions)

	2022-23			2023-24	
	Budget	Revised	Growth	Budget	Growth
Revenue Receipts					
GROSS REVENUE RECEIPTS	9,405	8,818	-6.2%	12,163	37.9%
(Minus) Transfer to Provinces	4,373	4,129	-5.6%	5,276	27.8%
I Net Revenue Receipts	***5,032***	***4,689***	***-6.8%***	***6,887***	***46.9%***
Federal Expenditure					
Debt Servicing	3,950	5,520	39.8%	7,303	32.3%
Other Current Expenditures	4,758	5,007	5.2%	6,017	20.2%
PSDP	727	787	8.3%	1,150	46.1%
II Federal Expenditure	**9,436**	**11,315**	**19.9%**	**14,469**	**27.9%**
Federal Budget Surplus (+)/Deficit (-) | (I-II)	**-4,403**	**-6,626**	**50.5%**	**-7,582**	**14.4%**
Federal Primary Surplus(+)/Deficit (-)	**-453**	**-1,105**	**143.9%**	**-280**	**-74.7%**
III Provincial Budget Surplus/Deficit	**750**	**459**	**-38.8%**	**650**	**41.6%**
Overall Budget Surplus (+)/Deficit (-) | (I-II+III)	**-3,653**	**-6,167**	**68.8%**	**-6,932**	**12.4%**
Overall Primary Surplus (+)/Deficit (-)	**297**	**-646**	**-317.7%**	**370**	**-157.3%**
As % of GDP					
Federal Budget Deficit	-5.6%	-7.8%		-7.2%	
Overall Budget Deficit	-4.7%	-7.3%		-6.6%	
GDP (MP)	**78,197**	**84,658**	**8.3%**	**105,817**	**25.0%**

Source: Federal Budget in Brief 2023-24

A worrisome aspect is the increased reliance on borrowing from the SBP to finance the fiscal deficit. This has significant implications for monetary policy and is likely to contribute to extensive monetary expansion. The monetization of the fiscal deficit, in turn, fuels inflationary expectations and carries the risk of leading to hyperinflation if not managed effectively.

It is crucial for the federal government to address these issues and take appropriate measures to ensure fiscal discipline, accurate estimation of expenditures and revenues, and prudent borrowing practices. Failure to do so may result in detrimental economic consequences and hinder long-term financial stability.

Conclusion

The budget highlights a worrisome resource mobilization strategy, characterized by weak performance, and a substantial increase in both current and development expenditures. As a result, there is a significant fiscal deficit, deviating from the expected trajectory. This deviation raises concerns about the financial stability and sustainability of the government's financial position.

Additionally, the financing strategy outlined in the budget indicates that the federal government plans to borrow a substantial amount exceeding PKR 3.5 trillion from the State Bank of Pakistan to cover the fiscal deficit. This approach raises further concerns, especially in light of the high inflationary conditions currently prevailing in the economy.

To ensure a sustainable fiscal policy path, it is crucial to implement significant structural reforms. Specifically, reforms need to be initiated within the FBR to enhance tax collection efficiency and align it with the growth in nominal GDP. Efforts should focus on minimizing tax expenditures and improving the tax-to-GDP ratio. These reforms will help improve revenue generation, reduce the reliance on borrowing, and bring the fiscal policy on a more stable and sustainable trajectory.

The current/recurring spending of the federal government has reached an extremely high and unsustainable level. These expenses are contributing to the huge budget deficit and eroding the much-needed fiscal space for public investment and development. These need to be rationalized in a way that isolates the effect on the provision of public services to the underprivileged and marginalized. Here are some suggestions to rationalize them:

- Use efficient debt management techniques to lower the cost of debt servicing. This entails managing borrowing risks and improving debt structure while also restructuring debt from high-interest to low-interest rates. It can help governments free up financial resources for other priorities, such as public investment, social welfare programs, or reducing budget deficits.
- To encourage sustained economic growth, the federal government can shift its focus on this budget from consumer subsidies to investment subsidies. By moving subsidies from consumption to investment, the federal government can encourage businesses and people to invest in productive assets, R&D, infrastructure, and other areas that support long-term economic viability. Green energy subsidies are one such area that can significantly speed up the shift to a low-carbon and sustainable energy system.
- Rationalize government recurring spending and optimize the allocation of resources to achieve desired outcomes while ensuring fiscal sustainability.

4. Future Landscape of the Economy

Wali Ullah and Fatima Sadik

Introduction

Pakistan's economic performance in the outgoing fiscal year was nothing short of abysmal. The GDP growth target of 5% set forth at the beginning of FY 2023 remains unattained as the reported growth rate stands at 0.29%, the lowest since the V-shaped recovery from the COVID-19 pandemic in the fiscal year 2020-21. Major factors contributing to subpar economic growth include low private sector investment, high interest rates, declining credit to the private sector, deteriorating law and order conditions, and ongoing political uncertainty.

According to the yearly average figures, credit to the private sector has declined by 6.87% as compared to a 17.8% growth in the fiscal year 2021-22. This massive decline can be attributed to high interest rates. The KIBOR stood at 21.3%[1] making it difficult for businesses to finance their activities as the borrowing cost skyrocketed. The private sector investment, which grew by 27.7% in the fiscal year 2021-22, only grew by 6.2% in the outgoing fiscal year. The interest rate hike of in the last year dampened business activities and investor confidence.

The current account deficit showed signs of easing due to import restrictions as the trade deficit declined from PKR 6.089 trillion to PKR 5.24 trillion, however, the rapid depreciation of PKR against USD and mounting inflation nullified those meagre gains. Moreover, foreign exchange reserves are dwindling, leaving the country unable to pay for crucial imports. The recent floods have devastated an already crumbling economy, and there is a constant fear of defaulting on internal and external debt repayments. Considering the current economic and political situation, Moody's downgraded Pakistan's credit ratings to Caa3[2]-the lowest in the last thirty years. Moreover, Bloomberg predicted a 70% chance of recession in the upcoming months[3] (see Info Box 1).

[1] 1-week KIBOR (Avg: March 23-May 23)
[2] Poor quality and high credit risk
[3] https://www.bloomberg.com/news/articles/2023-03-15/pakistan-s-recession-risk-looms-large-amid-imf loan-talks#xj4y7vzkg

In this article we make projections of major macroeconomic indicators under three possible scenarios and discuss the ramifications of government policies and budgetary allocations for the targeted growth rates.

Assumptions and Baseline Projections Scenarios

Here, we make projections of the major macroeconomic indicators under three different scenarios for the upcoming years, i.e., FY 24, FY 25, and FY 26. The indicators include the real GDP growth, the prices, and the external sector. The common assumptions across all four scenarios are:

- The US economy's GDP growth rate, interest rate, and inflation forecasts for 2023-2026 are taken as reported by the IMF.
- Oil prices forecasts are from the Environmental International Agency
- Data for all domestic variables in 2022-23 is from the Pakistan Economic Survey 2022-23 and the website (Easy Data) of the State Bank of Pakistan (SBP).

The projections are based on the following three different scenarios:

Baseline Scenario

Under this scenario, we assume that:

- The country will not go into a political crisis like the previous year, and there will be a moderate level of rain and flood (no severe flood like the previous year) in the upcoming monsoon season (July to September 2023, 2024, and 2025).
- The US economy will grow at the rate projected by the IMF and the international oil prices will grow at the rate given by the Economics Intelligent Unit.
- The IMF program will continue.

Scenario 1- The Budget FY 23- Proposed Spending and Current Policy Rate Based Scenario

On June 9, 2023, the Government of Pakistan (GoP) released its annual budget for FY 24. The federal government has set a GDP growth target of 3.5% and an inflation target of 21%. In addition, a revenue target of PKR 6.89 trillion and a target development expenditure of PKR 950 million are set.

Despite the 40% target for FY 23, government investment has witnessed a fall of 35.78%. For FY 2023–24, public investment will grow at 33% based on the figures presented in the budget speech. Using the budget 2023-24 and the facts and figures presented in the Pakistan Economic Survey 2022–23 for the projection of the future path of macroeconomic indicators, we assume in this Scenario that:

- The Baseline optimistic scenario prevails during FY 24.
- The exogenous variables (policy variables, for instance, government expenditure, credit to the private sector, and State bank policy rate, etc.) in the model are assumed to be the same as those released in the budget 2023-24 and Pakistan Economic Survey 2022-23.

Scenario 2- The Optimal Spending and Current Policy Rate based Scenario

Here we assume:

- the Baseline optimistic scenario prevails during FY 24.
- the growth rates in the federal government investment expenditures, credit to the private sector, and policy rate during the upcoming three years are to be as follows (Table 4.1).

Table 4.1: Scenario-2 Optimal Policy Interventions

FY	Government Investment	Credit to Private Sector	Policy rate
2023-24	32.25%	20.50%	21.75%
2024-25	25.25%	15.05%	17.75%
2025-26	20.25%	12.00%	15.75%

Growth Projections of Macroeconomic Indicators

Using the scenarios defined above, the GDP, private investment, consumption expenditures, exports, imports, and price levels are projected for the upcoming three fiscal years. Using the macro-econometric model, we have estimated the growth path of major macroeconomic indicators using data from 1973-2023 for the upcoming 3 fiscal years.

GDP and its Components Growth Projections

The real GDP growth rate declined sharply from 6.1% in FY 2022 to 0.29% in FY 2023. This decline can be attributed to:

- A substantial decrease of 35.78% in government investment in FY 23, which is the largest decline since 2019.
- A significant decline in credit to the private sector of 6.87% as compared to a considerable uptake of 17.86% in the previous year.
- A high policy rate, which hampered the performance of the credit channel to achieve the targeted growth rate.
- Considering the prevailing risks and negative expectations, the private sector's investment has been further discouraged, leading to persistently low investor confidence.
- A decline in exports due to weak international demand.

As shown in Figure 4.1, in all three scenarios, the growth rate remains positive for 2023-24, staying in the range of 1.99%-3.5%, given the stated assumptions hold true. It appears that the growth target for FY 2024 will be difficult to achieve under the current budgetary allocations. Nonetheless, the targeted growth path can be realized by lowering the policy rate and enhancing access to credit for the private sector and boosting the public sector development expenditure as mentioned in Table 4.1. These measures will help increase investment and create jobs, and the resulting multiplier effect will increase output by manifolds.

Figure 4.1: Projected GDP Growth Rate

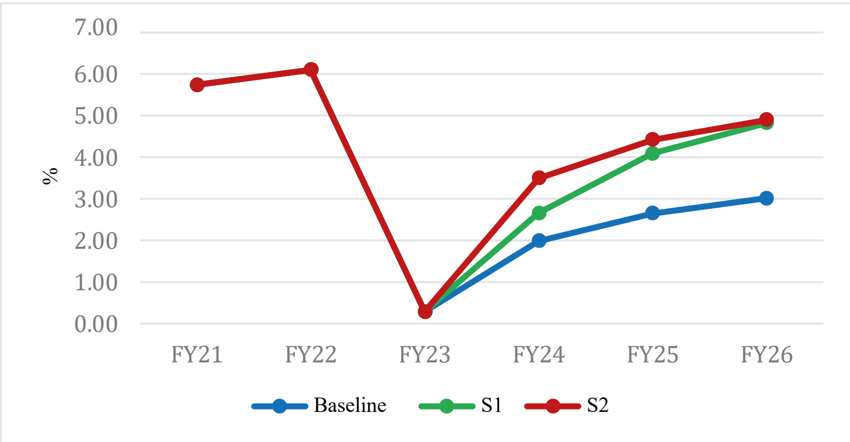
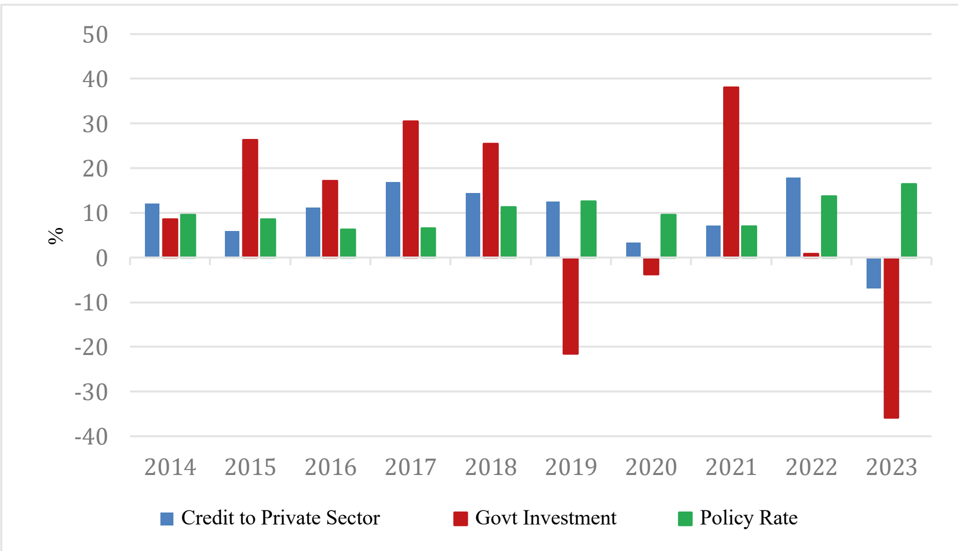


Figure 4.2: Policy Rate, Government Investment, and Private Sector Growth

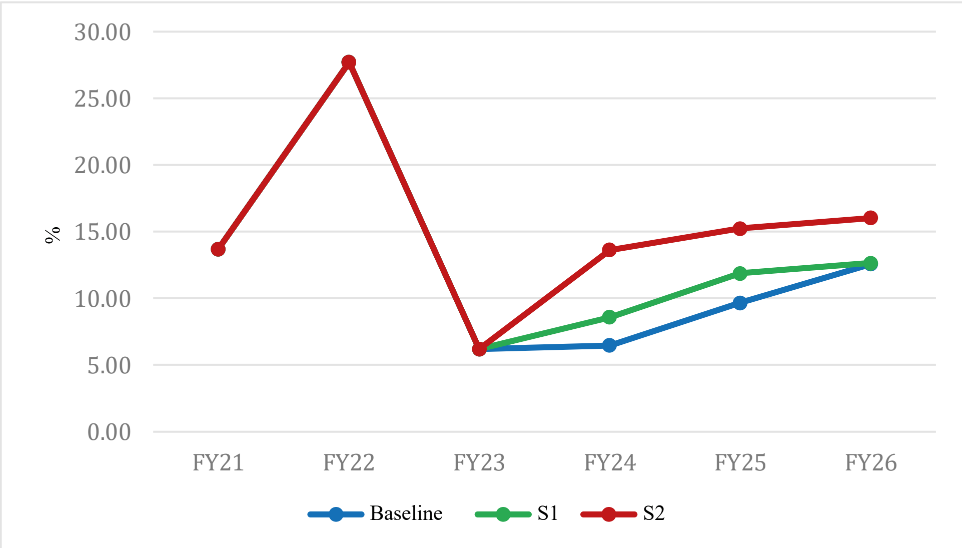


Growth of Private Investment:

Private sector investment shows a growth of 6.2% during the outgoing fiscal year, and a slightly higher growth rate of 6.48% is projected for FY 24 in the baseline scenario. However, lowering the policy rate from 21% to 19.75% will help boost the growth of private investment to 13.63%. The fall in private sector investment in FY 23 can be attributed to the following reasons:

- The lasting supply-chain disruptions caused by COVID-19, the rising global commodity prices following Russia’s invasion of Ukraine, and the unprecedented floods in Pakistan have increased uncertainty for investors.
- Limited financial inflows, depleting foreign exchange reserves, policy rate hikes, and import controls have eroded consumer and producers’ confidence.

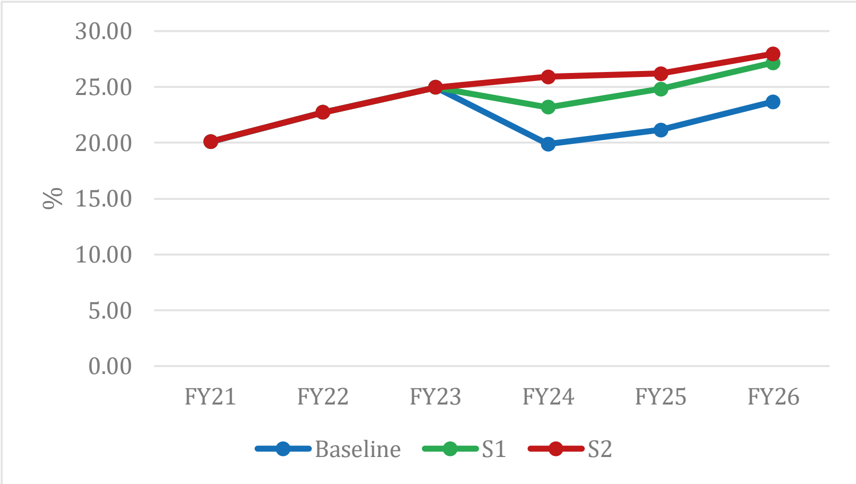
Figure 4.3: Growth Projections for Private Investment



Private Consumption Growth:

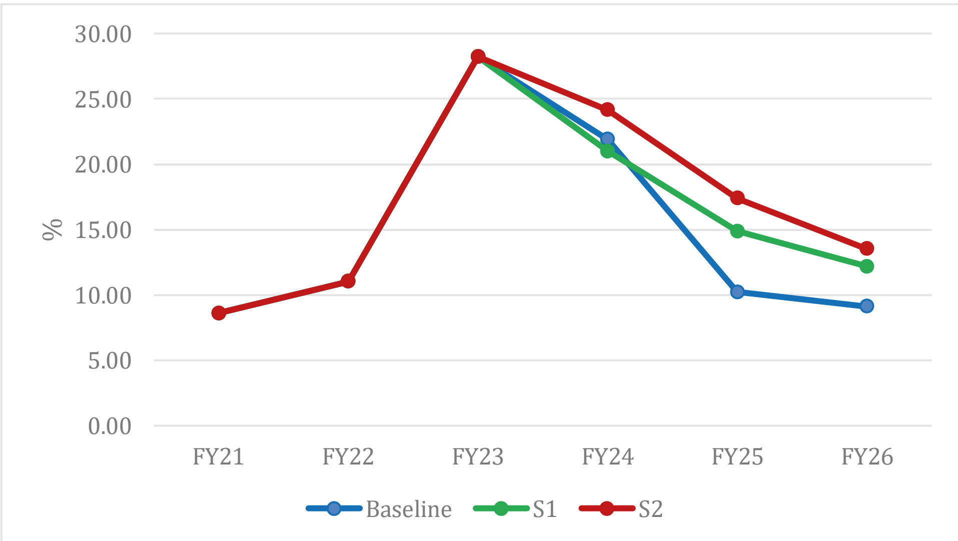
The expansionary monetary and fiscal policies following the COVID-19 pandemic increased private consumption, and the resulting stimulus in aggregate demand heated the economy. The global increase in commodity prices, high inflation, depreciation of the local currency against the USD, and demand-side pressures called for restrictive monetary and fiscal policies. Despite that, consumption growth has not changed much. Private consumption experienced a growth of 24.95% in FY 23 as compared to a growth rate of 22.72% in FY 22. The reason for the continued growth in consumption during FY 23 is cash transfers and remittance inflows. It seems that under the continuation of the current restrictive policy environment, as painted by the baseline scenario, the consumption growth would lower to 19.89% in FY 24.

Figure 4.4: Projected Consumption Growth Rate



Prices Growth Projections:

Figure 4.5: Projected Inflation Rate



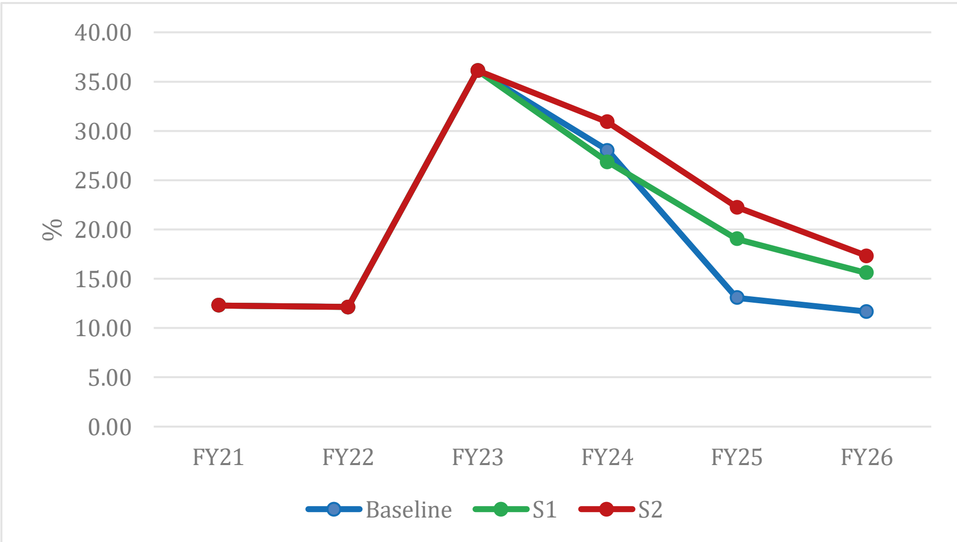
Inflation reached a record high of 28.23 % during 2022–2023—the highest level in 8 years—instead of the desired 11.5 %. Urban food inflation is even higher at 36.12%. Inflationary pressure is expected to subside owing to high interest rates and restrictive monetary policy measures under all three scenarios. Under Scenario 1, the government's targeted inflation of 21% appears achievable, however, the GDP growth rate for that Scenario is 2.6%, below the targeted rate of 3.5%.

Under Scenario 2, the inflation projection is 24.15%, higher than the targeted rate. This could be because of the following reasons:

- A decline in the policy rate
- Continued depreciation of the local currency against the USD, which nullifies the gains from a decline in global energy prices.
- Upward revision in gas and electricity tariffs, thus pushing up the cost of production.
- The demand and supply gap for food commodities increases due to rising demand and a slow opening up of supply chains, thereby leading to food inflation.

Food Inflation:

Figure 4.6: Food Inflation



Food prices in Pakistan have soared in FY 23, with wheat flour, chicken, and cooking oil prices escalating by 106.7%, 43.1%, and 34.7%, respectively. The possible reasons for the soaring prices are:

- Reliance on food imports due to domestic shortages.
- High fuel prices have made transportation expensive.
- High cost of fertilizers has increased costs for the farmers.
- Restriction on the import of soybeans, thereby increasing prices of poultry.

The projections of food inflation indicate that:

- Food inflation is expected to decline in all three scenarios, ranging from 26.87% to 30.9%. This can be realized if global oil prices continue to decline.

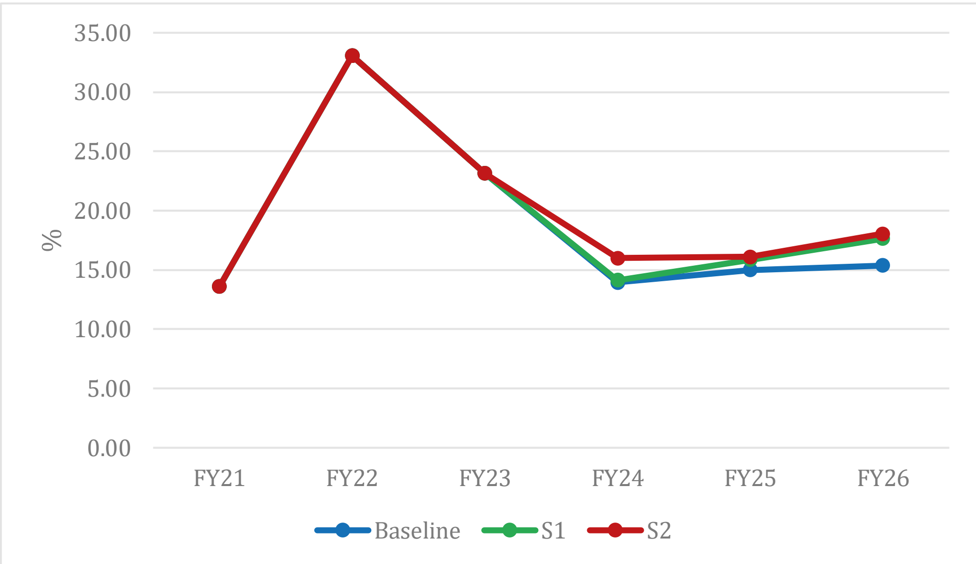
External Sector Growth Projections

Export Growth

Export growth witnessed a decline of 23.14% in FY 23 and is projected to decline in FY 24 under all three scenarios. This is because of:

- Low industrial production in the textile and food sectors. The import restrictions and depleting foreign currency reserves have hampered imports of machinery required for production. Consequently, the textile firms halted production.
- In addition to that, dampened global demand has inversely affected the demand for exports.
- Lack of diversification in exports as only cotton, leather, and rice constitute 68.1% of total exports.

Figure 4.7: Exports' Growth Projections

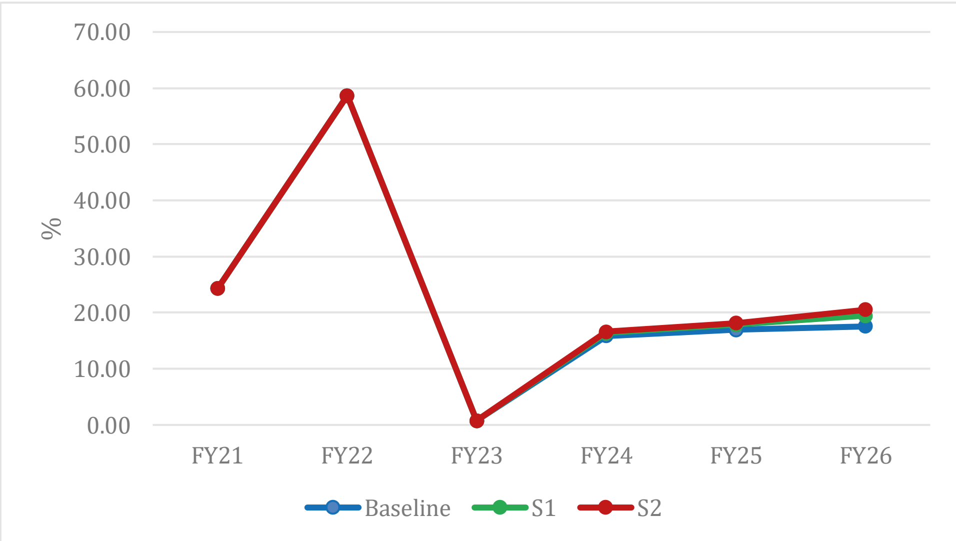


Import Growth

To preserve the foreign exchange reserves and manage the current account deficit, the government imposed import restrictions in the second half of FY 23. As a result, import growth declined sharply to 0.77% in FY 23. The projections are summarized below:

- In all three scenarios the projected import growth is similar and stands at 16.6% in FY 24. This is because of the gradual removal of restrictions on imports going forward.
- Remittance and CPEC-related inflows offset the trade imbalances, however, in the long-run import substitution and diversification of exports and finding new trading partners are required.

Figure 4.8: Imports' Growth Projections



Conclusion

Pakistan has been struggling with numerous challenges, including the lasting impact of floods, political and policy uncertainty, and dwindling foreign exchange reserves. These challenges have caused a significant economic downturn, with the country experiencing a GDP growth rate of only 0.29%, well below its target of 5%. The large-scale manufacturing and the industrial sector growth rates have contracted by 8.1% and 2.94%, respectively. Additionally, inflation has skyrocketed to approximately 28%.

The country's foreign exchange reserves have dwindled to less than $4 billion, which is insufficient to cover even a month's worth of imports. Moreover, the Pakistani rupee has depreciated by over 50% against the US dollar during FY 2023. In this critical situation, Pakistan urgently requires the release of more than $2.5 billion from a $6.5 billion International Monetary Fund (IMF) bailout program, dated to expire by the end of June 2023. The IMF funds are necessary to avoid defaulting on the piling debt and emerge from the prolonged economic crisis. Pakistan faces the conundrum of repaying over $20 billion to foreign lenders by the next spring and more than $77 billion by June 2026 with limited options at its disposal.

The targets set in the budget appear unachievable. With a high policy rate of around 22% and an inverted yield curve, the GDP growth target of 3.5% and the tax revenue target of 9.2 trillion rupees seem unattainable. The budget for FY 2023-24 presents challenges related to funding gaps, political uncertainties, and economic pressures. The government aims to strike a balance between spending and revenue collection while addressing key sectors and public concerns. However, the success of the budget hinges on effective measures to bridge the funding gap, maintain fiscal discipline, and stimulate economic growth. Maintaining the inflation target of 21% in the upcoming fiscal year will be challenging, as reducing the policy rate is not viable (as demanded by the IMF). Furthermore, obtaining such a substantial loan from the domestic market will result in exorbitant interest rate payments in the coming months, further weakening the economy.

Forecasts of major macroeconomic indicators, including GDP growth, investment, exports, and inflation, indicate that achieving the growth targets for FY 2024 and beyond is difficult with the current economic policies. The optimal policy solutions to avoid default and attain the targeted growth require a combination of fiscal and monetary measures, with increased government involvement in stimulating private investment and safeguarding the vulnerable population from rising inflation.

Our analysis recommends that government investment should grow between 30-32%, credit to the private sector should increase by 17-20%, and the policy rate should be maintained at 19.75%. Hence, it is necessary to revise the targets for the primary drivers of economic growth to attain a 3.5% GDP growth rate in the upcoming fiscal year.

However, even with the highlighted policy mix, achieving a 3.5% growth rate in FY 24 would still result in an inflation rate of approximately 26%, which Pakistan would struggle to sustain. This is due to a combination of deep-rooted structural issues within the economy, such as consumption-led growth, and external challenges like the Russia-Ukraine war, which has led to a surge in global commodity prices. Pakistan's growth heavily relies on consumption, which puts pressure on demand, price levels, and subsequently, the import bill. To achieve sustained economic growth, the government must focus on improving and preserving the country's export base and competitiveness in the volatile global environment, while also diversifying export markets.

To navigate the current economic challenges, the government should prioritize fiscal discipline and inflation management to revive the IMF program, whether it is the existing one or a new program post-budget. The budget's objective should be to prevent a balance of payments crisis, ensure a free-floating exchange rate, and align fuel prices with global rates.

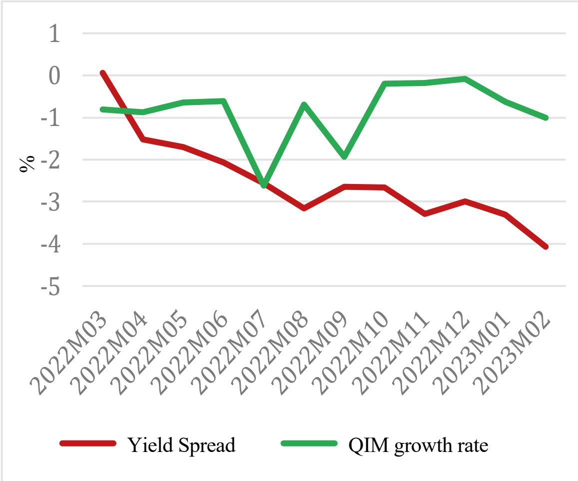
The allocation of a high budgetary amount to the Public Sector Development Program (PSDP) and the proposal of a significant increase in salaries and pensions for all employment grades seem imprudent. Instead, measures should be implemented to incentivize private investment in job-creating sectors, particularly manufacturing. There should be a focus on providing concessional loans to export-oriented sectors that struggle to finance their working capital given the high-interest rates.

Moreover, efforts should be made to broaden the tax base and implement fiscal controls. The current budget exhibits minimal expansion in taxed sectors, while expenditures increase predominantly in current expenditures, leading to heightened interest payments.

Overall, a holistic and coordinated approach is required to address the challenges faced by Pakistan's economy. This entails prudent fiscal management, strategic investment, and measures to enhance export competitiveness and diversification while safeguarding the economy against inflation and debt defaults.

Info Box 1: Assessing the Probability of Recession

A recession can be identified as a prolonged period of negative growth in GDP or industrial production of an economy. Pakistan is currently undergoing significant financial and economic stress, raising concerns about the possibility of a recession. To predict a recession, researchers often analyze various economic factors, such as the yield/term spread, which measures the difference between long-term and short-term treasury yields. An inverted yield curve, where short-term yields surpass long-term yields, is considered a warning sign of a recession. Historically, the term spread has proven effective in predicting US recessions compared to other macroeconomic variables.



The data for Pakistan as shown above reveals that the yield spread and growth in industrial production has turned negative since March 2022. Additionally, our analysis reveals that the term spread significantly explains the probability of recession in Pakistan. If the SBP continues with policy rate hikes there is over a 90% chance of a prolonged decline in industrial production-pushing the country towards a recession.

Note: Quantum Index of Manufacturing (QIM) measures the changes in production of Large-Scale Manufacturing Industries

5. Inflation in Pakistan: Is Monetary Policy Effective?

Muhammad Nasir[1]

Introduction

The national Consumer Price Inflation (CPI) in April 2023 was recorded at 36.40 percent Year on Year(YoY) with Sensitive Price Index (SPI) inflation touching 46% in the same month. The recent inflation episodes in Pakistan can be attributed to various factors. Expansionary fiscal and monetary policies implemented during the pandemic have contributed to economic overheating and inflationary pressures. More recently, however, global commodity prices, particularly for food and fuel, have risen significantly. The depreciation of the Pakistani Rupee (PKR), influenced by global financial market tightening and trade imbalances, has intensified inflationary pressures. Energy costs have also played a role, with increased global energy prices and the depreciation of the PKR leading to higher energy prices. The slow adjustment of supply to meet the rebounding demand for commodities, coupled with capacity constraints and supply bottlenecks, has added to inflationary pressures. Ongoing conflicts, such as the war in Ukraine, have caused volatility and uncertainty, affecting markets where Russia and Ukraine are significant suppliers. Weather shocks in major food-producing countries have further increased food prices. Additionally, recent floods in Pakistan have negatively impacted the agricultural sector, resulting in significant losses and disruptions to food processing, slaughtering, and logistics, thereby pushing up local food prices.

Although both demand and supply side factors contributed to the high inflation with the latter's significantly higher than the former, the government and State Bank of Pakistan have continuously attempted to control inflation through demand management policies, primarily through the monetary policy. The policy rate has increased from 12.25 percent in April 2022 to 21 percent in April 2023 – an increase of 8.75 percentage points in a period of twelve months. Yet, during the same period inflation tripled, rising from 12.7 percent in April 2022 to 36.40 percent in April 2023. This raises the question whether monetary policy is effective in controlling the current episode of inflation in Pakistan. There are, however, two parts to this question:

[1] Research assistance provided by Alishba Shoaib is gratefully acknowledged.

- Is monetary policy is effective in reducing investment and consumption spending and thereby reducing aggregate demand.
- If monetary is indeed effective in reducing aggregate demand but inflation is still on the rise, should the SBP continue to use this policy in a contracting economy given the high cost of disinflation (sacrifice ratio).

The next section discusses the transmission channels of how monetary policy could affect aggregate demand. Section 3 explores which of these channels indeed have been effective in reducing aggregate demand and inflation in Pakistan. Section 4 discusses the contractionary monetary policy, output loss, and the high value of sacrifice ratio in Pakistan. Section 5 concludes the chapter.

Transmission Mechanisms of Monetary Policy

Monetary transmission operates through multiple channels simultaneously, with their strength varying across countries based on financial market conditions. The process begins with Open Market Operations (OMOs), which impact money market interest rates and subsequently affect market interest rates through the supply and demand for money. In conventional macroeconomic models, the primary mechanism is the interest rate channel. It functions by increasing nominal interest rates, leading to higher real interest rates and user costs of capital. This, in turn, can potentially result in reduced consumption and investment. Another significant channel is the credit channel, which includes the narrow credit or bank lending channel and the broad credit channel. The bank lending channel focuses on credit market frictions, illustrating how a contractionary monetary policy reduces bank reserves, limits loan availability, and ultimately decreases aggregate spending. On the other hand, the broad credit channel considers the influence of asset prices on collateral values, affecting borrowing costs and consequently influencing consumption and investment.

The wealth channel establishes a connection between interest rates and asset prices, as an increase in policy-induced interest rates decreases the value of long-lived assets, thus reducing households' resources and leading to a decline in consumption. In open-economy models, the exchange rate channel plays a significant role by linking interest rate differentials to expected exchange rate movements. Specifically, a domestic interest rate increase relative to foreign interest rates results in a stronger currency, causing reduced net exports and aggregate demand. The expectations channel revolves around the perceptions held by the general public and investors, particularly regarding future interest rates and inflation in the economy. Market expectations regarding future short-term rates play a role in determining longer-term interest rates, which subsequently impact aggregate demand. Additionally, monetary policy can shape expectations regarding future inflation, which significantly influence the behavior of economic agents in wage and price setting, ultimately determining actual inflation. For instance, this announcement by the central bank about a tight monetary policy to control inflation alone can trigger market sentiments and prompt stakeholders to adjust their expectations, anticipating a decrease in inflation in the near term. It is important to note that these channels are not mutually exclusive, and the overall impact of a monetary policy shock depends on a combination of these channels.

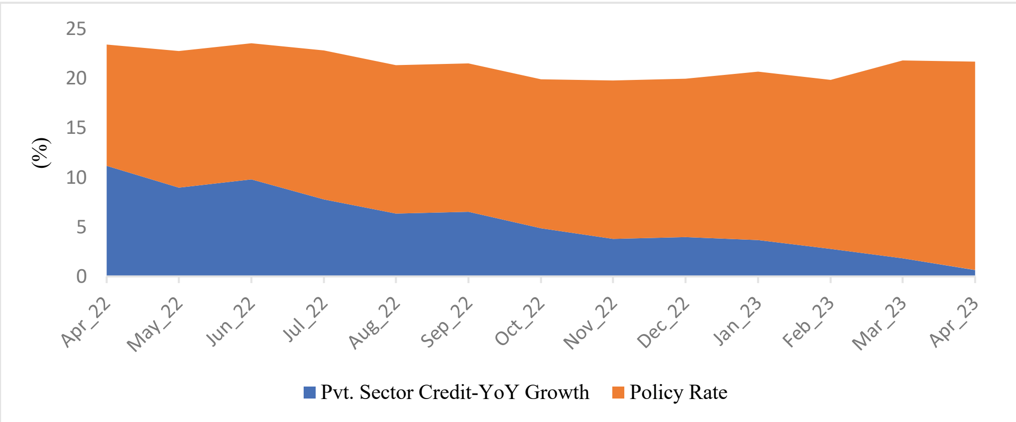
Policy Rate, Private Credit and Aggregate Demand

Previous research suggests bank lending, asset price, and exchange rate channels active although operating with different degrees of strength (Ahmed et al. 2005). We first examine the impact of policy rates on the private sector credit over the period April 22-April 23. Figure 5.1 shows the increase in policy rate has significantly reduced the growth in credit to the private sector. The credit growth was around 11 percent in April 2022 which consistently declined and reduced to less than one percent in April 2023 when the policy rate is 21 percent. Figure 5.2 further shows that while credit to private businesses and for consumer financing remained broadly stable, the net scheduled banks' credit to government sector increased by around 4.8 trillion rupees for the same period. While total loans by scheduled banks increased almost by 5.2 trillion, the majority (92 percent) went into government borrowing. This description highlights two points:

- increase in interest rate and hence the cost of capital reduces credit to private sector.
- the bank lending channel is operating in a different way.

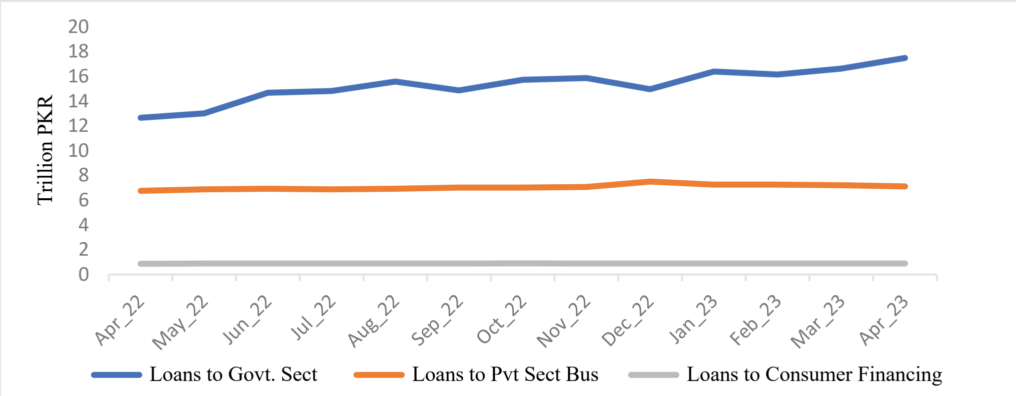
The rise in policy rate has not reduced the overall availability of loans, however, the banks have restricted their loan profiles by investing into government bonds and securities instead of loaning it out to private sector. This, on one hand, results in crowding out of private sector, while on the other, finances government large budget deficit which contributes to higher inflation thereby leaving the monetary policy ineffective in controlling inflation.

Figure 5.1: Policy Rate and Private Sector Credit (YoY Growth)



Source: Easydata, SBP

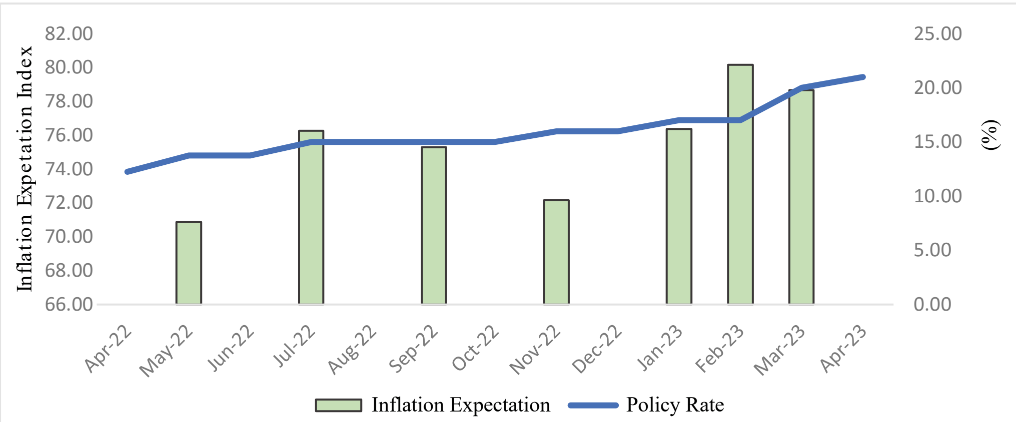
Figure 5.2: Government Borrowing, Private Sector Credit, and Consumer Financing



Source: Easydata, SBP

Figure 5.3 illustrates the relationship between the policy rate and inflation expectations. Interestingly, as the policy rate increases, inflation expectations also appear to rise. This finding contradicts the established theory, which suggests that a tighter monetary policy should result in lower inflation expectations in the market. Consequently, this discrepancy indicates that there might be a lack of clear communication by the SBP, as noted by some experts. [2] Alternatively, it could imply that the market questions the credibility of SBP in effectively controlling inflation. This skepticism does not arise necessarily due to the ineffectiveness of monetary policy, but because the market recognizes that the current inflation is primarily driven by supply-side factors that cannot be adequately addressed through demand management policies alone. Moreover, the current economic situation and the resulting default risk could also be significant contributing factors to this complex scenario.

Figure 5.3: Policy Rate and Inflation Expectations

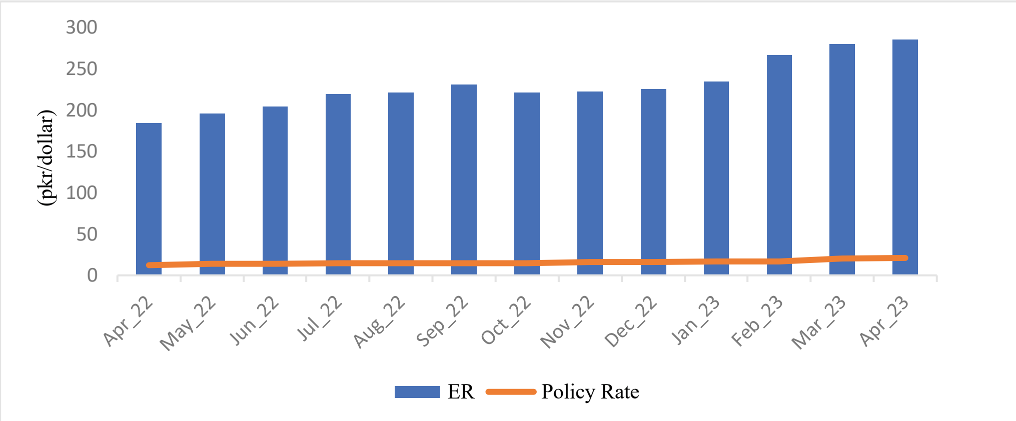


Source: Easydata, SBP

[2] https://www.dawn.com/news/1734933

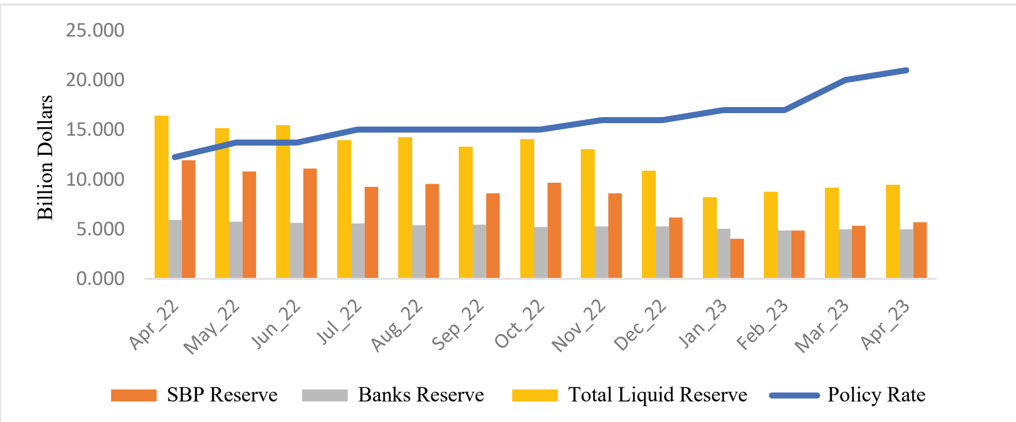
The exchange rate channel suggests that an interest rate increase relative to foreign interest rates results in a stronger currency, causing reduced net exports and aggregate demand. Figure 5.4 suggests that the increase in the policy rate did not lead to appreciation of the domestic currency. Instead, the nominal exchange rate further deteriorated from 184 to 285 during the last year. The increase in the policy rate was unsuccessful in attracting foreign investors. This is evident from Figure 5.5 which shows that net reserves of both commercial banks and State Bank of Pakistan declined resulting in the overall decrease in total liquid results. The decline in SBP reserves was steep compared to those of the commercial banks. Based on these figures we can conclude that the rise in the policy rate was not able to control the net outflow of dollars and hence this channel was ineffective in controlling aggregate demand. Instead, the deterioration of exchange rate made the imports, especially that of petroleum products, expensive thereby leading to imported inflation in Pakistan.

Figure 5.4: Policy Rate and Exchange Rate



Source: Easydata, SBP

Figure 5.5: Policy Rate and Foreign Exchange Reserves



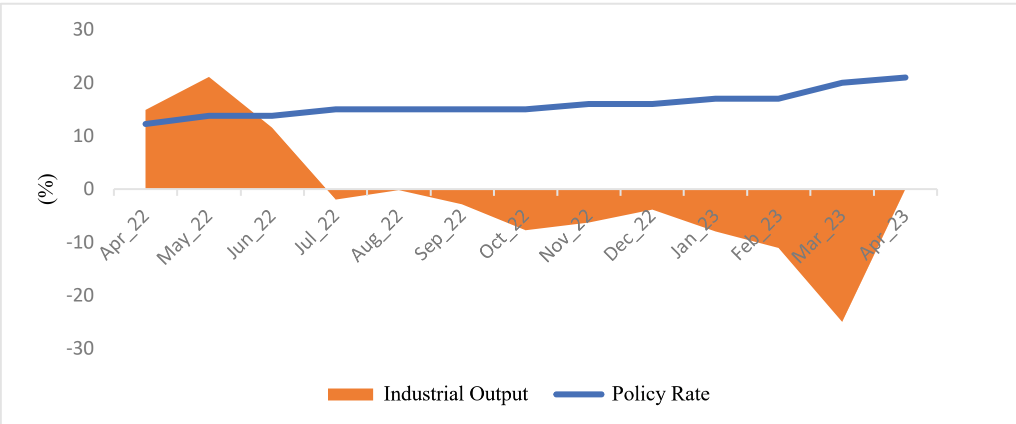
Source: Easydata, SBP

Overall, this analysis suggests that, while inflation expectations and exchange rate channels were ineffective, the interest rate and bank lending channels were effective in controlling aggregate demand. If this is true, we should see a decline in output. We will explore this next.

Policy Rate and Output Loss

If the aggregate demand is reduced, it should have led to a decrease in output. In other words, the GDP growth rate should be negative for FY23. While the recent estimate of GDP growth rate announced by the National Accounts Committee (NAC) is 0.29%, experts are skeptical about this number and believe it to be negative. In the absence of monthly GDP data, we take the monthly year-on-year growth rate of industrial production as proxy for output as it is major contributor to the national economy. Figure 5.6 shows negative growth of industrial output since July 2022 and reaching -25 percent in March 2023. This suggests that tight monetary may have resulted in reduced aggregate demand resulting in a decrease in output and therefore inflation. However, with inflation of 36.4 percent and with food inflation above 50 percent, one can see that inflation is still primarily driven by supply side factors, especially food and energy (Nasir and Malik 2011; Rehman and Malik 2010).

Figure 5.6: Policy Rate and Industrial Output



Source: Easydata, SBP

Concluding Remarks

The analysis above demonstrates that monetary policy has an impact on aggregate demand, indicating its effectiveness in that regard. However, when it comes to controlling the current inflation, its effectiveness is doubtful. This is not only due to the ineffectiveness of various monetary policy channels but also because of the underlying causes of the inflationary waves. The rising energy costs, influenced by the global energy price surge and the depreciation of the Rupee, have significantly contributed to inflation. Additionally, the government's recent efforts to reduce fiscal costs and tackle energy sector debt have resulted in a swift increase in energy prices. These measures involve phasing out subsidies and decreasing energy tax exemptions. Furthermore, the ongoing war in Ukraine has introduced further market volatility and uncertainty, particularly in sectors where Russia and Ukraine are major suppliers of agricultural products, fertilizers, and energy. Moreover, a series of adverse weather events in key food-producing nations have amplified the already high food prices. For example, recent floods in Pakistan have negatively affected the agricultural sector, causing substantial crop and livestock losses, as well as destroying essential inputs required for future production.

Considering the aforementioned discussion and the high Sacrifice Ratio of 0.662 for Pakistan (Haque and Jalil 2020), it is crucial to exercise caution when continuing the policy of increasing the policy rate. This approach would not be effective without a responsible fiscal policy in place, as a large budget deficit would compel the government to accumulate more debt. This situation, on one hand, crowds out the private sector and, on the other, elevates the risk of default, which sends worrying signals to the market. To mitigate the default risk, it becomes inevitable to complete the current IMF program or secure a new one.

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6. Trade to the Rescue: Duty-Free Access for Pakistan's Exports

Aadil Nakhoda and Qazi Masood Ahmed

Introduction

Pakistan faces a significant challenge in terms of increasing its exports. Given the size of its economy, its exports are dismally low. The balance of payments crisis that repeats every few years is driven by the trade deficit, which many experts believe arises due to the lack of exports. Tariff concessions, such as duty-free access into major export destination markets, can help increase exports from Pakistan. In recent years, Pakistan has received preferential duty-free access from China and the European Union (EU) on several of the goods it exports. Furthermore, Pakistani exporters face tariffs on their exports to the United States (US) and lowering them can help alleviate balance of payment concerns. The US is Pakistan's largest export destination, followed by China, with $6 billion exported to the former and $3 billion to the latter in 2021[1]. This chapter focuses on an alternative to the provision of export subsidies, which have not only cost the Pakistani economy billions of rupees each year but have not necessarily translated into higher exports.

An exporting country that negotiates for lower tariffs must account for the level of trade creation, which is defined as the change in the value of goods imported as the price of the good changes due to a tariff; and the level of trade diversion, which is defined as the substitution away from exporters who continue facing higher tariff rates. For instance, the value of trade diversion is the value of exports substituted away from Bangladesh if Pakistan is to receive duty-free access into the US market. It is reported that Pakistan will benefit, by our estimates more than $1.2 billion in terms of trade creation, from tariff reductions offered by the United States. However, benefits

[1] Further, according to International Trade Centre's, Trademap.org, the US exported more than $1 billion worth of raw cotton to Pakistan in 2022, up from $86 million in 2014. US raw cotton is likely to be an important input in Pakistani finished textile products.

from further tariff reductions by China will be limited mostly to rice as it is the only product of significant value that is currently subjected to an import tariff[2]. This study considers the value of trade creation and trade diversion if duty-free access is provided to Pakistani exporters by the United States and China on the complete set of products exported by Pakistan. It is a useful exercise in determining the losses from not having duty-free access in certain products to major export destinations. The implications of the findings reported in this study not only hold significance for the commerce and finance ministries but also for the foreign ministry due to the long-standing diplomatic and trading relationship with both the US and China.

Methodology

Trade Creation

Laird and Yeats (1986) provide the concept to build the methodology below. The equations are formed using the information provided in the United Nations Economic and Social Commission for Asia and the Pacific (UNESCAP) User Guide and Explanatory Note for Trade Intelligence and Negotiation Advisor[3].

The formula for trade creation is:

$$TC_{ijk} = \Delta t_{ijk} * \varepsilon_M * \frac{M_{ijk}}{t_{ijk}\left(1 + \frac{\varepsilon_M}{\varepsilon_S}\right)}$$

where TC_{ijk} is the value of trade created if existing tariff rates are reduced to zero for exporter *i* by importer *j* for product *k*. Δt_{ijk} is the change in the tariff rate imposed by importer *j* on product *k*. t_{ijk} is the existing tariff rate, ε_M is the elasticity of imports with respect to domestic price and ε_S is the elasticity of export supply with respect to export price. The estimates for elasticity of import demand are provided by the UNESCAP, while ε_S is set to an infinitely large number, $9.\overline{99} \times 10^{15}$.

Trade Diversion

The formula for trade diversion is:

$$TD_{ijk} = M_{ijk} * \left(\frac{\gamma_{ijk}}{M_{ijk} + \gamma_{ijk}}\right) * \beta * \sigma$$

[2] Pakistan has an existing free-trade agreement with China which offers its exporters duty-free access into Chinese market on several products. Some products remain excluded from duty-free access. It is expected that Pakistan can still create more than $160 million in exports to China if exports of rice from Pakistan is provided duty-free access into the Chinese market.

[3] The authors are grateful to the researchers at the Trade Policy and Facilitation Section, Trade, Investment and Innovation Division, UNESCAP for providing the key formulas to calculate the values for trade creation and trade diversion.

where σ, elasticity of substitution across products from different sources, is defined as 1.5 and,

$$\gamma_{ijk} = \sum_k M_{ijk} - M_{ijk}$$

$\sum_k M_{ijk}$ is total imports in product k and M_{ijk} is imports from exporter i to importer j in product k[4].

Data

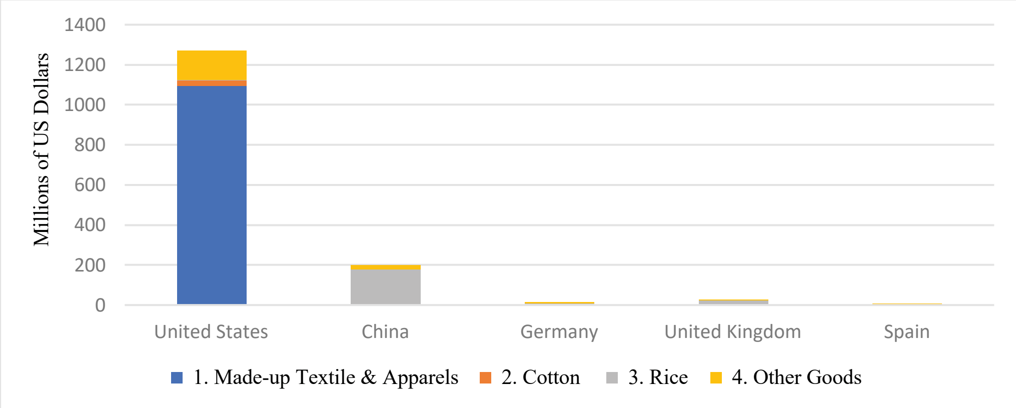
The data on tariffs and import values is extracted from World Bank's World Integration Trade Solution (WITS). The data is available for bilateral trade at the HS six-digit level. The data is collected on the imports of China, the United States and the all the export destinations of Pakistan[5]. The data on trade values to calculate the revealed comparative advantage (RCA) and the cumulative share of exports is borrowed from CEPII's BACI dataset. The import demand elasticities are borrowed from the UNESCAP's database on the import demand elasticity[6]. The results are averaged for 2020 and 2021 as exports from Pakistan suffered from volatility due to challenges related to the pandemic, decreasing in 2020 and increasing by approximately 30% in 2021.

Results

The amount of trade created if duty-free access is provided by the trading partners of Pakistan on the exports of its products is presented in Figure 6.1. The export destination markets are sorted according to the total imports into the trading partner from Pakistan. The United States is the largest export destination, followed by China and Germany. More than $1.2 billion worth of exports from Pakistan can be generated if duty-free access is provided to Pakistani exporters to the US market. As China and the EU, of which Germany is a member country, already provide duty-free access to Pakistan on majority of its tariff lines, the value of trade created due to further concessions is likely to be minimal. The United Kingdom also provides similar duty-free access to Pakistani exporters as the EU. As the number of existing exports from Pakistan to China, UK and EU in products not receiving tariff concessions is low due to the preferential tariffs, the potential to create trade from duty-free access is also likely to be minimal. However, certain products do stand out as tariff concessions are still possible. The following analysis will focus on the exports of Pakistan to the United States and China.

[4] The derivation of β is available on request.
[5] As some countries may use older HS classifications for reporting their trade values, correspondence tables are used to match the product codes.
[6] Utoktham et al. (2020) provides the technical notes for the calculation of the import demand elasticities.

Figure 6.1: Trade creation from duty-free access to Pakistani goods across top export destinations



The value of total trade diverted from the specific trading partners if Pakistani exporters were awarded duty-free access to the US and the Chinese markets is presented in Figure 6.2. The products are categorized according to the major product categories and the trading partners are sorted according the to the level of exports from them to the US and China. Approximately $140 million worth of exports from China will be diverted, while $90 million worth of exports from India and $50 million worth of exports from Vietnam will be diverted if the US awards Pakistani exporters duty-free preferences. Similarly, approximately $20 million worth of exports will be diverted from Vietnam and Thailand if China is to award duty-free access to Pakistani exporters. While made-up textile and apparels dominates total trade diversion if the US was to provide duty-free access, rice dominates if China was to provide duty-free access to Pakistani exporters.

Figure 6.2: Trade diversion from duty-free access to Pakistani goods into the United States and China

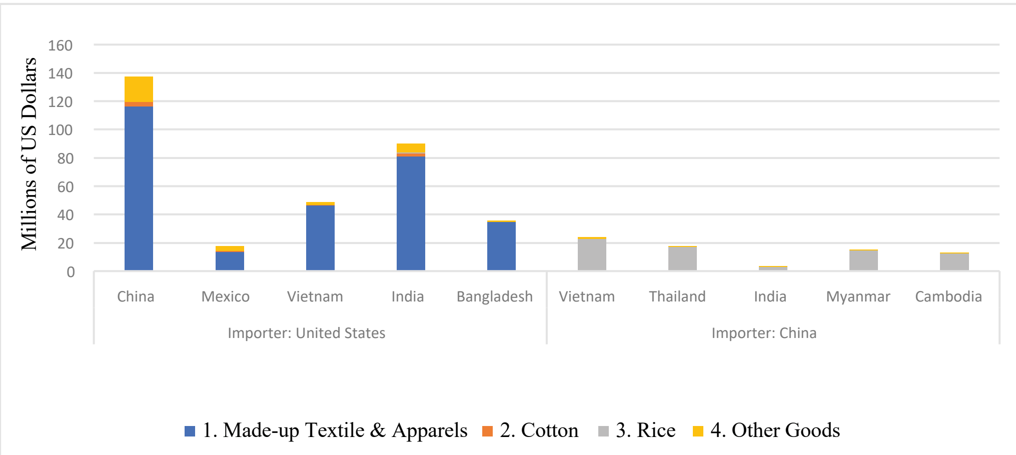
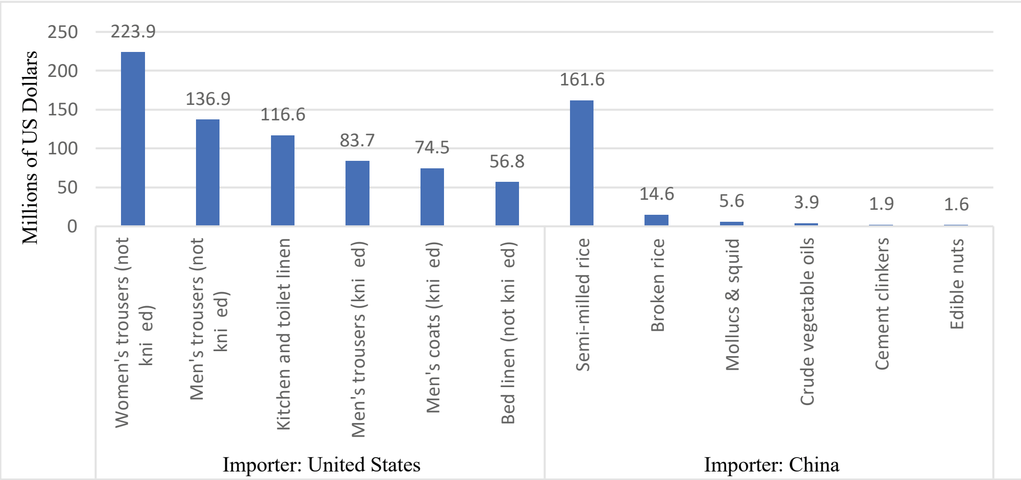
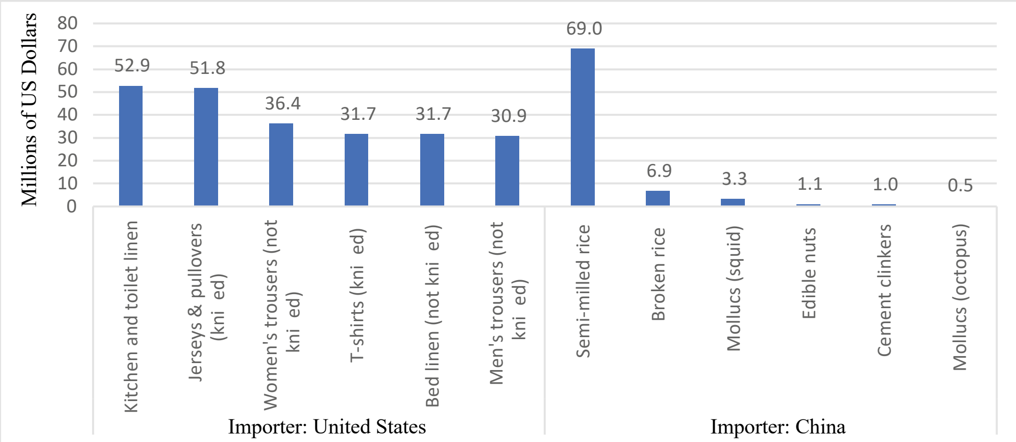


Figure 6.3: Trade creation from duty-free access to Pakistani goods into the United States and China (product-level)



The products that report the highest value in terms of trade creation if duty-free access is provided to Pakistani exporters by the US and China are listed in Figure 6.3. The top six products for which the largest value of trade will be created if the US provides duty-free access to Pakistani exporters are women's trousers, not knitted (HS 620462) at $224 million, men's trousers not knitted (620342) at $137 million, kitchen and toilet linen (HS 630260) at $117 million, men's trousers, knitted (HS 610342) at $84 million, men's coats, knitted (HS 610120) at $75 million and bed linen, not knitted (HS 630221) at $57 million. Comparatively, the value of trade creation for exports to China is limited. Semi-milled rice (HS 100630) is the only product that reports substantial value, at $162 million, as China continues to impose significant tariffs on the imports of rice. All other products report less than $15 million. However, there is a wider range of products ranking within the top six products benefitting from duty-free access into the Chinese market. This is unlike that of the exports to the US, which are heavily concentrated in textile products.

Figure 6.4: Trade diversion from duty-free access to Pakistani goods into the United States and China (product-level)

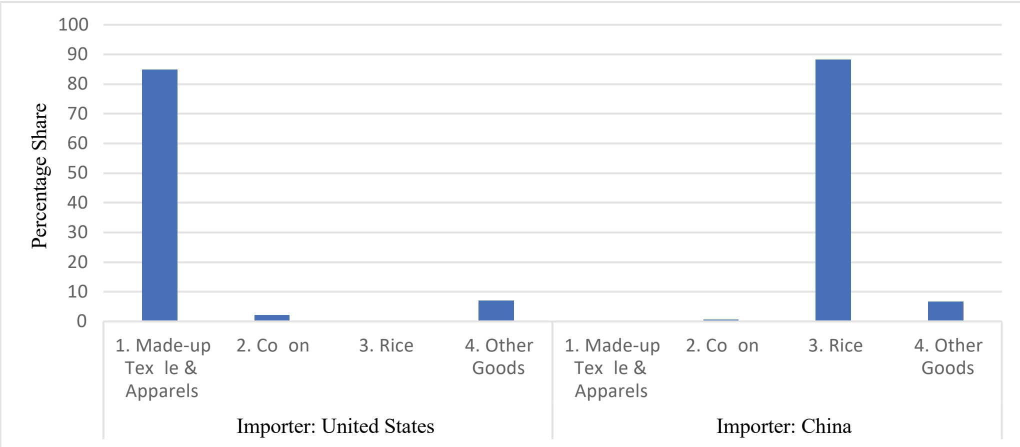


The products that report the highest value in terms of trade diversion if duty-free access is provided to Pakistani exporters by the US and China are listed in Figure 6.4. $53 million worth of trade will be diverted towards Pakistan in kitchen and toilet linen (HS 630260), of which $29 million will be diverted from India and $14 million from China. $52 million worth of trade will be diverted towards Pakistan in jerseys and pullovers, knitted (HS 611020), of which $12 million will be diverted from Vietnam, $9 million from China and $4 million from Indonesia and Cambodia. $36 million worth of trade will be diverted towards Pakistan in women's trousers, not knitted (HS 620462), of which $8 million will be diverted from Bangladesh and China. $32 million worth of trade will be diverted towards Pakistan in T-shirts, knitted (HS 610910), of which $4 million will be diverted from Honduras and Nicaragua. $32 million worth of trade will be diverted towards Pakistan in bed linen (HS 630231), of which $22 million will be diverted from India and $6 million from China. $31 million worth of trade will be diverted towards Pakistan in men's trousers (HS 620342), of which $10 million will be diverted from Bangladesh and $5 million from Mexico. Considering the imports into China from Pakistan, $69 million worth of trade will be diverted towards Pakistan in semi-milled rice (HS 100630), of which $20 million will be diverted from Vietnam, $17 million from Thailand, $14 million from Myanmar and $13 million from Cambodia. $7 million worth of trade will be diverted towards Pakistan in broken rice (HS 100640), of which $3 million will be diverted from Vietnam.

Although, the total trade diverted away from the trading partners is insignificant compared to the value of trade already taking place in each product, this exercise shows from where competing forces are likely to originate if Pakistan is to be provided duty-free access. This is important for policymakers as they may find main competitors pursuing similar policies with the US and China.

The key message is that Pakistan can benefit by developing better trade linkages with the US, considering that trade is a viable alternative to aid. This chapter highlights the potential increase in exports to the United States and China from Pakistan from the elimination of import tariffs on all products.

Figure 6.5: Share in trade creation of products reporting RCA of more than 1 from Pakistan and low export contribution into importing country (by-product type)



The share of the product categories which are more likely to create trade given that the products considered have a revealed comparative advantage of more than 1 in Pakistan and that the products imported into the US and China rank in their respective bottom quantile in terms of exports originating from the importing countries is presented in Figure 6.5. Graham et al. (2018) considers similar proxies. The position in the bottom quantile in terms of the exports value generated by the product in the importing country is a proxy for the level of domestic production in the importing country. Duty-free access can be more easily negotiated for products that are less likely to be produced and exported by the importing country. Out of the total trade created from duty-free access, more than 90 percent of the trade created will be in products that satisfy the above conditions. The products predominantly belong to the made-up textile and apparel category if the US is to provide duty-free access, while rice products report the same if China is to provide duty-free access. In essence, the biggest beneficiaries of duty-free access will be the textile exporters to the US and rice exporters to China. Unfortunately, due to the current structure of exports from Pakistan that lacks diversification, the benefits from duty-free access to Pakistani exporters will be limited to only a select few products in each export destination market. The remaining share of goods that either do not report RCA of more than 1 or rank in the bottom quantile for exports originating from the importing country are not accounted for in Figure 6.5.

Conclusion

In conclusion, there are significant gains if Pakistan is to negotiate for duty-free access to the US and China, even for a limited number of goods. These are some of the low hanging fruits to increase exports particularly at a time when Pakistan requires external financing to avert its deepening balance-of-payment related crisis. A deeper study that not only lists the major products on which negotiations should be prioritized with the US and China but also lists the major competitors in the global market can aid policymakers and businesses in Pakistan as they strive to increase exports from Pakistan.

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7. Downward Spiralling Business Confidence Index

Aadil Nakhoda and Qazi Masood Ahmed

Introduction

Policymakers commonly use the Business Confidence Surveys (BCS) to guage the perceptions of the business community and understand the conditions prevailing in the economy. In Pakistan, the BCS is conducted by the State Bank of Pakistan (SBP) in collaboration with the Institute of Business Administration (IBA), Karachi. Since August 2018, it has been carried out as a bi-monthly telephonic survey conducted in the even numbered months of the calendar year. Since February 2023, it has been conducted as a monthly survey. This change was made to better facilitate the economic policymakers given the volatility in the economic environment.

The survey targets firms belonging to the manufacturing, construction, financial services, retail and wholesale and services sectors across Pakistan. More than 500 firms are surveyed in every wave. The sample of firms was extracted from the business registry provided by the Securities and Exchange Commission of Pakistan (SECP). Firms with the highest paid up capital within selected sectors were selected.

The businesses surveyed share their perceptions on the current and expected (in the next six months) performance of the economy via several different indicators. Although all indicators provide critical information to policymakers, this study will focus on the following indicators:

- Current Business Confidence index (CBCI)
- Expected Business Confidence Index (EBCI)
- Business Confidence Index (BCI)
- Current Employment Index (CEI)
- Expected Employment Index (EEI)
- Purchasing Manager Index (PMI) and
- Inflation Expectations Index (IEI)

The details of these and other indicators are available on SBP's website under the Business Confidence Survey[1]. In the analysis that follows, the trend in the above BCS indicators are compared to those of major indicators on economic activity that are easily available, namely Large Scale Manufacturing Index (LSMI) and exporting activities.

The Methodology:

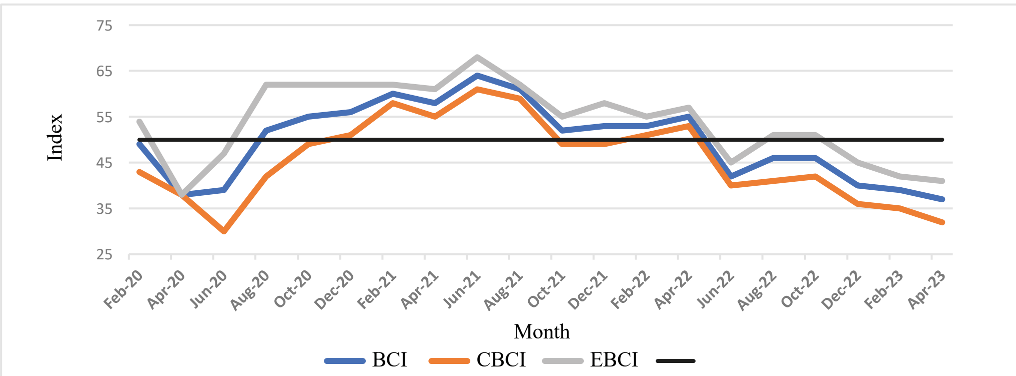
The results of the Business Confidence Survey are reported in the form of a Diffusion Index (DI), which is calculated based on the answers received on each indicator. The diffusion index shows the tendency of the respondents about a particularly aspect gauged in a survey. The responses are collected on the basis of five options, ranging from 'very positive' to 'very negative'. The DI falls between 0 and 100, with 50 indicating a neutral perception, greater than 50 indicating a positive perception and less than 50 indicating a negative perception.

Main Results

The DI for major indicators are presented in Figure 7.1 -Figure 7.4. These include the Business Confidence Index, Employment index, the PMI and the Inflation Expecations Index.

Figure 7.1 presents the trend of the current and expected economic and business conditions using the CBCI, EBCI, CEI EEI. Literature suggests that if the perceptions on the economy hold and are a good predictor of the actual conditions, the trend in the BCI should follow the trend in indicators that account for the actual level of production, i.e., LSMI and the exporting activities are likely to show similar trends as the BCI. BCI as determined in the SBP-IBA Business Confidence Survey does follow a similar trend to the LSMI and the level of exports from Pakistan. The data on the quantum index of Large Scale Manufacturing industries (base year 2015-16) and on total exports from Pakistan and total imports into Pakistan is borrowed from Pakistan Bureau of Statistics (PBS). The time period considered is February 2020, when the COVID-19 pandemic was about to hit the world economy, to April 2023[2].

Figure 7.1: Business Confidence in Pakistan between February 2020 and April 2023

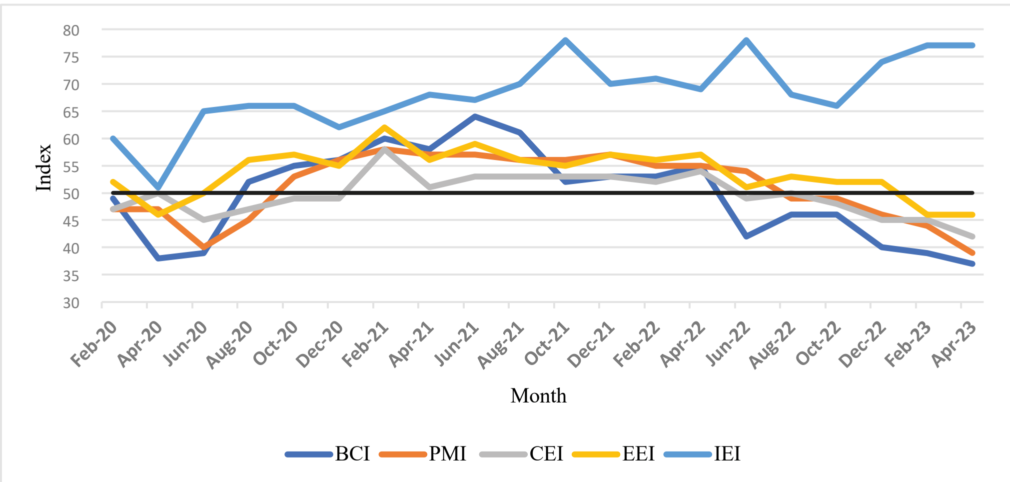


[1] The website can be accessed through the following url: https://www.sbp.org.pk/research/BCS.asp

[2] It is not the purpose of this exercise to econometrically prove the validity of the BCI. The main purpose is to present the BCI and report on its trend along with that of major indicators on economic activity.

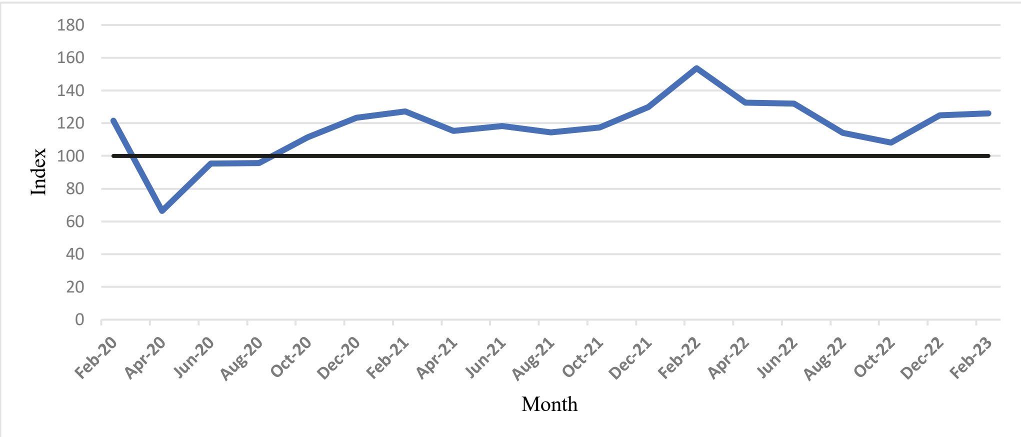
The BCI, which is the average of the current BCI (CBCI) and the expected BCI (EBCI), was slightly below 50 (at 49) in February 2020, right before the nationwide lockdown due to COVID-19. It fell more into the negative zone in the next wave as the lockdown imposed in order to curtail the spread of the pandemic decreased the business confidence. The trough bottomed out in June 2020 and recovered into the positive zone in August 2020. While the EBCI was quick to recover as the government announced several incentives for the business sector during this period, the CBCI was slower to recover. It entered the positive zone in December 2020. However, once the economy recovered from the COVID-19 pandemic related shock, the BCI remained in the positive zone till April 2022. This suggests improved confidence of the business community in the economic conditions between August 2020 and April 2022. The BCI peaked in June 2021, when all the three indices reported a value above 60. Several of the incentive schemes provided by the government to counter the slowdown as a result of the pandemic had matured by then. It started a downward trend at the start of fiscal year 2022. Further, as noted in Monetary Policy Statement release in Septemeber 2021, the SBP had shifted towards policies that sustain growth rather than enhance it, and keep inflation expectations from rising and consequently decrease the pressure on the current account. The most interesting aspect has been the EBCI, which has remained in the positive zone for much of the period between February 2020 and April 2022. However, the BCI has mainly remained in the negative zone since June 2022 mainly due to administrative measures introduced to curtail the current account deficit and the uncertain political environment. The CBCI hit low 30s, which is similar to the level it had decreased to during the midst of the COVID-19 lockdown. However, it is more disconcerting that the EBCI had decreased to 41 in April 2023, the lowest level reported since the lockdown. This clearly indicates that the perception of the business community on the economy currently not only remains negative but the business community also believes that there is little respite from the economic challenges in the upcoming six months.

Figure 7.2: Recent trend in selected indicators suggesting the level of confidence in the economy



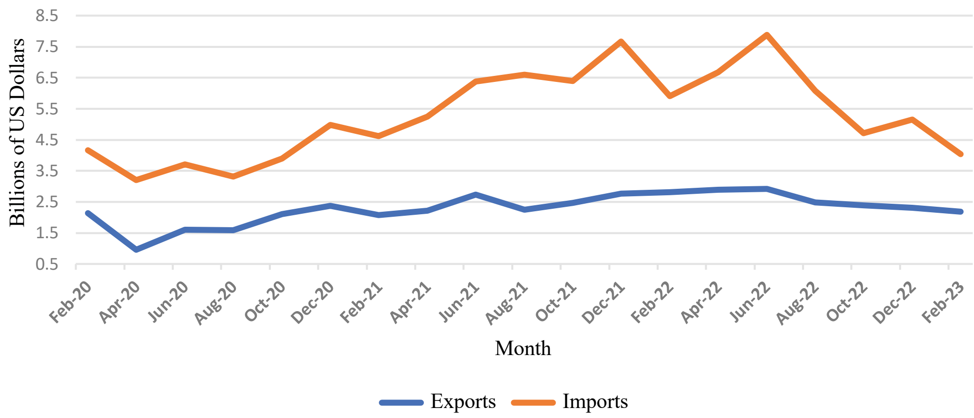
The recent trend in the BCI, the PMI, CEI, EEI and IEI is presented in Figure 7.2. The trend in the PMI and the employment indices are correlated with the BCI. However, the IEI at 77 in April 2023, is almost as high as it was in June 2022 when it peaked at 78. The IEI had decreased to 50 in April 2020, when the lockdown was imposed. It has since increased gradually, remaining mostly above 70 since October 2021. Further, it is important to mention that CEI and EEI along with PMI were all reported to be in the negative zone in April 2023. EEI was the quickest to recover after the lockdown was lifted in April 2020 and remained in the positive zone till December 2022. The current indicators suggest not only poor business confidence but also poor confidence in creating employment in the next six months. With IEI rising and the inability of firms to generate employment in the next six months, the conditions do look ominous as shown by the business confidence survey.

Figure 7.3: Large-scale manufacturing industries index between February 2020 and February 2023



The trend for the LSMI (base year 2015-2016) (LSMI) is reported in Figure 7.3. The LSMI index decreased to a low of 66 in April 2020. It recovered to more than 100 in October 2020. Since then, the index has remained above 100. However, it peaked at 154 in February 2022. It decreased to 108 in October 2022. It has recovered to 126 in February 2023. The recovery post-lockdown, peaking in February 2022, and the decline in the index that followed characterizes the recent economic conditions in Pakistan. The LSMI index is closely related to the indices reported in the BCS. The loss in confidence also suggests the loss in output of major industries. Although, it can be said that the index in February 2023 is higher than the index in February 2021, it is unlikely the trend in LSMI index will recover to the extent it did in 2021 when economic activities and the business confidence had mostly improved.

Figure 7.4: Exports from Pakistan and imports into Pakistan between February 2020 and February 2023



The trend in the exports from Pakistan and imports into Pakistan is reported in Figure 7.4. Exports from Pakistan had posted a strong recovery after the nationwide lockdown was lifted in April 2020. The exports from Pakistan in April 2020 was at a dismal $957 million. It peaked at $2.9 billion in June 2022. Between October 2021 and August 2022, exports mostly remained above $2.5 billion each month. Exports in FY22 surpassed $31 billion. The incentives provided to the export-oriented industries after the COVID-19-induced slump provided exports with a crucial impetus. Exports have declined since their peak in June 2022, reaching $2.1 billion in February 2023. The low levels of business confidence have reduced exporting activities from Pakistan. Imports into Pakistan have suffered immensely during the recent months. The balance of payment crisis has resulted in several administrative measures in recent months to reduce the pressure on the meagre foreign exchange reserves from import payments. Coupled with the reduction in economic activities and loss in business confidence, imports into Pakistan have decreased from their peak of $7.8 billion in June 2022 to $4 billion in February 2023. Imports were reporting an upward trend as the economic conditions and business confidence improved between August 2020 and December 2021. Imports were at $3.3 billion in August 2020, increasing to $7.7 billion in December 2021. There was a slight downturn as it fell below $6 billion in February 2022 but increased again till June 2022. Administrative measures were imposed at the start of the FY23 to drastically reduce imports, which led to its decline. Such has been the trend since June 2022 as shown in Figure 7.4. The continued decline in imports highlights the lack of demand and the lack of economic activities in Pakistan.

Conclusion

The BCI recovered strongly once the lockdown was lifted. As the stimulus packages offered to counter the challenges due to COVID-19 began to take effect, it remained mainly in the positive zone. However, the business confidence took a hit in June 2022 as the country became deeply engulfed in political turmoil. The lack of certainty on the external front, with the delay in approaching the IMF for crucial financing, exacerbated the conditions. The EBCI has always performed more positively than the CBCI. Other than the BCI; CEI,IEI and PMI have also been in the positive zone since late 2020. However, they are now all in the negative zone since early 2023. IEI has also risen. The business community felt confident about their hirings and their purchases, suggesting good business prospects in the economy for most of 2021. The conditions persisted till early 2022. The LSMI and the exporting activities from Pakistan were also showing an upward trend, particualrly in late 2021. However, the indices report a downturn since mid-2022. This correlation highlights that the BCI does well in explaining the economic trend in Pakistan, even during political turmoil. ***The Business Confidence Index published by the State Bank of Pakistan in collaboration with Institute of Business Administration, Karachi is an excellent tool for economists, policymakers and analysts as it does well to determine the prevailing economic conditions.***

Key points

The BCI (BCI), which is the average of the current BCI (CBCI) and the expected BCI (EBCI), remained in the positive zone between June 2020 and April 2022. It has fallen into the negative zone since June 2022. The EBCI has always performed more positively than the CBCI.

Other than the BCI, the employment index and the Purchasing Manager Index have both been in the positive zone since late 2020 but are now in the negative zone. The business community felt confident about their hirings and their purchases, suggesting good business prospects in the economy for most of 2021. However since mid-2022, all major indicators suggest poor levels of confidence.

The LSMI and the trading activities from Pakistan were also showing an upward trend, particualrly in late 2021. The indicators have shown a downward trend in 2022, particularly in the last half of the calendar year. This suggests that the BCI does well in explaining the economic trend in Pakistan as it correlates well with the trend in LSMI index and exports, particularly in explaining the recovery post COVID-19 lockdown and in the last twelve months.

8. Circular Debt and Viability of the Energy Sector

By Amir Jahan Khan

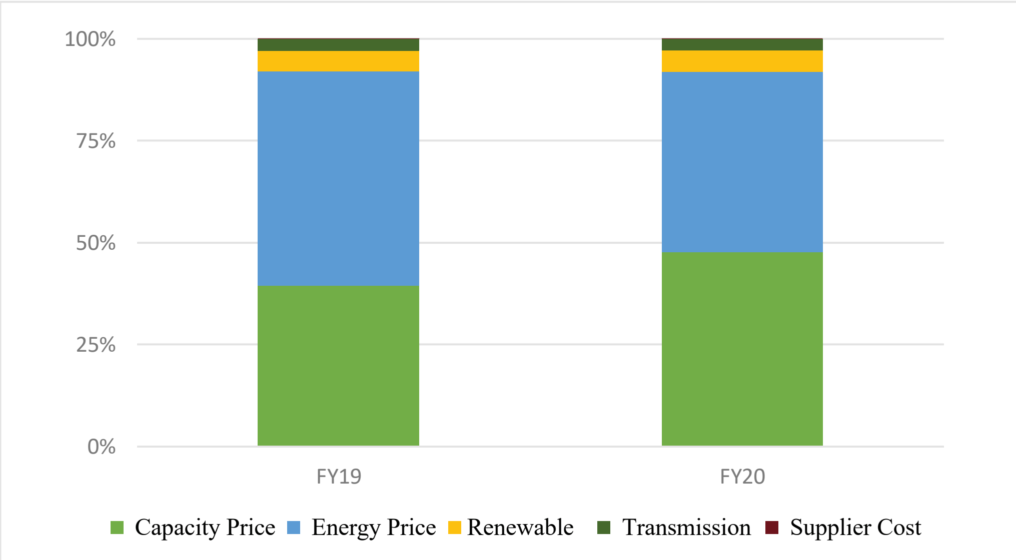
The prices of electricity are increasing across the country for households and industries in recent times. The global fuel price index has increased 7 times from May 2020 to June 2022. Despite the increase in the prices the circular debt in the energy sector of Pakistan is persistently increasing. On 30 June 2022, the circular debt stood at PKR. 2,252,750 million, which is about 1.5 times of the total cost of electricity sold in a fiscal year. The allocation of federal government subsidies to the electricity industry is also on the rise, with PKR 366 billion during FY21 (revised) against PKR 596 billion in FY22 (allocated). That raises questions about the sustainability of the energy sector given that public expenditures will have less and less space for paying this debt in the coming days. On the demand side, consumers are also moving away from relying on the national grid as the cost of electricity from the grid increases while the cost of photovoltaic (PV) technologies declines. From July 2021 to March 2022, a total of 10,783 net metering-based systems of 196.77 megawatt (MW) capacity were installed by different types of consumers. As of 31st December 2021, the number of net-metering-based solar installations had reached 17,950 with a cumulative capacity of 305.79 MW.

The electricity industry dynamics of increasing cost and declining demand will have substantial implications for the functioning of the industry and the overall economy. This chapter explains some aspects of the puzzle around increasing prices and rising energy sector debt. In section one, I discuss the recent price increase and the lack of transparency in reporting these prices to the end consumer. The second section focuses on the increase in circular debt and the factors behind this increase. In the third section, I explain the supply and demand gap evolution and the requirement of baseload capacity for sustaining the system. Few recommendations are provided at the end. The analysis provided in this chapter is based on the data up to 2022 as authenticated data for 2023 is not available.

Increase in Electricity Prices

The price of electricity determined by the National Electric Power Regulatory Authority (NEPRA) reflects the electricity industry's overall cost of production. The available electricity generation mix in the power system is skewed in favor of fossil fuel-based generation. About 60% of electricity during the year FY22 was produced by oil and gas. The rising fuel prices are one of the main drivers of the increase in prices of electricity to end consumers. Under-utilization of the 'Take or Pay' power generation capacity is also feeding into the high cost of electricity over recent years. The current total generation from these plants translates into a 43% utilization factor of dependable capacity meaning thereby 57% of the 'Take or Pay' based power generation capacity remained unutilized. Figure 8.1 shows that the capacity component of the electricity price is on the rise.

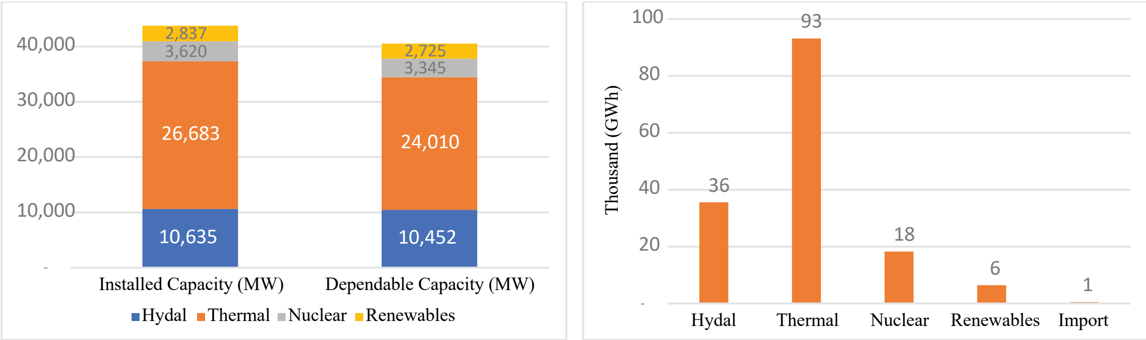
Figure 8.1: Regulated Electricity Price Components.



Source: NEPRA

The consistent devaluation of the Pak Rupee against the US dollar over the last year also caused an increase in the prices of imported fuel. Fuel supply management issues are pushing the cost further up. For example, the regulator observed that the power sector faced a shortage of RLNG (Regasified Liquefied Natural Gas) during most part of the year which compelled generation from expensive power plants. During the period of FY22, due to the unavailability of the RLNG, comparatively costly power plants have been operating having a financial impact of PKR 19,332 million.

Figure 8.2: Electricity Generation Capacity in MW and Total Generation in Gwh



Source: NEPRA

A close look at the electricity prices paid by consumers indicates that the Federal Government has imposed various taxes, charges, and fees, through electricity bills which are not directly related to the cost of electricity. Additional surcharges are imposed on the consumers of the electricity and a few surcharges are being imposed to make up for the system inefficiencies. All these factors increase the volume of the overall price of electricity. Electricity is the basic right of every citizen according to the constitution of Pakistan. Recovering taxes, duties, fees (like TV license fees), and other charges through electricity bills raise questions about the role of the relevant departments and delivery, which are unable to directly recover the same from the relevant buyers. Higher electricity cost also enhances the taxes, and duties which infringe on the basic right to electricity. It is therefore needed to restructure the electricity billing volume by either eliminating/reducing the burden of unrelated taxes and surcharges from the price of electricity.

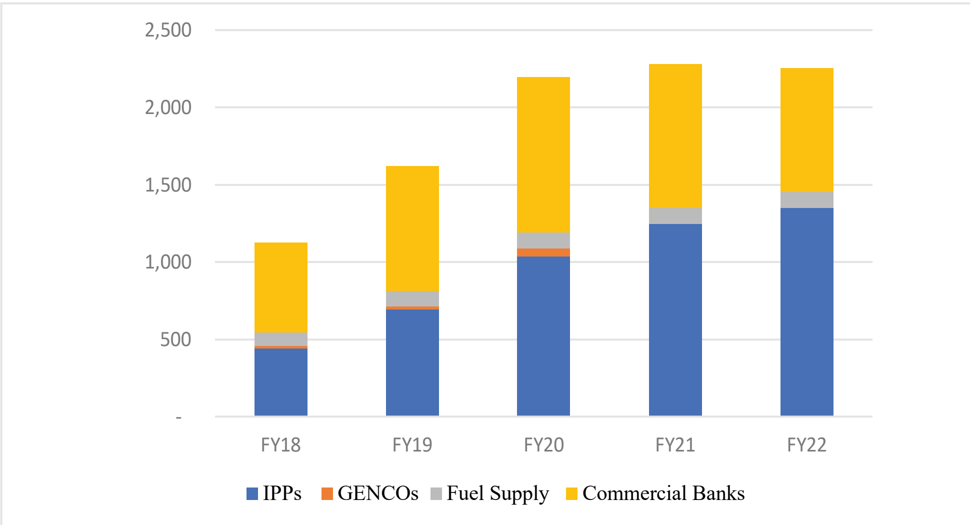
The regulator has also observed that the government-owned generation, transmission, and distribution companies have not kept independent pension funds of their employees. These entities are recovering the cost of pensions from the consumer end tariff. Estimates show that over the next five years, the six distribution companies will pay PKR 53 billion per year for the pension funds and they will recover this cost partially through consumer end tariffs. In addition, the electricity cost also includes medical expenses of staff and free electricity provided to the staff. That raises serious concerns for the transparency of electricity prices, as in principle, energy prices should reflect the variable cost of electricity that doesn't include the fixed or quasi-fix costs.

Circular Debt of the Power Industry

In the vertical supply chain of the power sector when a downstream distribution company is unable to recover and pay to an upstream transmission company, and the transmission company is unable to pay to the generation company, then this cycle of non-payments results in circular debt. Persistent transmission/distribution losses, recoveries, underutilization of assets, running defaulters, and delays in payment of subsidies are the main factors behind the circular debt. For example, the financial impact of running defaulters is around PKR 700 million, which is alarming as these consumers are still connected with the system and no action has been taken by the respective distribution companies (DISCOs)[1] to recover the amount. Further, non-payment of subsidies by the Federal and Provincial governments on time is another reason causing this whooping debt.

As of 30 June 2022, the circular debt stood at PKR 2,252,750 million, of which a total amount of PKR 83,399 million (about 4%) is payable to DISCOs on account of subsidy to be paid by the government. Payment of subsidies to the distribution companies has remained a big challenge for the Government. On the other hand, nonpayment of subsidies on time affects the ability of DISCOs to pay back to the transmission and generation companies which is one of the main reasons for accumulating circular debt.

Figure 8.3: Circular Debt of the Power Sector in Billion Rupees



Source: NEPRA

[1] The Distribution companies (DISCOs) play the role of the retail supplier in the industry. There are ten DISCOs in Pakistan excluding K-Electric

Figure 8.3 shows various components of circular debt and growth in the circular debt during the last five years. About 60 % of the debt is due for the payments against verified invoices of Independent Power Producers (IPPs), while 25 % of the debt is due to Energy Payable Swap by Government of Pakistan (GoP) through loan from commercial banks by Power Holding (Pvt.) Limited. In short, high transmission and distribution losses and low recoveries are the main causes of the accumulation of circular debt. This requires immediate attention to improve public distribution companies' performance through privatization, Public-Private partnership, provincilization, or market-oriented reforms.

Understanding Capacity Mechanism

The electricity industry is going through a transition globally. Due to the high external cost of fossil fuel-based electricity generation for society, the new generation capacity is shifting towards renewables (e.g., solar, and wind). The commissioning of renewables will not only change the source of electricity production but will also impact the overall functioning of the electricity markets. Due to security and system stability concerns, renewable production will not be sufficient to sustain the national grids. For example, renewable sources are not available around the clock, so sufficient investment will be required in the storage of the energy to be used when required. In the absence of large-scale investment in storage, substantial reliance on conventional capacity will be heavy in the medium to short term. Also, new hydel generation is costly in the initial years, while the cost of intermittent power is also a challenge. The system operators need to study the capacity mechanism for conventional generation and understand economic incentives for investment in the new generation and the price of the product. This will need a detailed audit of current capacity and retirement of the capacity or contract whichever is earlier to predict future capacity requirements in the country.

To sustain the peak load demand, sufficient capacity is required in the system. The average figures show that current capacity is in access to the demand in the system and burdens the consumer unnecessarily. In Central Power Purchasing Agency (CPPA-G) system, during FY22, the utilization factor of 30,303 MW base load 'Take or Pay' thermal power plants remained at 46% only which means that consumers had to pay capacity charges for 54% unutilized capacity as well. That translates into higher unit costs for consumers. Ideally, the larger economic benefits to society result when consumers pay the marginal cost of the production. The capacity or fixed cost price payments by consumers only make sense if the firm's profit and consumer surplus are larger than these fixed costs.

Policy Recommendations

Moving on, to lower the electricity cost it is essential to:

- Develop the base load power plants on indigenous fuel like Thar Coal (although the external cost will be higher for coal) and dedicated local wellhead gas and
- Develop more and more renewable resources including wind power and distributed solar plants.

According to the currently regulated tariff mechanism for the end-consumers, a uniform tariff is levied on all the consumers of the distribution companies across the country irrespective of their performance, delivery, and efficiency. And by not passing on differential tariffs to the inefficient companies, the burden of cross-subsidies on the consumers of efficient companies and subsidies has been increasing. The retail energy supplier companies need to be restructured by the privatization of the distribution companies, Public-Private partnership with Provincial contributions, and breaking the companies into smaller sizes through horizontal restructuring. Lastly, to improve the efficiency of the power system role of provinces needs to be measured with differentiated electricity tariffs in a phased manner.

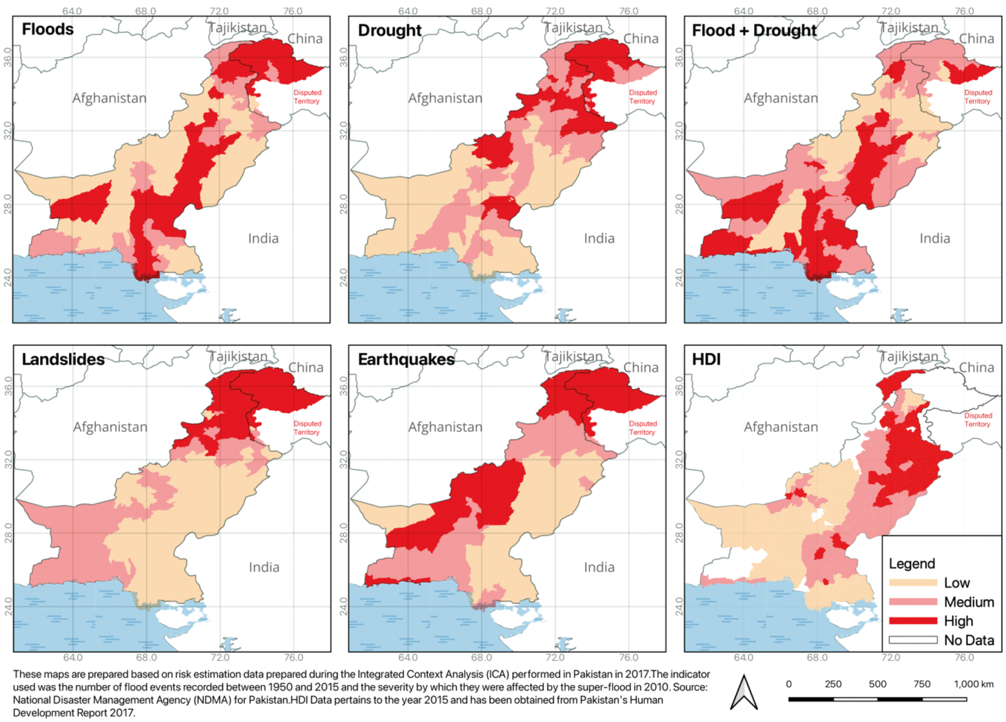
9. Flood Responsive Planning and Budgeting for Community Resilience

Junaid Alam Memon and Arooj Waheed Dar [1]

Introduction

Changing climatic patterns have exposed Pakistan to various natural disasters, rolling back its already abject developmental progress. A fifty years account suggests that the country remains vulnerable to a wide range of natural disasters, including floods, drought, earthquakes, and landslides (Figure 9.1).

Figure 9.1: Pakistan's Vulnerability to Natural Disasters



[1] We also recognize contributions by our student, Muhammad Hasnain, in terms of data collection and cleaning.

Natural disasters have a way of undoing development that pushes nations back into the tresses of impoverishment through the loss of existing infrastructure, expenses on early response & recovery, and expenditure incurred on reconstruction. The monsoon floods remain the most destructive of all natural disasters as the nation has sustained at least 30 major floods since 1950. Of these, 2010 and 2022 floods were the most devastating, each drowning thousands to death, displacing millions, and resulting in billions of dollars in economic damages.

This chapter takes the stock of understanding of flood risk and resilience in Pakistan and suggests investment in resilient long-term recovery. We theorize that human capital formation, research & development (R&D), and climate resilient infrastructure are key to sustainable development of those living in and around Indus Basin.

The chapter is organized as follows: After viewing the existing flood management system in Pakistan and its pitfalls, we discuss the human development approach to resilience building. Next, we apply this approach based on Sindh's experience with recurrent floods and glean over the federal Public Sector Development Program (PSDP) to see how it deals with similar issues. Finally, we synthesize these pieces to suggest a way forward.

Existing Flood Management System in Pakistan

Over the years, Pakistan has developed various plans to mitigate the impact of floods[2]. Initial programs focused on construction of flood protection embankments, bunds, spurs, etc., i.e., hard infrastructure. National Flood Protection Plan (NFPP)-III (1998) shifted the focus to non-structural measures which included institutional reforms, R&D, etc. In the aftermath of 2010 floods, NFPP-IV (2015-2025) was developed which promised increased focus on both structural and non-structural measures (FFC, 2015). None of these plans, including the current NFPP-IV (2015-25) with a hefty cost outlay of PKR 335 billion[3], has been very effective in protecting the nation against major floods, as can be witnessed from various flood catastrophes including those sustained in 2010 and 2022 (Box 1).

Box 1: Flood 2022 Losses

Pakistan is still recovering from the devastating impact of the 2022 flood that resulted from changing direction and severity of monsoon rainfalls. With one-third of the country inundated, more than 33 million people were adversely impacted, with over 2 million houses destroyed, and 8 million people displaced (UNDP, 2022a). Road networks, bridges, schools, farmlands, and orchards were completely uprooted. A total of 80 districts were declared "calamity hit" out of which 31 were in Baluchistan, 23 in Sindh, 17 in KP, six in GB, and three in Punjab (OCHA, 2022b). Over 3.5 million acres of crops were lost, posing serious threat to deteriorating food security and a widening current account deficit (Hanif, 2022; UNDP, 2022a). Flood loss estimates sum up to USD 30 billion - equivalent to 10% of the national GDP (Hanif, 2022). Approximately USD 16 billion is needed for resilient recovery and to prevent nine million people from sliding back into poverty (UNDP, 2022b).

[2] NFPP-I, NFPP-II, FPSP-I, 1988-FDRP, 1992-FDRP, NFPP-III, FPSP-II, Lai Nullah Flood Forecasting and Warning System, Normal/Emergent Flood Programme (2009-2014), and NFPP-IV.

[3] National Flood Protection Plan-IV – accessible via: ***https://ffc.gov.pk/national-flood-protection-plan-iv/***

A closer look into NFPPs shows that the Federal Flood Comission (FFC) relies overly on technological and infrastructural adjustments to hazards and exercising Standard Operating Procedures (SoPs), thereby paying inadequate attention to effectiveness of monitoring and early warning systems, maintenance of natural waterways, and utilization of local knowledge and community participation for effective flood management.

Furthermore, the structural bias of flood management for the protection of urban and irrigation infrastructure has pushed rural poor and marginalized groups to suffer disproportionately. They suffer not only from the natural, but also from the manmade disasters arising from the decisions to breach levees, often allegedly to protect the farm fields of large landholders, generals, politicians, and local influentials (Mustafa, 1998).

Human Development and Vulnerability Nexus

Vulnerability to natural disasters is directly linked to human development at individual and community level. Absence of economic opportunities, low investment in health and education, and inequitable access to opportunities manifest themselves in high poverty. This results in an inability of individuals and communities to prepare for, respond to, and recover from natural and manmade disasters. Poverty and lack of affordable housing push people to make precarious housing choices along the banks of natural waterways, steep slopes, and other unsafe places which increase their exposure to disaster.

Human development approach advocates for investment in resilient infrastructure, quality skill education, basic healthcare, and enhancing economic opportunities for poor. Contemporary literature on disasters such as Torani et al and local experiences reveal that education empowers people by making them self-reliant, significantly reducing the need for government relief and assistance. Skills and education allow people to find opportunities even in disasters and capitalize on them for the greater good of community (Sultana et.al, 2020).

Pakistan currently stands at 161 on the global ranking of 192 countries in terms of HDI, placing it among the low human development category (UNDP, 2022c). Vast HDI disparities exist within the country, with the south and southwest regions experiencing the lowest levels of human development (Figure 9.1). The dismal state of health and education in the districts most vulnerable to flooding have resulted in a situation where every time disaster strikes, people are left helpless, awaiting government's rescue and relief.

Therefore, the project ahead for countries like Pakistan is not to build stronger levees or more powerful weather satellites, but to ensure equity and justice in resource management and supporting community resilience through investments in human capital, climate resilient infrastructure, timely access to quality information, and local decision-making (Mustafa, 1998). We must acknowledge that disasters are discriminatory in their socioeconomic impacts, weighing heavier on some sections of society than the others due to power and other imbalances.

Principles of Effective Flood Prevention Planning and Budgeting – Sindh's Experience

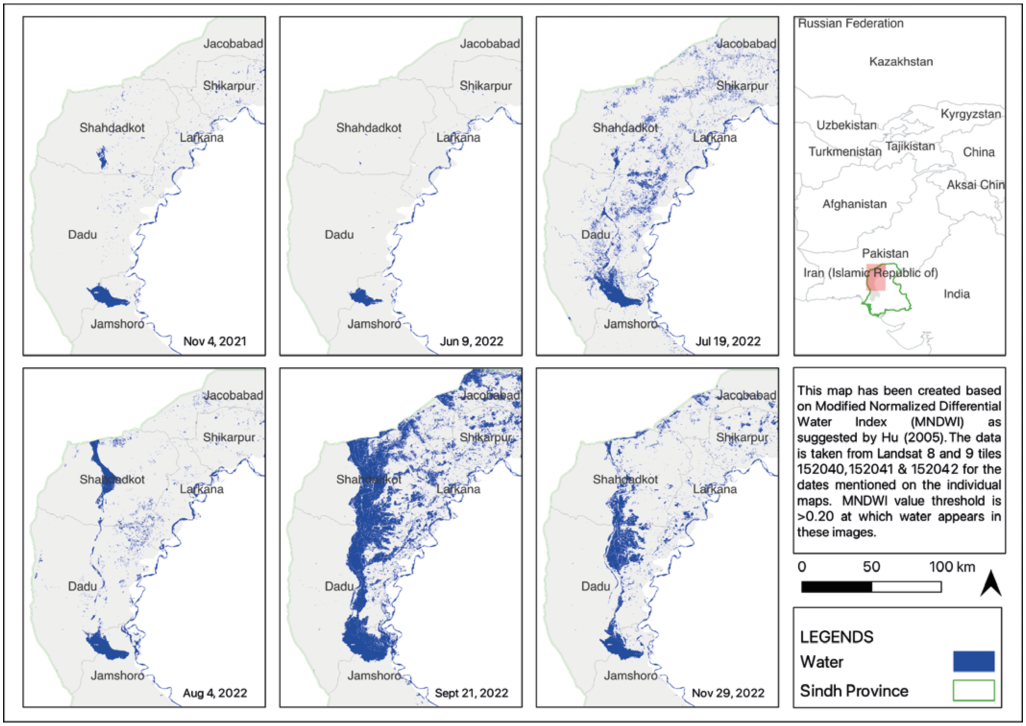
Being the gateway for Indus waters to the Arabian sea, Pakistan's vulnerability to climate-induced floods is most evident in Sindh. Regardless of where floods originate in the Indus Basin, they must pass through the administrative boundaries of Sindh, putting people and infrastructure high at risk.

This section builds upon lessons learnt from frequent climatic catastrophes and identifies principles for flood management in the deltaic and low laying plains of Sindh. These principles were initially drawn for Sindh Government Flood Response Strategy by a team to which one of the authors was a member[4]. The three-pronged strategy includes (1) restoring drainage and waterways; (2) adopting a human development approach to disaster preparedness; and (3) aligning the budgetary framework and resource commitments.

1) Restoring Drainage and Waterways

Evidently, relying too much on engineering solutions for flood management has caused great loss of conventional wisdom that avoided unnecessary interference with the river. Resultantly, people have settled in precarious places, blocking the natural drainage and waterways in this low laying landscape turning a natural hazard into a devastating disaster.

Figure 9.2: Recession of Flood Water During Flood 2022



[4] Sindh Strategic Policy For Floods Response 2022: ***https://pnd.sindh.gov.pk/reports***

During the 2010 and 2022 flooding, blockage of waterways turned the flood into disaster for millions in Sindh. Figure 9.2 shows that even almost a year after the catastrophic floods, some areas have retained flood waters and continue to suffer from the loss of livelihood and vector-borne diseases.

Therefore, the first and most important principle is to concede to nature by working with it, and not against it. This means clearing encroachments on the natural waterways and strengthening embankments where necessary, along with designing & enforcing regulations about flood plains. The key idea behind this is to let water find its way to the sea without causing too much damage so we can advance toward rapid rehabilitation of farmlands for recovery of rural livelihoods, food security, and agricultural exports.

Completion of the Left Bank Outfall Drain (LBOD) the Right Bank Outfall Drain (RBOD) is key to enhance surface drainage. The ineffective 'Salinity Control & Reclamation Project' (SCARP) requires revitalization by transferring solar panel-equipped tube wells to farmers and focusing on broader water management instead of solely agriculture-centric planning. Additionally, constructing new infrastructure is crucial to facilitate the smooth flow of water from the neighboring hilly regions of Baluchistan to avoid flooding threats to the local communities.

2) Adopting a Human Development Approach to Disaster Resilience

Investment in expanding livelihood opportunities, securing communities, and improving human capacity will help build resilience. Investments in education, health, and nutrition are crucial in Sindh as the province already faces daunting challenges of a high number of out-of-school children, poor learning outcomes, poor immunization, malnutrition, and lack of access to health, water, and sanitation services. Damage to school infrastructure or use of school premises to provide temporary shelter during floods causes discontinuity of schooling, obstructing access to health, education, and other services.

Climatic hazards are not novel to Pakistan, but the changing weather patterns have increased the vulnerability of its people. The government’s typical response to any natural calamity is the announcement of a cash grant, and distribution of relief through National Disaster Management Authority(NDMA). While crucial, this is problematic for several reasons: (1) it is a short-term measure that provides temporary relief; (2) government may not fully understand the needs of people (as it is not unusual to find relief items being sold in the local markets); (3) it exacerbates consumerism; (4) it creates an incentive for black markets; and (5) it disincentivizes people from insuring themselves against future risk, thereby remain relief dependent every time disaster strikes.

Experiences in Sindh suggest that such fixes have repeatedly failed in changing the vulnerability context without which the durable functioning and long-term prosperity of the local communities is difficult to conceive. A revolutionary idea that popped up during 2010 floods in Sindh but did not gain momentum was “building back better” following a meso-level approach to rehabilitation.

The idea was that with community-level upgradation of the fully damaged villages, the climate resilience of associated household can be ensured.

Accordingly, communities may be engaged in redesigning and rebuilding a climate resilient village at higher elevation where each house is equipped with basic amenities such as own kitchen, latrine, and solar system. Each village will have paved wide streets, water supply and drainage systems, school, and a community hall. Sindh serves as a perfect spot to experiment this idea precisely because floods uproot many villages completely which can be rebuilt using this model.

Given the recent flood and rain damage, policy focus is also required on integrated development of secondary cities based on city strategies and master plans already prepared for 17 cities in Sindh. These cities will be equipped with facilities such as water supply, sewage and solid waste management systems, road infrastructure, housing, education, healthcare and recreational facilities, communication networks, and the city-based economic models to promote specialization and agglomeration.

3) Creating Fiscal Space for Climate Resilience

Resource scarcity, no matter perceived or real, is often the first excuse that any revolutionary idea encounters. No doubt, the quantum of damage from the floods of 2010 and 2022 surpass the capacity of local resources. However, it is important for a nation's dignity to first explore its own resources to address such disasters.

The analysis of Sindh's Provincial Annual Development Plan (ADP) reveals that there is significant margin to create fiscal space from existing schemes (Table 9.1). Pre-2010 schemes have a throw-forward of Rs. 21.1 billion (38.5% of which is allocated in FY 2022-23); whereas those approved between 2010 and 2018 have a throw-forward of Rs. 171.8 billion (38.3% of which is allocated in FY 2022-23). Five years or older schemes have a combined ADP allocation of 74 billion in FY 2022-23 which is 29.3% of the total ADP allocations this year.

Additionally, PKR 79.01 billion are allocated for 1,652 new schemes included in the ADP during FY 2022-23. New schemes in flood-affected districts can be repurposed either completely or by diverting their relevant components. For instance, the production sector can prioritize green investments such as climate-smart agriculture, deep-well bore drilling technology, and rainwater harvesting by creating incentives for relevant authorities.

Currently, the World Bank and Asian Development Bank has a combined financial commitment of USD 2.05 billion under their flood emergency portfolio. Two significant projects, the Sindh Flood Emergency Rehabilitation Project (SFERP) and the Flood Response Emergency Housing Project (FREHP), make up nearly half of it. These projects aim for restoration of crucial infrastructure, a livelihood component that finances agricultural input subsidies, expansion of Rescue 1122, Sindh-PDMA's capacity building, and low-cost reconstruction and rehabilitation of damaged houses.

Table 9.1: Fiscal Space available in Annual Development Budget 2022-23 (Rs. Billion)

Sector / Dept.	Schemes approved before 2010				Schemes approved between 2010-18				Total	
	No of Schemes	Cost	Throw forward	Allocation	No of Schemes	Cost	Throw forward	Allocation	Total Schemes	Total Allocation
Agriculture	1	0.491	0.118	0.068	6	8.836	5.839	1.822	7	1.890
Board of Revenue	3	2.698	0.368	0.201	2	2.460	2.460	0.010	5	0.211
Culture, Tourism...	1	0.087	0.040	0.001	14	5.382	1.444	0.792	15	0.793
Education (School)	9	13.691	5.729	0.131	33	22.685	5.339	3.245	42	3.376
Education (College)	2	3.212	0.482	0.328	13	14.608	6.732	2.861	15	3.189
Education (U & B)	2	1.302	0.175	0.152	27	25.104	15.453	4.027	29	4.179
Education (STEVTA)	1	0.110	0.047	0.047	17	7.919	4.681	1.030	18	1.077
Excise & Taxation	1	0.087	0.000	0.000					1	0.000
Health	8	13.511	5.036	3.514	96	42.847	14.563	9.740	104	13.254
Home	3	1.110	0.190	0.050	31	13.205	8.002	2.173	34	2.223
Industries & Commerce	2	0.302	0.213	0.059	3	1.899	0.558	0.114	5	0.173
Law, P.A. & Prosecution	4	0.749	0.266	0.035	26	5.573	1.849	0.666	30	0.701
Livestock & Fisheries	4	2.955	0.192	0.004	6				10	0.004
Matching Allocation	2	3.556	3.556	0.048	2	6.309	0.797	0.382	4	0.430
Provincial Ombudsman	1	0.075	0.019	0.004					1	0.004
Public Health Eng.	4	1.596	0.270	0.297	52	26.229	9.072	5.899	56	6.196
Social Welfare	1	0.265	0.121	0.070	5	0.276	0.099	0.043	6	0.113
Sports & Youth Affairs	5	4.239	0.880	0.155					5	0.155
Transport & Mass Transit	1	0.102	0.026	0.000	3	4.708	1.291	1.248	4	1.248
Works & Services	7	8.353	3.393	2.976	40	29.015	10.192	7.142	47	10.118
Other	0				191	194.622	79.816	24.296	191	24.296
Total	62	58.488	21.120	8.139	567	411.677	168.191	65.490	629	73.630

Similarly, Sindh Water and Agricultural Transformation (SWAT) project provides for emergency repairs to irrigation infrastructure and input subsidies to farmers. A Contingent Emergent Response Component (CERC) also exists to address future disasters that the project area may encounter. The World Bank also agrees over Sindh Human Capital Investment project to rehabilitate primary healthcare services and provide social protection for the "First 1000 Days" of a child's life. With a clear roadmap in hand, a convincing case may be made to channelize these funds for projects that fit into the indigenous scheme of building resilience.

A Quick look at Federal Flood Responsive Planning and Budgeting

Given Pakistan’s high vulnerability to climate change, disaster preparedness of different communities is key and requires means necessary to act as buffer against future calamities. Nevertheless, a grim 0.005% of total federal expenditure was allocated in FY 2022-23 to environmental protection and related research and development. Same year, with the Climate Division’s total allocation of PKR 9.6 billion, mere PKR 19 million were parked for ‘Climate Resilient Urban Human Settlements Unit’. Meanwhile, the PKR 9.5 billion allocated to ‘10 billion Tree Tsunami’ was used mostly to finance recurrent expenditures.

The highly publicized 4R (Resilient Recovery, Rehabilitation, and Reconstruction) Framework is a USD 16 billion plan but suffers from inadequate resource arrangements. Failure to invest in resilience implies that Pakistan would remain at donor’s mercy at every critical juncture. To recover from 2022 floods, Pakistan secured USD 10 billion commitments at the Geneva Conference mostly as conditional loans tied to macro-economic stability (Ebrahim, 2023) which, given the on-going situation, seems like an elusive dream.

Conclusions and Way Forward

Flood management in Pakistan is under-evolved, technology- and engineering-based, and biased towards the protection of irrigation and urban infrastructure. It exhibits indifference towards how socioeconomic and locational factors mediate local disaster experiences. Relying on learnings from Sindh’s encounter with frequent disasters, we have shown how these lessons may reflect in a policy that works by creating synergies between ecological and social system, simultaneously increasing community resilience and self-reliance. We have synthesized these learnings as a three-pronged strategy that Sindh itself and other provinces in Pakistan can adopt for an ecologically sustainable, human development based, and self-reliant approach to national resilience building. Recurrent natural calamities, specifically floods, should act as a signal for policy makers to center development around resilience and sustainability. Rescue and relief may be necessary, but it is now high time for the government to go above and beyond this bare minimum and equip people with capital needed to approach catastrophes with tenacity.

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10. Conclusion

Asma Hyder

During the fiscal year 2022-23, Pakistan faced three major challenges: political upheaval, economic turmoil, and catastrophic impact of devastating floods. This report provides very insightful discussion on these three key areas.

The first chapter recommends a complete overhaul of the political economy because the existing power structures have failed to achieve their intended goals. The analysis by S Akbar Zaidi is very clear and precise: continuing with the same elite and their established ways of wealth accumulation, power, and privileges will not bring better outcomes in Pakistan. The failures experienced by the country are undoubtedly attributed to the behavior and policies of the elite. This chapter demands a new approach to political economy considering the recently changed geopolitical situation.

The budget for the fiscal year 2023-24 has some good news like reduced taxation, import duties, and easy loans for productive activities. Initiatives like eliminating import duty on solar panel batteries and imported seeds and no new tax on industry and agricultural machines are encouraging. Even with the IMF staff-level agreement, which the Government of Pakistan is hoping to finalize a , our fiscal space continues to be fragile. Thus, this expansionary budget will pose a challenge for the government in the coming days.

Controlling rising prices is always challenging for every government and the State Bank of Pakistan. The effectiveness of non-traditional monetary policy measures in controlling aggregate demand and inflation has been limited, as policy rate hikes have failed to anchor inflation expectations. Chapter four concludes that the current high policy rate has resulted in the crowding out of credit from the private sector to the government sector, leading to concerns about the sacrifice ratio and the need for caution in raising the policy rate. It is crucial to have a responsible fiscal policy in place to complement the monetary policy, as a large budget deficit would increase government debt and the risk of default, negatively impacting the market. It is necessary to complete the current IMF program or secure a new one to mitigate the default risk. Regardless of IMF involvement, the analysis recommends that the government prioritize fiscal responsibility in the current budget and aim to keep the deficit below 3 percent of the GDP to address the rising prices.

There is a consensus among economic experts that the lack of exports is the primary cause of the trade deficit, contributing significantly to the balance of payment crisis. This year's report suggests duty-free access to international markets as an alternative to export subsidies, which is costly and does not necessarily translate into higher exports. Granting duty-free access to Pakistani exporters in the US market can generate over $1.2 billion in exports. This could result in a diversion of approximately $280 million worth of exports from China, India, and Vietnam collectively. The primary beneficiary of duty-free access would be textile exporters to the US and rice exporters to China. However, due to limited diversification in Pakistan's export structure, the benefits of duty-free access would be limited to specific products in each market.

The report also discusses the Business Confidence Survey (BCS)- a joint initiative of IBA and the State Bank of Pakistan- to gauge the business community's perception. The authors of this analysis suggest that besides the BCI, the Employment Index and the Purchasing Manager's Index (PMI) have been in the positive zone since late 2020 but are now in the negative zone. The business community felt confident about their hiring and purchases, suggesting good business prospects in the economy for most of 2021. It is also concluded that the business confidence index does well in explaining the economic trend in Pakistan as it correlates well with the movement in the LSMI index and exports, particularly in explaining the post-lockdown recovery in the last twelve months.

The cost of electricity and its distribution has been an ongoing debate for many years. Besides measures like the utilization of indigenous fuel and an increase in the deployment of renewable energy, it is suggested that uniform tariffs, regardless of performance, should be reconsidered. Retail energy supplier companies should undergo restructuring through privatization, public-private partnerships, and horizontal restructuring. The report also suggests that provinces should be assigned differentiated electricity tariffs in a phased manner to enhance the efficiency of the power system.

Flood management in Pakistan is a developing field, and the government’s response is limited to rescue and relief. Pakistani communities do not have the local capacity and preparedness to deal with such calamities. The report advocates a three-pronged strategy: restoring drainage and waterways, adopting a human development approach to disaster preparedness, and aligning the budgetary framework and resource commitments.

This report is very informative, must-read for students of economics, policy makers and anyone seeking to gain insights into the current situation in Pakistan. I would recommend this report to those students globally who are interested in knowing about Pakistan's economy.'

Jere Behrman
W.R. Kenan, Jr. Professor, University of Pennsylvania, USA

In making certain decisions, I am mindful of the significance of independent academic analysis on Pakistan's economy. Hence, I look forward to the insights and recommendations presented in this report.'

Dr. Aisha Ghaus Pasha
Minister of State for Finance and Revenue

'I appreciate this effort by faculty members of economics department at IBA, Karachi. This report shows the intellectual rigor and impartial evaluation. The independent and academic analysis of political and economic situation of the country is very important and the report serve this purpose.'

Dr. Ishrat Husain
Former Advisor to Prime Minister of Pakistan

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