Report No. 104831-PK

PAKISTAN DEVELOPMENT UPDATE

From Stability to Prosperity

April 2016

WORLD BANK GROUP

Cover photo by Matthieu Paley.

Preface

The objective of this report is to update the Government of Pakistan, think-tanks and researchers, the general public and the Bank's senior management on the state of the economy, outlook, risks, structural reform and challenges faced by the economy. The report begins with a chapter on economic and fiscal developments, with sections on growth, fiscal reform, the external sector and monetary developments. The second chapter provides an outlook and describes upcoming challenges, including structural reform needs. The final chapter identifies several topical issues for detailed analysis, encompassing sections on export competitiveness, the electricity sector, urbanization and the systematic challenges facing provincial development spending (as experienced in Punjab).

This Update was prepared by the Macroeconomic and Fiscal Management Global Practice under the guidance of Shubham Chaudhuri (Practice Manager, GMFDR) and Patchamuthu Illangovan (Country Director). Analyses were contributed by: Enrique Blanco Armas (Lead Economist, GMFDR), Saadia Refaqat (Senior Economist GMFDR), Muhammad Waheed (Senior Economist, GMFDR), Mehwish Ashraf (Economic Analyst, GMFDR), Sarmad Shaikh (Financial Sector Specialist, FAM) and Mohsina Atiq (Consultant). The team is appreciative of the contributions from other Global Practices, particularly the authors of the special sections, who are acknowledged in each section, and Ms Ghazala Mansuri (Lead Economist, Poverty) who also provided input. The overall effort was led by Saadia Refaqat (Senior Economist, GMFDR), with assistance from Amelia Johnston (Consultant).

Table of contents

Acronyms and Abbreviations

ADP	Annual Development Plan
bbl	Barrel
CAD	Current account deficit
CPEC	China-Pakistan Economic Corridor
CPPA-G	Central Power Purchasing Agency Guarantee Limited
CRR	Cash reserve requirement
CSF	Coalition Support Fund
CY	Current year
DISCOS	Distribution companies
EFF	Extended Fund Facility
EIU	Economist Intelligence Unit
EU	European Union
FABS	Financial Accounting and Budgeting System
FBR	Federal Board of Revenue
FDI	Foreign Direct Investment
GCC	Gulf Cooperation Council
GDP	Gross Domestic Product
GST	Goods and Services Tax
H1FY	First half of the financial year
H2FY	Second half of the financial year
IMF	International Monetary Fund
JICA	Japan International Cooperation Agency
KIBOR	Karachi interbank offered rate
KSE	Karachi Stock Exchange
LGU	Local government unit
LHS	Left-hand side
LNG	Liquid natural gas
LSM	Large-scale manufacturing
M-o-M	Month-on-month
MW	Megawatts
NDA	Net domestic assets
NEPRA	National Electric Power Regulatory Authority
NFA	Net foreign assets
NPLs	Non-performing loans
NTDC	National Transmission & Despatch Company
OECD	Organisation for Economic Cooperation and Development
OMO	Open market operations
OTRI	Overall trade restrictiveness index
PSDP	Public Sector Development Program
PSX	Pakistan Stock Exchange Limited
PTCL	Pakistan Telecommunication Company Limited
REER	Real effective exchange rate
RHS	Right-hand side
ROA	Return on assets
ROE	Return on equity
Rs.	Pakistan Rupees
SBP	State Bank of Pakistan
SME	Small and medium enterprises
SoE	State-owned enterprise
UAE	United Arab Emirates
UK	United Kingdom
US	United states
WAY	Weighted average yield
WEO	World Economic Outlook
Y-o-Y	Year-on-year

Executive Summary

South Asian growth remains strong amidst global economic turmoil

South Asia emerged as the fastest growing region in the world in 2015, posting GDP growth of 7 percent. Weak oil and commodity prices, slowing capital flows and shrinking global trade contributed towards a deceleration of growth in most of the world's economies. South Asia—as a net importer of oil—was an anomaly, growing significantly on the back of higher private consumption and public investment. Higher remittances and reserve buffers throughout the region offset the fall in exports caused by the drop in global demand. The region is set to maintain real GDP growth above 7 percent over the next few years. However, the tailwinds are now fading—capital flows have declined and remittances are starting to feel the reality of low oil prices.

Aided by low oil prices, Pakistan continues to post moderate economic performance

Pakistan, while not growing as quickly as its neighbors, has continued its steady growth recovery in H1FY16. Strong growth in consumption, rising foreign exchange reserves, fast-growing workers' remittances and a lower import bill compensated for a significant fall in exports. Low oil prices generated a significant boost, driving a 9.1 percent fall in the import bill and reducing inflation significantly, in turn creating scope to reduce the policy rate. Private sector consumption, propelled by higher remittances and a loosened monetary policy, is expected to account for over half of FY16 GDP growth.

The policy environment is improving, particularly in terms of macroeconomic stability

While exogenous factors such as oil prices and fast-growing remittances undoubtedly contributed to Pakistan's growth, the policy environment is also improving. Macroeconomic stability has improved significantly over the last two to three years, as evident in the steady growth of foreign reserves, reduced fiscal deficits and low inflation environment. Further, the government is methodically working through plans to improve the country's grim investment climate by boosting electricity supply, improving access to credit and increasing tax revenue. While Pakistan continues to score very poorly on doing business indicators, there are some early signs of improvement as a result of these efforts. Private sector credit is showing signs of growth. And structural challenges have not prevented large-scale manufacturing from taking advantage of low global prices for raw materials in H1FY16. Investment is also expected to pick up marginally in FY16 after remaining stagnant in FY15 at 15.1 percent of GDP, a dismal figure.

Growth in FY16 is expected to be moderate at 4.5 percent, well below the 5.5 percent target

The growth outlook for FY16 remains modest with growth expected to increase slightly to 4.5 percent of GDP in FY16 from 4.2 percent in FY15, driven by large-scale manufacturing growth of 4.0-4.5 percent and services growth of over 5 percent. The agriculture sector, after suffering a poor cotton harvest, is expected to have slowed to between 2.0 and 2.5 percent for FY16, compared with 2.9 percent in FY15. The near-term outlook will be supported by three major near-to-medium tailwinds—rising investments under the China Pakistan Economic Corridor (CPEC), persistently low international oil prices and the anticipated return of the Islamic Republic of Iran to the international community. The expected growth rate, however, remains well below the 5.5 percent target envisaged under Pakistan's Annual Plan FY16 and the growth rates of its South Asia peers. A further growth revival will remain contingent on the government making further progress in addressing structural challenges like poor electricity availability, narrow fiscal space and inadequate access to credit.

Fiscal consolidation, a key reform priority, is progressing steadily—the FBR is driving strong revenue growth

Fiscal consolidation, one of the most urgent reform needs, has been central to the current government's economic reform program. And the government's commitment is delivering results. The Federal Board of Revenue (FBR) has posted an impressive 20 percent increase in tax revenue for the first eight months of FY16 on the back of a broad-based increase in direct and indirect tax collection. While this is commendable, Pakistan continues to lag in realizing its tax revenue potential. The tax revenue-to-GDP ratio has increased by 1.5 percentage points over the past three years to 11 percent in 2015, but it remains well below comparator emerging economies and less than half of the 22.3 percent tax capacity recently estimated by the IMF.

…and expenditure growth was restrained in H1FY16, leading to a much reduced fiscal deficit

Consolidated government expenditure registered a growth of only 8.1 percent, meaning that the fiscal deficit was over 20 percent lower than that in H1FY15. This positive result was largely due to the federal government's tight rein on its recurrent expenditure, which grew less than 5 percent. Outlays for subsidies also continued to decline, declining since H1FY13 from 0.7 percent of GDP to 0.27 percent of GDP in H1FY16. A positive development has been the commitment of significant resources towards PSDP-related development spending in spite of the broader fiscal restraint—federal PSDP during H1FY16 grew by 24 percent while provincial PSDP registered a growth of 54 percent.

Pakistan also improved its external position, strengthening macroeconomic stability

Also contributing to Pakistan's improved macroeconomic stability was its improved external position. A lower current account deficit and relatively healthy financial inflows contributed to the sustained build-up of foreign exchange reserves during H1FY16. However, this performance masks the structural weaknesses that continue to make the external sector vulnerable. Exports shrank by 11.1 percent as an uncertain global economy magnified existing domestic bottlenecks. Imports similarly declined by 9.1 percent during H1FY16. The 6.2 percent growth in workers' remittances continued to compensate for the negative trade balance in absolute terms. However, this steady increase in remittances will come under pressure if oil prices remain low and Gulf Cooperation Council (GCC) countries—key destinations for Pakistan's offshore workers—cut public expenditure.

…but its narrow export base, poor trade facilitation and protectionist trade policies are dragging on export competitiveness

Pakistan exports to a small number of destination markets, making it vulnerable to exogenous shocks. Low global commodity prices, depressed prospects of economic growth in export destinations and an appreciating Real Effective Exchange Rate (REER) continue to drag on export performance. Furthermore, Pakistan is constrained by domestic challenges including poor trade facilitation, a high cost of doing business and protectionist trade policies. Vessel charges in Karachi, for example, are almost 10 times those of Dubai or Singapore. Dwelling times for shipping containers are three times longer in Karachi than in developed countries or East Asia. Pakistan's import tariffs are also almost twice as high as global averages, putting local manufacturers at a severe disadvantage if they aim to join global supply chains (by importing intermediate goods).[1]

China's CPEC-driven investment

In the first eight months of FY16, the capital and financial account posted a surplus of US$ 3.13 billion, fractionally higher than the corresponding period in FY15 of US$ 3.09 billion. This positive outcome was made possible by some

[1] See the special section on export competitiveness (**Section C1**) for a fuller discussion of these issues.

has offset a decline in FDI from other sources

improvement in foreign direct investment (primarily on account of inflows from China related to the CPEC), issuance of a US$ 0.5 billion Euro bond in the international market, and loans from IFIs. However, FDI from other countries has dried up, likely due to global economic uncertainty. Official reserves reached US$ 16.1 billion in the final week of March 2016, an increase of US$ 2.5 billion in the nine months since the start of the financial year. The Rupee remained largely stable in nominal terms against the US dollar with a small depreciation of 2.8 percent during the first nine months of FY16.

Inflation was low in H1FY16 but is now starting to inch upwards

While cheap oil imports kept inflation low in H1FY16, the broad-based decline in y-o-y inflation seen in FY15 seems to have bottomed out. Headline inflation registered at 3.3 percent at the start of H2FY16 compared with 1.9 percent at the start of H1FY16. Similarly, y-o-y core inflation (non-food, non-energy) started inching upwards in December 2015, touching 4.7 percent in March 2016 after a low of 3.4 percent in September. However these inflation measures are still significantly lower than those witnessed in the same period last year, likely allowing a continued low policy rate.

Monetary easing continued in H1FY16 but has now been halted in response to an uptick in inflation

A 50 basis point cut in the monetary policy rate in H1FY16 brought it to a decade's low of 6.0 percent. However, the uptick in headline inflation since October 2015 has arrested the slide in the policy rate. Monetary aggregates remained on course, with broad money supply growing by 13 percent during H1FY16 compared to 10.9 percent in the same period last year. The government continued to retire its debt to the State Bank of Pakistan (SBP) while borrowing substantially from the scheduled banks, thus expanding the net domestic assets of scheduled banks by 6.8 percent in December 2015. However, fiscal consolidation has led to a decline in government's incremental borrowing needs. This, coupled with lower interest rates, led to an encouraging increase in lending to the private sector by 9.7 percent as of March 11, 2016 (y-o-y).

Lower interest rates and the government's fiscal consolidation will create pressures for the banking sector

The banking sector remains robust, largely because of heavy investment in risk-free government securities. Commercial banks hold about Rs. 6.1 trillion of government domestic debt as of December 2015, equal to 43 percent of their total assets. Furthermore, investments in government securities constitute approximate 90 percent of total banking system investments. While profitability remained high for the quarter ending December 2015, it is expected to come under pressure in the current environment of low interest rates and reduced government borrowing. Commercial banks have started to look towards riskier asset classes as SME lending grew marginally by 3.7 percent after a downward trend over the preceding five years. Going forward, growth in the sector is thus expected to reflect the slow recovery in the real sector.

Growth is expected to pick up slightly in the medium-term driven by investment and productivity gains in services and manufacturing

The outlook for FY16 to FY19 is for moderately higher economic growth. Growth acceleration will be gradual, driven by strengthening investment flows and productivity gains in services, large-scale manufacturing and construction. These sectors should benefit from expected reforms leading to decreased electricity load-shedding and improvements in the business climate. Gross fixed investment is expected to increase from 13.4 percent of GDP in FY15 to 14.2 percent by FY19, primarily due to the CPEC lifting foreign direct investment flows over the medium-term. Any demand-driven economic expansion as a result of CPEC's implementation is expected to be limited in the short-run as increased investment will likely be offset by a significant increase in imports. However, supply-side effects facilitated by higher power generation capacity and better infrastructure will be beneficial for the economy in the medium- to long-term.

…but this outcome will depend on the government persisting with its structural reform agenda

To achieve growth comparable to its South Asian neighbors, however, Pakistan will need to achieve steady progress in the key pillars of its medium-term reform program. In the electricity sector, the ambitious expansion in generation will need to be matched by investments in transmission and distribution. Privatization of distribution will be a necessary step toward funding these upgrades, as will elimination of circular debt. In lifting tax revenues, efforts may need to focus on strengthening authorities' capacity to monitor and enforce compliance through market analysis, access to data and increased recourse to tax audits. Successful completion of the CPEC will also be crucial to addressing Pakistan's low investment rates.

Domestic reforms will be particularly important if China slows further and GCC countries cut public expenditure

These structural reforms are particularly important given the shifting winds likely to affect the Pakistan economy. While the country is currently benefitting from a CPEC-driven spike in Chinese investment, fast-growing remittances and low oil prices, these factors all face downside risk. A further slowdown in China would deliver a knock to Pakistan's exports and FDI. And low oil prices, if sustained, are likely to drive GCC economies to cut public expenditure, thereby reducing remittances to Pakistan from these countries.

The new poverty line will allow policymakers to focus on inclusive growth

Pakistan's recent adoption of a new poverty line is a hopeful sign that *inclusive* growth will continue to be a policy focus. Pakistan registered a continuously declining poverty trend on the poverty line set in 2001. By 2014, poverty rates fell below 10%, making the old poverty line less policy-relevant. The new poverty line incorporates changes in the economy over the past 10 to 15 years, and sets a higher bar for inclusive development. The new line identifies almost 30 percent of the population as poor, which is close to 60 million people—as compared to 20 million people who were identified as poor on the old poverty line. This implies the country has committed to focusing more on pro-poor and inclusive development policies.

Stronger growth is within Pakistan's grasp

The recent pick-up in growth is encouraging, but at 4.5 percent, it remains modest—not sufficient to create jobs for the large number of youth joining the workforce every year, and significantly below the growth path that some countries have taken to become strong and confident middle income countries. GDP per capita only increased by about 50 percent over the past 25 years, which is far lower than most of its peers. GDP growth rates closer to that of China would quadruple Pakistan's GDP per capita within a generation. Given the strong relationship between growth and poverty in Pakistan, strong growth would also allow Pakistan to make a more significant dent on its recently revised poverty estimate of almost 60 million people.

A. Economic update

1. Economic growth developments

Amid global economic turmoil, South Asian growth has remained strong

The global economy slowed in 2015, growing at just 2.4 percent compared with 2.6 percent in 2014. Weak oil and commodity prices, slowing capital flows and shrinking global trade contributed towards a deceleration in most developed and emerging economies. South Asia—led by India—was an anomaly, registering the highest GDP growth in the world at 7 percent as the region benefited from lower international oil prices (being a net oil importer) and relative resilience to external shocks. South Asia is expected to maintain real GDP growth above 7 percent over the next few years. Domestic demand will remain the main driver of growth across the region, and export growth will also weakly recover. However, the tailwinds are fading—capital flows have slowed and remittances are beginning to feel the reality of low oil prices, which is oil-producing economies to cut investment and hire fewer foreign workers. Nonetheless, the region remains sheltered by a strong external position (due to limited trade exposure) and a low inflation environment, albeit with a recent up-tick. On the domestic front, fiscal management has remained a challenge with weak revenue collection in the context of political challenges.

Pakistan's modest economic recovery continues,

Pakistan—while not growing as quickly as its neighbors—has continued its modest growth recovery. Growth in FY16 is expected to pick up to 4.5 percent from 4.2 percent in FY 2015. Like the rest of the region, Pakistan is benefitting

supported by low oil prices, high remittances and CPEC investment

from low oil prices, which have reduced the trade deficit (in spite of a notable decline in exports) and increased consumption. Fast-growing remittances and rising investments under the China Pakistan Economic Corridor[2] (CPEC) have also supported growth in H1FY16. However, growth remains well below the 5.5 percent target envisaged in Pakistan's Annual Plan FY16 and the South Asia average of 7.5 percent.

Structural challenges prevent Pakistan from growing as quickly as its neighbors

The effects of the high remittances and low oil price windfall (driving such high growth rates in the rest of South Asia) are somewhat hampered in Pakistan by its continuing domestic structural challenges. Unreliable electricity supply, limited fiscal space and a poor business environment continue to impede investment. Further, Pakistan has been steadily losing market share in global trade because its exports are concentrated in slowing markets, trade facilitation is poor and its trade policy is protectionist and complex (see **Section C1**).

The government is making progress on the structural reforms that will be essential to safeguard growth

The government has made great strides in increasing foreign reserves and has recently made progress in power sector and revenue reforms[3] but its ambitious reform agenda is necessarily a medium- to long- term plan. (See **Section C2** for an in-depth discussion on the status of electricity sector reforms.) Given the risks presented by the current global economic situation, these reforms will be necessary to safeguard Pakistan's growth. In particular, while low oil prices boosted consumption and reduced the import bill in H1FY16, sustained cheap oil may reduce public investment in GCC countries, ultimately lowering Pakistan's remittance receipts. A continued slowdown in China will also be damaging, reducing demand for Pakistan's exports and stifling the recent foreign investment boost driven by the CPEC.[4]

Investment may be beginning to recover, and policymakers have targeted Pakistan's historically low savings rate

Investment, a key ongoing challenge in Pakistan's economy[5], is expected to increase marginally in FY16 on the back of increased national savings and public spending on infrastructure, mostly CPEC. Private sector loans for long-term investment have increased substantially in H1FY16 compared with the corresponding period in the previous year. However, while national savings tend to be the most reliable source of funds for investment, Pakistan's historical rate of savings has been very low. National savings were 10 percent of GDP in the 1960s, increasing to 15 percent in the 2000s but remaining below that level ever since. Furthermore, Pakistan's saving rate is low when compared to that of its regional counterparts: a five-year average of almost 13 percent compared to India's 32 percent, Bangladesh's 30 percent and Sri Lanka's 25 percent[6]. For FY16, the government's Annual Plan has identified a savings rate target of 16.8 percent rate. This, however, seems optimistic given the lack of complementary policies and historical obstacles that continue to persist including high propensity to consume,

[2] The CPEC will connect Western China to the Arabian Sea via the Gwadar port and with an estimated cost of US$ 45 billion until 2030 and will consist of publicly funded transport projects (US$ 11 billion) and privately funded energy projects (US$ 33 billion) – Global Economic Prospects January 2016, World Bank

[3] See Section B2 for further discussion of the government's progress in structural reform

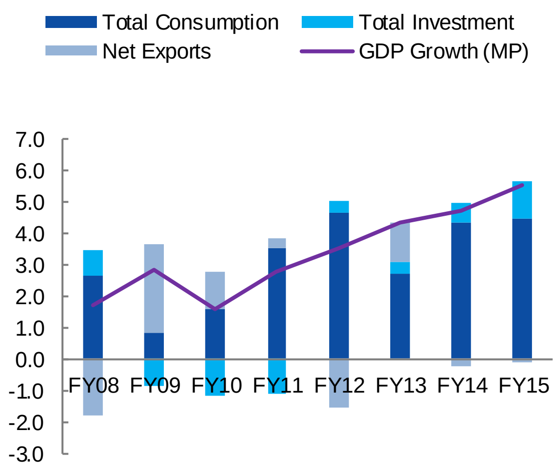
[4] See Chapter 3 for further discussion of the growth outlook and risks

[5] Section D1 in the Fall 2015 Pakistan Development Update outlined several reasons why investment is low in Pakistan, including low public infrastructure investment driven by limited fiscal space, a shallow financial market, a lack of coherent industrial and trade policies, and a poor business environment.

[6] Saving and Investment in Pakistan – Amjad Ali (State Bank of Pakistan, Staff Notes, January 2016)

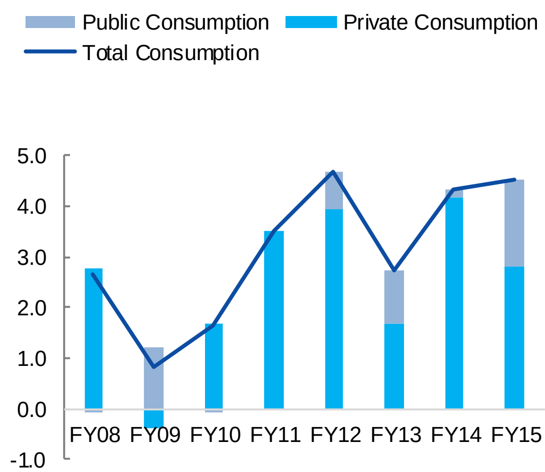
high dependency ratio, lower real returns on financial instruments as well as a lack of access to and trust in financial markets and institutions.

Figure 1: Consumption contributes the largest to GDP expenditure...
Measured in percent



Source: Economic Survey of Pakistan 2014-15

Figure 2: ...with private consumption largest component of total
Measured in percent



Source: Economic Survey of Pakistan 2014-15

On the demand side, growth is driven by consumption

On the demand side, growth in FY16 is being driven by consumption, which accounted for an 88 percent share in GDP last year. Contributing over 4 percentage points towards GDP growth[7] (see **Figure 1**), consumption appears to be dominated by private consumption, supported by sustained growth in remittances and a looser monetary stance. However, recent trends are showing some departures from historical norms, as the share of the public sector within overall consumption is growing stronger (see **Figure 2**).

On the supply side, the disastrous cotton harvest has slowed agricultural growth

The most significant supply side shock in FY16 is a disastrous cotton harvest, whose full effects have not yet been felt. Agricultural growth is expected to slow to between 2.0 and 2.5 percent, below the 2.9 percent witnessed in FY15. Cotton production remained 30 percent below FY16 target and 22 percent below last year's production of 14.0 million bales (see **Table 1**).[8] This was driven by a combination of factors, including a prolonged cold spell and severe pest attacks, and led to crop losses concentrated in Southern Punjab and Sindh. In addition, the depressed price of cotton may have reduced farmers' incentive to invest in good quality pesticides and inputs. Rice production also fell 4 percent from FY15 production levels as a result of rising production costs, a heavy downpour in July

[7] Average for eight years (2008-2015)

[8] Most of the crop losses occurred in Southern Punjab, the cotton belt of the country, where output fell by 30 percent while almost 23 percent shortfall took place in Sindh – Pakistan Central Cotton Committee

2015 and large carryover stocks. Amongst Kharif[9] crops, it was only sugarcane whose production increased although it nonetheless remained below its FY target (see **Table 1**). The poor Kharif crop performance may be compensated somewhat by higher growth in livestock and a favourable outlook for wheat, which is expected to be a bumper crop.

Table 1: Agricultural production was below target for major crops
Production in millions of tons

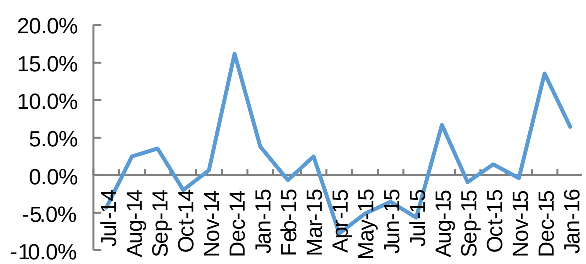
				Percent	
	FY15 P	FY16 T	FY16 P	FY16 P/FY15 P	FY16 P/FY16 T
Cotton*	14.0	15.5	10.9	-22%	-30%
Sugarcane	62.8	68.0	65.4	4%	-4%
Rice	7.0	6.9	6.6	-6%	-4%
Wheat	25.5	26.0	26.0	2%	0%
Maize	4.7	3.7	4.8	2%	30%

T: Target, P: Provisional
*Millions of bales
Source: Targets based on Annual Plan, FY15, Government Planning Commission. Provisional estimates based on World Bank Staff estimates

The industry sector is expected to grow faster in FY16, driven by growth in large-scale manufacturing

After a dismal performance in FY15, industrial sector growth has a more favorable outlook in FY16. Large-scale manufacturing (LSM) has already achieved 3.9 percent growth in H1FY16 compared to a meagre 2.7 percent in H1FY15. LSM, which comprises more than half the industry sector, is being supported by growth in several key sub-categories, including food, beverages and tobacco; automobiles; fertilizers; petroleum; pharmaceuticals; and cement production all of which benefited from the persistently low prices of raw materials and inputs. These sectors, comprising almost 51 percent of LSM, grew by an average of 12 percent y-o-y in H1FY16 with automobiles posting the highest growth rate of 32 percent followed by fertilizers at 15 percent and petroleum products at 8 percent. The textiles sector continued to suffer from subdued demand in the European market, growing y-o-y by 1 percent with local manufacturers losing export share to competitors India and Vietnam. While manufacturers continue to face a lack of access to credit, a slowdown in global demand and power shortages, LSM is nonetheless expected to enjoy growth of 4.0 to 4.5 percent, below the 6 percent target but well above last year's disappointing performance of 2.4 percent. This growth will be supported by healthy cotton yarn manufacturing, significant increase in construction activities, increased production and financing of automobiles from both commercial and

Figure 3: Quantum growth in LSM (m-o-m)



Source: Pakistan Bureau of Statistics

[9] Includes cotton, rice and sugarcane – season: July to October

government schemes[10] and recent LNG imports which are expected to improve energy supply to the industrial sector.

The services sector remains the main contributor to growth

The services sector remains the strongest contributor to growth on the supply side, comprising more than half of GDP in FY15 with an expected growth of around 5.3 percent in FY16. This is slightly better than the 5 percent growth witnessed last year and considerably better than the 4.4 percent growth in FY14. While all services sub-sectors are expected to grow, the primary drivers will be transport, storage and communication; finance and insurance; and wholesale and retail trade. In particular, transport, storage and communication, which comprises almost 23 percent of the services sector, is expected to perform well in FY16. This is on account of a hefty increase in automobile (60 percent increase in Q1FY16) and petroleum sales, an improved financial position of Pakistan Railways and higher cargo handling at ports. Communication is also expected to recover after no growth in FY15 due to higher numbers of broadband users, improved cellular and tele-density and lower PTCL losses in H1F16 compared to H1FY15.

'Messy' and 'hidden' urbanization is an emerging concern

A recent World Bank study has highlighted the likely cost of South Asia's current approach to urbanization. While studies have illustrated the potential productivity benefits of rapid urbanization, South Asia's cities have largely succumbed to congestion pressures, resulting in urbanization that is occurring most quickly in sprawls at the margins of cities ('messy' urbanization) and outside the administrative boundaries of urban areas ('hidden' urbanization). An independent measure of agglomeration found in 2010 that over 55 percent of Pakistan's population was living in urban areas, compared with official estimates of only 36 percent[11]. The unguided nature of urbanization is curtailing the potential productivity benefits of agglomeration, and driving the proliferation of urban slums and poverty. Developing an effective policy response to congestion pressures will be a long and complex process, but the Pakistan government has made a strong start—the Pakistan's Vision 2025 program places cities at the center of national policy for sustained and inclusive economic growth. (See **Section C3** for a further discussion on the challenges facing Pakistan's urbanization.)

Pakistan's growth is bolstered by exogenous factors—more robust growth will rely on resolving structural challenges

In summary, Pakistan's economic recovery is promising, but it is fueled equally by domestic policy and exogenous factors such as low oil prices. While sizeable domestic growth constraints persist, the government's efforts to strengthen macroeconomic stability are well progressed and its structural reforms may be just beginning to yield results. To further boost growth and insure against global uncertainty, Pakistan must continue to make progress in its energy sector reforms and other improvements to the investment climate. Fiscal consolidation efforts—which now have some momentum—will be a crucial foundation for the rest of the government's ambitious reform agenda.

---

[10] Vehicle sales surged by 66 percent in H1FY16 aided by strong consumer spending and well-marketed and easy auto-financing. Note, however, the Punjab government continued to provide taxi cabs in the province under the *Apna Rozgar* Scheme but the scheme will conclude in February 2016, possibly reducing overall automobile sales for FY16.

[11] Source: World Bank, 2015; *Leveraging Urbanization in South Asia*. See special section on urbanization for further discussion.

2. Fiscal update

Pakistan's fiscal balance is improving due to greater discipline and an economic reform program

Pakistan's fiscal position has undergone a significant consolidation over the last three years as the fiscal deficit (excluding grants) has declined from 8.5 percent of GDP in FY12 to 5.4 percent of GDP in FY15. Two factors explain this apparent departure from the past. First, the elected government appears to be more committed to fiscal discipline. Second, the government has prepared an economic reform program with fiscal consolidation as a cornerstone. The program is supported by the IMF under the Extended Fund Facility (EFF), which commits the government to actions that lower the fiscal deficit.

Table 2: Summary of Pakistan Fiscal Operations

Rs. billion unless mentioned otherwise

					Percent growth	
	Budget FY16	H1FY14	H1FY15	H1FY16	H1FY15	H1FY16
Total Revenue	**4,622**	**1,665**	**1,749**	**2,005**	***5***	***15***
Tax Revenue	3,702	1,172	1,361	1,639	*16*	*20*
Federal	3,418	1,084	1,266	1,517	*17*	*20*
Provincial	283	88	95	122	*8*	*29*
Non-Tax	921	493	388	366	*-21*	*-6*
Federal	883	468	363	335	*-22*	*-8*
Provincial	38	25	25	31	*-3*	*27*
Expenditures (booked)	**5,950**	**2,214**	**2,320**	**2,529**	***5***	***9***
Current *of which*:	4,276	1,888	1,989	2,104	*5*	*6*
interest	1,280	598	573	632	*-4*	*10*
subsidy	138	136	117	82	*-14*	*-30*
defense	781	295	330	303	*12*	*-8*
Development Exp.	**1,678**	**316**	**286**	**417**	*-10*	*46*
Net lending	-4	98	45	7		
Statistical Discrepancy	**n.a.**	**-8**	**81**	**-9**		
Fiscal Balance	**-1,328**	**-540**	**-652**	**-515**	*21*	*-21*
% of GDP	*-4.3*	*-2.1*	*-2.2*	*-1.7*		
Memorandum items:						
GDP (nominal)	30,672	25,402	29,708	30,672		

Source: Ministry of Finance

The fiscal deficit of the consolidated government has fallen to 1.7 percent of GDP due to restraint in federal recurrent expenditure and a 20 percent increase in tax revenues

The fiscal consolidation appears to be on track during H1FY16. The fiscal deficit of the consolidated government during H1FY16 stood at 1.7 percent of GDP – the smallest half-year deficit in the last three years (see **Table 2**). Total expenditure registered growth of 8.1 percent while total revenues registered robust growth of 14.6 percent on the back of 20 percent growth in tax revenues of the consolidated government. The federal government continued to hold recurrent spending under tight rein—federal recurrent spending grew by 3.7 percent compared to 2.4 percent in the same period last year. But the same can't be said for the provincial governments—provincial recurrent spending registered an increase on the previous year of 25 percent. However, as the bulk of recurrent spending takes place at the federal level (with a 70 percent share), the consolidated government recurrent spending has been kept in-check. This, coupled with strong tax revenue performance has been instrumental in generating a primary surplus (excluding interest payments) of 0.40 percent of GDP during H1FY16.

Table 3: FBR Tax Collection, July 2015-February 2016

Rs. billion unless mentioned otherwise

	Budget				Percent Growth	
	FY16	FY14	FY15	FY16	H1FY15	H1FY16
Direct	1,348	500	599	676	19.8	12.9
Indirect	1,756	861	939	1126	9.1	19.9
Customs	299	147	181	241	23.1	33.1
Sales Tax	1,250	636	669	786	5.3	17.4
Federal Excises	206	78	89	99	13.7	12.1
Total Taxes	3,104	1,032	1,172	1,385	13.6	18.2

Source: Federal Board of Revenue

The remarkable revenue increase in H1FY16 is the result of a concerted effort by the Federal Board of Revenue

Total revenue performance of the consolidated Government is showing a remarkable turnaround on the back of strong performance by the Federal Board of Revenue (FBR). FBR revenue during H1FY16 showed robust growth of 18 percent, only marginally lower than the 20 percent growth required to meet the FY16 revenue target of Rs. 3,104 billion. This is quite remarkable given tax collection during Q1FY16 stood at just Rs. 600 billion. Following a Q1 result that was well below target, the government adopted quick remedial measures to correct the shortfall before the end of the first half of FY16.[12] While these measures were effective at increasing revenue, however, it is worth noting that some may also dampen Pakistan's export competitiveness (if increased duties raise the price of intermediate inputs for exporters, for example). As a result of this effort, collections from direct and indirect taxes grew by almost 13 percent and 20 percent respectively. More importantly, growth within indirect taxes remained broad-based,[13] with customs, sales tax, and federal excise duty growing by 33 percent, 17 percent, and 15 percent respectively. Sales tax performance exhibited the most improvement, moving from a contraction of 1.9 percent during Q1FY16 to a growth of 15 percent despite the overall deceleration in international fuel prices and subsequently lower inflation rate.[14] Robustness in customs duties can be attributed to increased tariffs on imported items as well as the impact of

[12] These include: (i) imposition of regulatory duty in the range of 5 to 10 percent on 61 new imported items (projected to yield Rs. 4.5 billion); (ii) enhancing regulatory duty by 5 percent on 289 imported items (Rs. 4.5 billion); (iii) increasing Federal Excise Duty on cigarettes (Rs. 6.5 billion), (iv) additional one percent customs duty across the board except the exempted items (Rs. 21 billion); and (iv) additional regulatory duty on imported used and old cars (Rs. 2.5 billion).

[13] In FY15, Government removed concessions and exemptions within direct and indirect taxes amounting to Rs. 105 billion. In FY16, the GoP has committed to further removal of exemptions amounting to Rs. 120 billion. Moreover, the government has strictly limited the authorization of administrative tax concessions and exemptions through Statutory Regulatory Orders (SROs) to be temporary and only applicable in a number of exceptional circumstances. Furthermore, The Parliament approved legislation that permanently removed the FBR's authority to grant tax concessions or exemptions, except in a number of specified circumstances in which the Economic Coordination Committee of the Cabinet can grant exemptions or concessions on a temporary basis.

[14] Part of this performance can be attributed to increasing sales tax rate on petroleum products over this period.

reforms carried out over the past two years, including removal of exemptions, concessions and curtailment of powers to issue SROs.

However, deeply-rooted problems need to be addressed before Pakistan's tax regime will reach its tax capacity of 22.3 percent of GDP—or double current revenues

There is no doubt this turnaround in FBR performance is noteworthy but it should not take policymakers' focus from the real issues in Pakistan's tax regime—narrow tax bases, extensive use of tax concessions and exemptions, weaknesses in revenue administration, and low taxpayer compliance. Pakistan faces significant challenges in realizing its tax revenue potential and thereby, in providing the much-desired fiscal space for growth. While the tax revenue-to-GDP ratio has increased by 1.5 percentage points over the past three years to 11 percent in 2015, it remains significantly below comparator emerging market economies and is only half of the IMF's estimated tax capacity of the country.[15] Thus, a more concerted effort is required over the medium- to long-term to ensure that Pakistan reaches its maximum tax capacity.

Table 4: Non-Tax Revenues

Rs. billion unless mentioned otherwise

				% Growth	
	H1FY14	H1FY15	H1FY16	H1FY15	H1FY16
Mark-up (PSEs and others)	58.1	4.1	2.2	-93	-46
Dividends	28.3	39.5	31.4	40	-21
SBP Profits	145.0	137.5	122.6	-5	-11
Defense (incl. CSF)	38.2	80.2	78.2	110	-2
Passport and other fees	7.3	7.2	6.2	-2	-14
Discount ret. on local crude price	8.3	5.4	4.2	-35	-22
Royalties on Oil/Gas	36.8	40.9	31.5	11	-23
Others	117.3	48.6	58.4	-59	20
Provincial	25.4	24.6	31.3	-3	27
Total	**493.5**	**388.0**	**365.9**	**-21**	**-6**

Source: Ministry of Finance

Non-tax revenues fell by 6 percent, due to falling oil prices

Non-tax revenues posted Rs. 366 billion, representing a contraction of 6 percent or Rs. 22 billion compared to H1FY15. Although this is not an insignificant fall from H1FY14, collection in that year was abnormally high due to the accrual of one-off inflows including the universal service fund and the mark-up received from PSEs against the circular debt[16] settlement. The revenue collected vide discount retained on crude oil and windfall levy declined for the third consecutive year due to declining international petroleum prices. Similarly, royalties on gas and oil also declined due to a price effect. Meanwhile, other major components such as State Bank of Pakistan (SBP) profits, and Coalition Support Fund (CSF) inflows continued to support the non-tax revenues to some extent.

[15] A recent estimate by IMF puts Pakistan's tax capacity to be around 22.3 percent of GDP (source: IMF Country Report 16/2).

[16] Circular debt refers to the cash shortfall within the Central Power Purchasing Agency (CPPA). The revenue received by the CPPA from electricity distribution companies (as determined by the regulatory authority) and from government subsidies does not cover costs, leading to underutilization of existing capacity and the build-up of arrears.

Table 5: Analysis of Consolidated Spending

Rs. billion unless mentioned otherwise

				Percent growth	
	H1FY14	H1FY15	H1FY16	FY15	FY16
Total expenditures	2,208	2,332	2,520	*5.6*	*8.1*
Current	1,888	1,920	2,104	*1.7*	*9.6*
Federal	1,353	1,386	1,437	*2.4*	*3.7*
Interest payments	598	573	632	*-4.2*	*10.4*
Domestic	559	524	578	*-6.2*	*10.2*
External	38	48	55	*25.6*	*13.3*
Pensions	85	73	108	*-13.8*	*48.6*
Grant	116	156	160	*34.3*	*2.6*
Defense	295	330	303	*11.6*	*-8.0*
Public Order and Safety	39	44	47	*12.9*	*7.3*
Health & education	32	33	37	*2.8*	*12.4*
Others	189	178	149	*-5.6*	*-16.3*
Provincial	535	535	668	*0.0*	*24.9*
Development	245	321	426	*30.9*	*32.6*
PSDP	215	269	378	*25.6*	*40.3*
Federal	121	126	156	*4.1*	*24.2*
Provincial	94	144	222	*53.2*	*54.4*
Other dev. Expenditures	31	52	48	*68.3*	*-7.2*
Net-lending	83	10	-2	*-88.4*	*-119.0*

Source: Ministry of Finance

Consolidated government spending growth was restrained, driven largely by federal discipline in recurrent spending

Sluggish growth in recurrent spending at the federal level remained the key factor behind the success of the consolidation effort. Total expenditure of the consolidated government during H1FY16 grew at a moderate 8.1 percent or slightly above the 5.6 percent growth registered during the same period last year. This reflected tight control by the federal government, whose recurrent expenditure grew by less than 5 percent for the second consecutive year. Although interest payments and pensions grew more quickly during H1FY16 compared to same period last year, federal grants (to SoE's and provinces)[17], defense spending, and public order and safety expenditures remained almost at the same level as last year. The consolidation effort was further supported by a decline in the subsidy bill—which was Rs. 35 billion lower than the same period last year. It is important to note that this marks the fourth consecutive year of decline in the subsidy bill—from 0.7 percent of GDP in H1FY13 to 0.27 percent of GDP in H1FY16. On the other hand, in a clear break from past trend, the federal government continue to direct significant resources towards PSDP-related development spending. Federal PSDP during H1FY16 grew by 24 percent while provincial PSDP registered 54 percent growth. (See **Section C4** for an exploration of the systemic challenges facing Punjab's development budget

[17] Reflecting lesser financial support for the SOEs.

process.) On the other hand, non-PSDP related development spending (comprising largely of Benazir income support program, which has a 60 percent share) remained under tight control with expenditure totaling Rs. 4 billion less than H1FY15. Looking at this trend, it is clear that expense under this category will remain underspent by Rs. 25-35 billion compared to the targeted allocation of Rs. 164 billion.

The provincial governments have achieved a surplus of 0.5 percent of GDP, although this is likely to diminish considerably before the end of the fiscal year

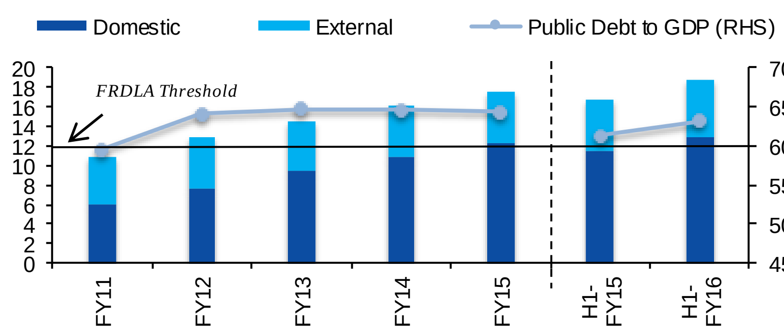
The fiscal consolidation effort during H1FY16 continued to be supported by the provincial governments, which registered a combined surplus of 0.5 percent of GDP. Nevertheless, the budgeted assumption of Rs. 279 billion or 0.9 percent of GDP surplus coming from the provinces at the end of FY16 is unrealistic given provincial spending typically picks up during the third and last quarter of the fiscal year. For example, the H1FY15 provincial surplus of 0.49 percent of GDP diminished to a mere 0.01 percent of GDP by the end of the fiscal year. Nonetheless, the existence of a provincial surplus in the first half of FY16 is noteworthy given the 50 percent growth in provincial PSDP. It is clear that, despite the ongoing consolidation effort, spending cuts are not falling disproportionally on the development side—which has been a practice in the past. This is a positive development and bodes well for providing necessary stimulus for the country's sluggish growth.

Total public debt has temporarily increased, but is expected to decline before the end of FY16 as fiscal consolidation continues

As of end-December 2015, total public debt stood at 63.2 percent of GDP[18], 1.9 percentage points higher than the December 2014 stock of 61.3 percent (see **Figure 4**) primarily due to temporary buildup of government deposits with SBP during H1FY16. Thus, domestic debt dominated the stock in line with the past trend. On the other hand, foreign currency public debt increased marginally by 0.5 percentage points during this period due to disbursements under multilateral loans, the ongoing IMF program[19], substantial commercial borrowings and a US$500 million Eurobond issued in September 2015. However, this trajectory is expected to return to a declining trend by the end of the fiscal year and continue thereafter as fiscal consolidation efforts continue and temporary factors subside.

Figure 4: Trends in Public Debt

External and domestic debt measured in Rs. Trillion (LHS) while public debt to GDP is measured in percent (RHS)



Source: State Bank of Pakistan and staff calculations

[18] The total public debt is still above the threshold of 60 percent stipulated under the Fiscal Responsibility & Debt Limitation Act 2005.

[19] With the completion of IMF-SBA repayments, net flow in IMF debt during H1FY16 pertain to the 8th and 9th review disbursements under EFF.

3. Trade and balance of payments

Pakistan has improved its external position, strengthening foreign reserves and maintaining a surplus in the capital and financial account

A lower current account deficit and relatively healthy financial inflows contributed to a sustained build-up of foreign exchange reserves during H1FY16. Exports shrank as an uncertain global economy magnified existing internal bottlenecks. Similarly, imports declined too—and by a larger margin in absolute terms—thus resulting in a lower trade deficit. Receipts from the coalition support fund and continued strong remittance inflows also supported a lower current account deficit during H1FY16. This, coupled with healthy inflows in the capital and financial account, resulted in reserve accumulation, and stability in the foreign exchange market.

Table 6: Balance of Payment Summary
US$ billion

	H1FY15	H1FY16
i. Current account (A+B+C+D)	**-2.5**	**-1.5**
A. Trade balance	**-10.0**	**-9.3**
Export	12.2	10.8
Import	22.1	20.1
B. Services net	**-1.5**	**-1.0**
of which: CSF	0.7	0.7
C. Income net	**-2.3**	**-2.4**
D. Current transfers net	**11.3**	**11.3**
Of which Remittances	9.2	9.7
ii. Capital and Financial A/c	**2.9**	**4.2**
of which:		
Direct investment	0.6	0.6
Portfolio investment	1.2	0.2
Other Investment Assets	0.2	-0.1
Other Investment Liabilities	1.8	3.2
iii. Errors and omissions	**0.1**	**-0.3**
Overall balance	**0.5**	**2.5**
SBP reserves (excl. CRR, sinking fund)	**10.6**	**15.9**
Memorandum Items		
Current A/c Balance (% of GDP)	*-0.9*	*-0.5*
Trade Account (% of GDP)	*-3.7*	*-3.1*
Financial & Capital A/c (% of GDP)	*1.1*	*1.5*
Export growth %	*-2.4*	*-11.1*
Import growth %	*4.6*	*-9.1*
Remittance growth %	*17.5*	*6.2*

Source: State Bank of Pakistan

The current account deficit is narrowing due to a fall in imports, fast-growing remittances and coalition support fund inflows

The current account deficit (CAD) amounted to 0.5 percent of GDP in H1FY16—narrowing to almost half of the last year's level (see **Table 6**). The trade deficit, which was lower by US$ 0.7 billion compared to same period of FY15, was the main contributor (see **Table 6**). Exports declined by 11.1 percent during H1FY16, compared with a 9.1 percent drop in imports which was larger in absolute terms, thereby reducing the trade deficit. Worker remittances grew by 6.2 percent during the period and more than compensated for the negative trade balance in absolute terms. These, together with about US$ 0.7 billion coalition support fund inflows, supported the improvement in overall CAD.

Imports declined due to cheaper international oil

The significant contraction in the overall imports bill by 9.8 percent during H1FY16 was largely an impact of the decline in international commodity prices, especially crude oil.[20] The country was able to save around US$ 3.2 billion in the

[20] Arabian light crude oil was around $90/barrel on average in H1FY15 and fell to $44/barrel in H1FY16

prices, in spite of Pakistan importing larger quantities of petroleum and crude oil

'crude oil and products' category during H1FY16 compared to H1FY15. While prices declined, Pakistan imported larger quantities of petroleum products and crude oil, which grew by 9 and 24 percent respectively (see **Figure 5**). Nonetheless, the savings realized from imports of petroleum are neutralized by an increase in the import bill from the non-oil segment (see **Figure 6**). This category grew by 7.3 percent in H1FY16, though at a slower pace than H1FY15. This growth mainly came from a significant increase in imports of soybean oil by 82 percent and raw cotton by 197 percent[21], followed by power and electricity generation machinery, fertilizer and insecticide. On the other hand, textile items, construction and office machinery, transport group, iron and steel scrap, jute, rubber and paper product witnessed a fall during the period under review. [22]

Exports also declined, led by textile exports which suffered from weak economies in destination markets and domestic bottlenecks

The decline in exports is broad-based. Exports fell significantly by 11.1 percent mainly due to weak performance of the textile sector and food[23] exports. The decline was also observed in exports of petroleum, carpets, leather manufactures, sports goods, chemical and pharmaceutical, engineering, furniture, and cement. Textile exports—with around 60 percent share in total export in H1FY16— fell significantly by 4.5 percent, particularly in the high value-added segment. Despite duty-free access to the European markets under the GSP Plus scheme, high value-added textile exports witnessed a fall of 0.3 percent against a healthy growth of 9.5 percent in the comparable FY15 period. This decline reflected the weak economic situation in destination markets as well as persistent structural bottlenecks in the domestic economy. (See **Section C1** for further discussion on export competitiveness.)

Pakistan's exports are highly concentrated in textiles and US and European markets

Pakistan's exports are highly concentrated in terms of destination markets. And although Pakistan's export products are relatively diversified relative to peer countries,[24] roughly 60 percent of its export earnings are comprised of textiles and that share has remained stagnant over many years. The other three major components are leather products, rice and chemical and pharmaceutical products, which together contribute about 17 percent of total exports. Pakistan has not made much progress in diversifying the number of products it exports (see **Figure 7**). In addition, its exports are highly concentrated to few destination markets. About 63 percent of Pakistan's exports' are destined to be sold to ten countries—US, China, UAE, Afghanistan, UK, Germany, France, Bangladesh, Italy and Spain—and over time, the share of exports to these countries has largely remained stagnant (see **Figure 8**). Among these countries, the highest export earnings come from USA (18 percent) and European countries (20 percent), which together comprise approximately one-third of the total. China, with a 9 percent share of total exports, has recently become an important trading partner (see **Section C1**).

---

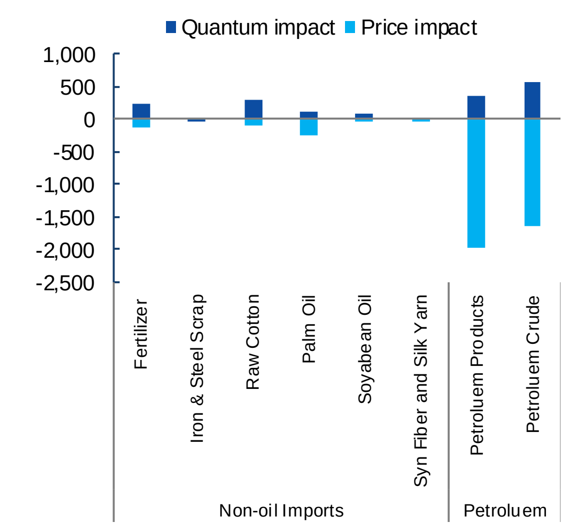
[21] There has been sharp increase in imports of raw cotton after slump in domestic production—especially in Punjab. Unfavorable weather and pest attack across the cotton growing areas caused this fall in production. Pakistan imported US$ 434 million worth of raw cotton during H1FY16 compared to US$ 146 million in H1FY15.

[22] Specifically, a decline was observed in iron and steel scrap (-12 percent), jute (-14 percent), rubber crude (-8.2 percent), paper products (-4 percent) and construction machinery (-16.4 percent).

[23] Rice export — constituting 50 percent of food group exports — declined by 13 percent due to cheaper supplies from India. Basmati rice export was particularly affected with a decline of 31 percent.

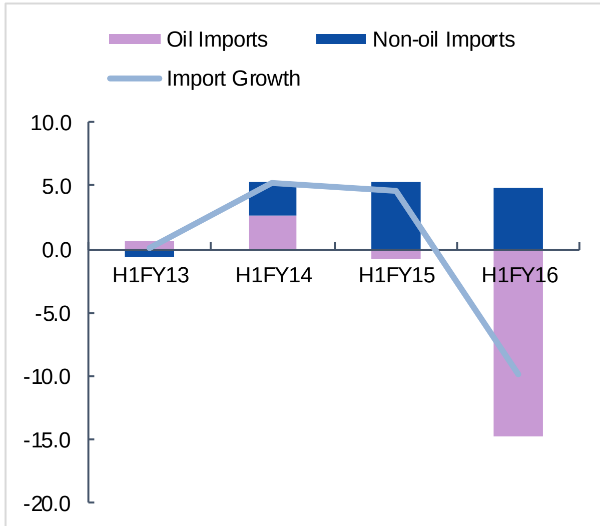
[24] According to the Herfindahl Index. Source: Reis & Taglioni, 2013, Determinants of export growth at the extensive and intensive margins: evidence from product and firm-level data for Pakistan

Figure 5: Price & quantum effect on imports in H1FY16
US $ million



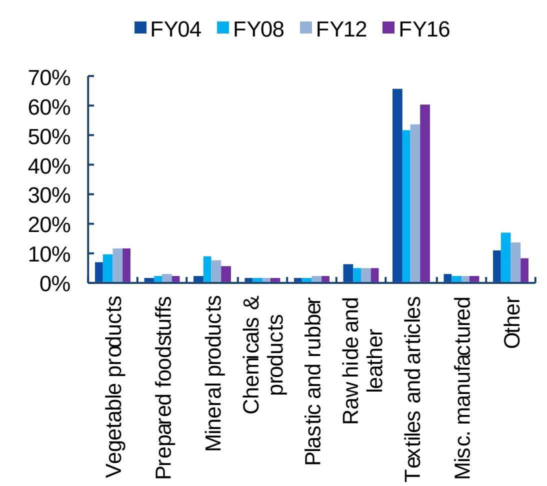
Source: State Bank of Pakistan

Figure 6: Oil and non-oil contribution to import growth
Measured in percent



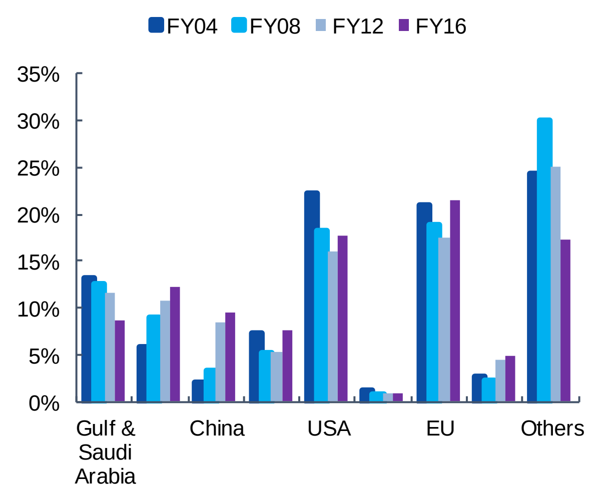
Source: State Bank of Pakistan

Figure 7: Export Shares by commodity
Measured in percent



Source: State Bank of Pakistan

Figure 8: Export Shares by Destination
Measured in percent



Source: State Bank of Pakistan

Pakistan's highly concentrated exports are particularly vulnerable to the slow growth in key markets and falling

The combination of a narrow product base and so few destination markets means that Pakistan exports are very vulnerable to exogenous shocks. During H1FY16, Pakistan's exports to most of its destination markets have shrunk—particularly those to EU, UAE, and China. According to the World Economic Outlook (WEO), the Chinese economy is projected to slow further to 6 percent in 2016 and 2017 from its current 6.8 percent growth. So Pakistan's exports to China, which have declined by about 10 percent during H1FY16 compared to the same

cotton and rice prices

period of last year, are likely to decline further. Similarly, economic growth in the EU is not projected to accelerate from its current level of about 2 percent in medium-term, which will limit Pakistan's potential for export growth. The share of exports to the UAE witnessed a decline in recent years from 8 percent in FY12 to 5 percent during the current fiscal year. Furthermore, global prices of cotton and rice —significant export products for Pakistan—are under pressure. Textile exports have also fallen in price and quantity, mostly due to weakening global demand and constrained domestic textile production. Pakistan's Real Effective Exchange Rate (REER) is also appreciating compared to its comparators, which may be amplifying the effects of the global slowdown and domestic challenges.

Remittances are a substantial source of foreign exchange inflows, funding the trade deficit and comprising about 7 percent of GDP in FY15

Current transfers (mainly remittances) continue to grow steadily. During H1FY16, current transfers increased to US$ 11.3 billion, mainly on the back of workers' remittances, which posted a growth of 6.2 percent and reached US$ 9.7 billion, compared ith US$ 9.2 billion during the same period in the preceding year. Growth in remittances from all major countries, including Saudi Arabia, UAE, UK and other GCC countries (Bahrain, Qatar and Oman) increased—albeit at a slower pace than H1FY15. Workers' remittances remained a source of comfort for the overall external position as they financed almost 50 percent of the import bill and more than compensated for the overall merchandise trade deficit. Remittances in Pakistan amounted to about 7 percent of GDP in FY15 and are one of the largest sources of non-debt creating foreign exchange inflows.[25]

If oil prices remain low, it is likely that GCC countries will cut public expenditure and drive down remittance inflows to Pakistan

About two thirds of remittance inflows to Pakistan are from GCC countries, and are currently facing downside risks. There is continuous emigration from Pakistan to these countries which, coupled with large public spending in GCC economies due to high oil prices in the recent past, has supported rising remittance flows (see **Figure 9**). However, many of these oil-dependent economies are now under fiscal stress due to much lower international oil prices.[26, 27] Given oil prices are expected to remain low for some time, the possibility of a further cut in public expenditure in GCCs is an important downside risk for Pakistan's remittance flows. GCC countries were historically able to sustain their public spending in a temporary low oil price environment by drawing on reserves. However, a persistent low oil price may force some GCC countries to dramatically revise their public investments. This occurred between the late 1980's and the early 2000's, when oil prices remained very low and drove down remittances flows to Pakistan from Saudi Arabia and the UAE (see **Figure 10**).

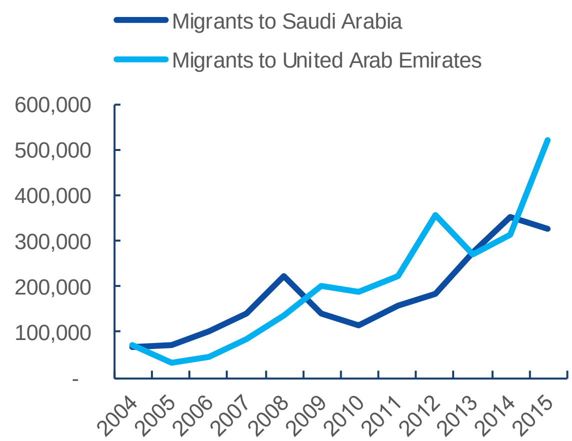
[25] Remittances in Pakistan not only support the overall current account but have also contributed significantly to supporting private consumption and poverty alleviation. Households that receive remittances tent to increase spending on health and education.

[26] In 2016, Saudi Arabia is expected to post a fiscal deficit of 16.3 percent of GDP, with Qatar and Kuwait also likely to post deficits of 5.0 and 5.2 percent respectively. Source: 2016 Macroeconomic and Poverty Outlooks for relevant countries

[27] Recent reports even suggest the Saudi Arabia Ministry of Labor has banned foreigners from working in mobile phone sales in an effort to create jobs for Saudis, and is considering similar bans in other industries. Source: http://www.reuters.com/article/saudi-labour-idUSL5N16G596

Figure 9: Pakistani Migrants to Saudi Arabia and the UAE

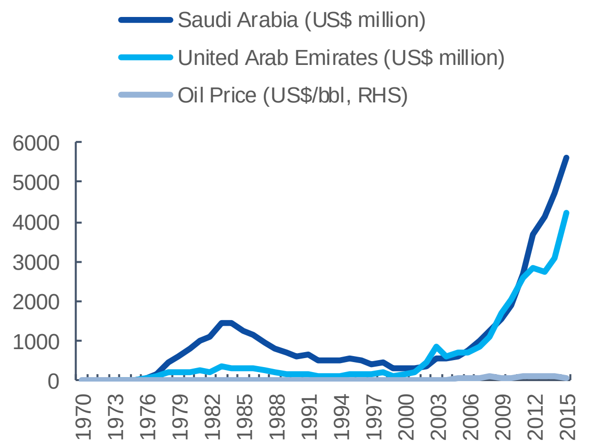
Number of people



Source: Bureau of Emigration and Overseas Employment

Figure: 10: Remittance outflow to Pakistan from Saudi Arabia and the UAE

Remittance outflows (US$ million, LHS) and oil prices (US$/bbl, RHS)



Sources: Remittance data are from State Bank of Pakistan. Oil price is the average crude oil price from World Bank Commodity Price data

The capital and financial account posted a surplus, although foreign investment remains subdued

The capital and financial account posted a surplus of US$ 4.2 billion in H1FY16, higher than last year's US$ 2.9 billion. This moderate improvement was driven by issuance of US$ 0.5 billion worth of Euro bonds in international market[28] and significant loans from IFIs (including US$ 756 million from WB). The country attracted FDI amounting to US$ 618 million compared to US$ 557 million in the corresponding period of H1FY15, primarily on account of inflows from China under China-Pakistan Economic Corridor (CPEC) and concentrated in electricity generation and oil and gas exploration[29]. However, FDI from other countries has dried up, likely due to global economic uncertainty. In addition, the energy crisis and weak business environment have contributed towards investors' dampening sentiments and slowdown in foreign investment. Overall, FDI continues to be a concern, remaining stagnant as a percentage of GDP.

Increased reserves have improved sentiment on the foreign exchange market

Official reserves reached US$ 15.9 billion by end-December 2015, an increase of US$ 2.2 billion in first six months of FY16. The Rupee remained largely stable against the US dollar as a result of the foreign exchange market reacting positively to the build-up of reserves, with a small depreciation of 2.8 percent during H1FY16. In addition, successful continuation of the IMF's EFF program has also improved sentiment in the foreign exchange market. With a relatively stable nominal exchange rate against the US dollar and inflation that is stable in comparison to peer countries, Pakistan's real effective exchange rate (REER) has appreciated in recent times and has perhaps contributed to declining competitiveness for exporters.

[28] Pakistan was able to enter the international bond market and raised about US$ 500 million.

[29] More FDI is expected from China under CPEC in coming years, and power and construction will likely be the main recipient.

4. Monetary, finance sector and inflation update

The first half of FY16 saw largely positive developments in the financial sector

While the government's fiscal consolidation efforts are likely to increase pressure on banks' profitability, they are good news for the rest of the economy. Private sector credit has expanded significantly, with loans for both long-term investment purposes and working capital more than doubling in the first half of FY16 compared with H1FY15. Non-performing loans are also falling for both SMEs and consumers. Monetary easing has significantly reduced the average lending rate, although an uptick in inflation is likely to foreshadow a less accommodating monetary stance in the future. The financial sector is likely to grow more slowly going forward, reflecting the recovery in the real economy rather than a continuation of the historic boost from growth in government borrowing.

Monetary easing has continued in FY16

Following a 350 basis points cut in FY15, continued improvement in macroeconomic fundamentals during the first six months of FY16 has led to a cut in the policy rate by 50 basis points[30], resulting in a decade's low policy rate of 6.0 percent[31]. However, headline inflation has started inching up since October 2015 (y-o-y) and has thus halted the declining trajectory of the policy rate.

Monetary aggregates grew substantially

Monetary aggregates increased sharply in H1FY16. This was driven by unusually high seasonal demand for currency in Q1FY16 due to the two Eid festivals,[32] a higher volume of cash transactions in anticipation of the government's imposition of withholding tax on non-cash banking transactions[33] and heavy injections in the interbank market (explained below). While reserve money accelerated to 25 percent in H1FY16, broad money supply grew by 13 percent during the same period compared with 10.9 percent in H1FY15. A visible improvement in the external account led to a sharp increase in the net foreign assets (NFA) of the banking system. The NFA of the central bank in H1FY16 expanded to almost three times that of the corresponding period of last financial year. This was primarily influenced by substantial official financial inflows[34] during the period under review. On the other hand, the government's retirement of funds to SBP for budgetary borrowing limited the growth in net domestic assets (NDA)[35] and also resulted in meeting the net quarterly zero borrowing limit from the central bank under the SBP Act. This was more than substituted by sizeable borrowings from the scheduled banks, in continuation of last year's trend, expanding the NDA of scheduled banks by 6.8 percent in December 2015 (y-o-y). Despite this, the overall amount of government borrowing from the banking system was down by Rs. 22 billion during H1FY16 compared to same period previous year,

---

[30] The central bank decreased the policy rate from 6.5 percent to 6.0 percent in one of the three Monetary Policy Statements announced during H1FY16 (September 2015).

[31] Before this, the lowest discount rate in Pakistan's recent history was around 7.5 percent in November 2002.

[32] Eid al-Fitr and Eid al-Adha are Muslim festivals, for which many Pakistanis travel to celebrate with their families.

[33] In a bid to bring non-compliant taxpayers into the tax net, the government in the Federal Budget 2015/2016 imposed 0.6 percent withholding tax rate w.e.f. July 01, 2015 (from existing 0.3 percent) on such transactions.

[34] These include, more notably, CSF inflows, US$ 500 million Eurobond, Second Power Sector Reform DPC, debt-creating inflows from China; and disbursements on commercial borrowing amounting to almost US$ 1 billion under Syndicated Finance Facilities by Credit Suisse and UBL, a Murabaha facility by Noor Bank, and oil import financing by Dubai Bank.

[35] NDA of central bank amounted to Rs. 133.6 billion during H1FY16.

reflecting continued fiscal consolidation efforts. In a positive development, private sector credit also contributed to an increase in the NDA in H1FY16[36] (see **Table 7**).

Market liquidity concerns were largely eased by central bank liquidity injections

To ensure the overnight rates adjusted to the policy rate[37] and neutralize the impact of high budgetary borrowing from the scheduled banks on interbank liquidity, the central bank continued with open market operations (OMOs) during FY16, averaging around Rs. 709 billion of injections[38] (see **Figure 11**). This window also allowed the banking sector to extend credit to the government comfortably, given OMO cut-off rates stayed mostly above the policy rate and lower than Treasury bill yields. Weighted average yields (WAY) on T-bills have historically remained below the policy rate, however, after May 25, these have largely remained close to the interest rate corridor ceiling rate (see **Figure 12**). Moreover, the WAYs on 3-month and 6-month T-bills declined by 2.0 percentage points and 1.7 percentage points respectively[39] in line with the decline in policy rate.

Table 7: Monetary Aggregates (Flows during July - December)
Rs. billion

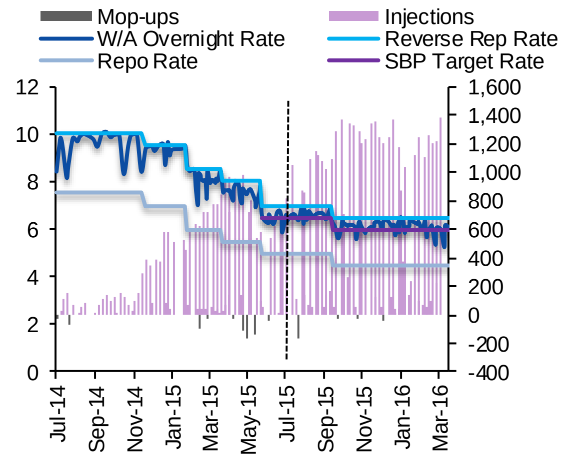
	FY15	FY16
Net Foreign Assets	49	151
of which: SBP	67	180
Net Domestic Assets	394	329
Government borrowing:	191	152
Budgetary borrowing	216	194
from SBP	-405	-436
from Scheduled banks	621	630
Commodity operations	-26	-42
Non-govt. sector borrowing:	203	177
Private sector	222	353
Public Sector Enterprises	52	1
Other Items	-71	-177
M2	443	480
Growth (YoY)	10.9	13.0
RM	-80	334
Growth (YoY)	2.0	25.1
Currency in circulation	124	325
Demand and Time Deposits	343	270

Source: State Bank of Pakistan

[36] Credit to private sector amounted to Rs. 353 billion during July-December 2015, thereby posting a hefty growth of 60 percent compared to same period previous year. More recently, it has grown by 9.85 percent (y-o-y) as of March 04, 2016 as compared to an almost 50 percent contraction witnessed as of March 06, 2015.
[37] Under the newly-introduced SBP Target Rate (the policy rate) w.e.f. May 25, 2016 within the interest rate corridor (IRC).
[38] During July 1, 2015-March 18, 2016 as opposed to an average of Rs. 226 billion during the same period last year.
[39] As of March 16, 2016 (y-o-y).

Figure 11: Liquidity injections increased through OMOs

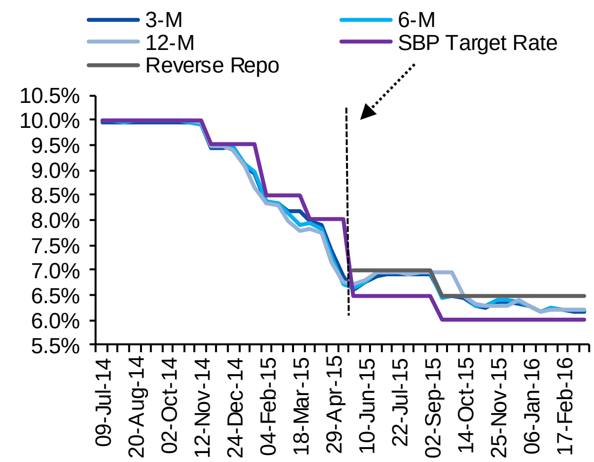
Rates measured in percent (LHS), injections and mop-ups measured in Rs. billions (RHS)



Source: State Bank of Pakistan

Figure 12: T-bills WAYs remained above the policy rate

Measured in percent



Source: State Bank of Pakistan

The government's budgetary borrowing needs were largely met by medium-to-long term market instruments

Demand for government securities remained high and was matched by adequate supply. However, both the auction profile of T-bills and Pakistan Investment Bonds (PIBs) exhibited a shift of the market towards the shorter end of the sovereign yield curve in Q2FY16 due to the increase in inflation and an associated expectation of monetary tightening. The market offered the most for the 12-month T-bill in Q1FY16 but offers declined in the second quarter,[40] leaving the government able to realize only around 75 percent of the target during that quarter (see **Figure 13**). Acceptance of T-bills during H1FY16 was just sufficient to roll-over due maturities. Thus, in order to meet financing needs, the government resorted to PIBs – where the market response was overwhelming – by accepting more than the initial targets in the second quarter while clinging to the pre-auction targets during Q1FY16[41] at lower yields[42]. In this segment, a change in bid pattern was also witnessed. During both quarters, the market's interest almost disappeared in 10-year paper and more than doubled in 5-year bonds[43] (see **Figure 14**).

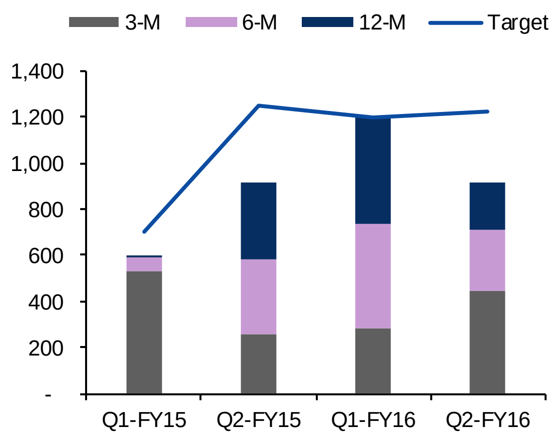
[40] The bid pattern was somehow evenly distributed amongst the three tenors during Q1FY16 – mostly in the longest 12-month tenor (40 percent) followed by 36 percent offers in the 6-month paper – allowing the government to accept almost the same pattern and, in parallel, achieve a little above the targets announced for the quarter. In contrast, almost 45 percent of the bids were received in the shortest tenor of 3-months during Q2FY16 and, subsequently, the government mopped up the realized amounts in a way that reduced the acceptance-to-offer ratio by almost half compared to the previous quarter.

[41] Against a target of Rs. 200 billion for Q1FY16, the market offered to the tune of almost 4 times and the government comfortably accepted the amounts in line with the targets. For Q2FY16, almost similar pattern was observed and the government, in a bid to compensate for the below-target realization under T-bills during the same quarter, accepted almost 116 percent of the pre-announced targets.

[42] The WAYs on 3-, 5- and 10-year PIBs declined by 220, 210 and 150 basis points respectively as of February 25, 2016 (y-o-y).

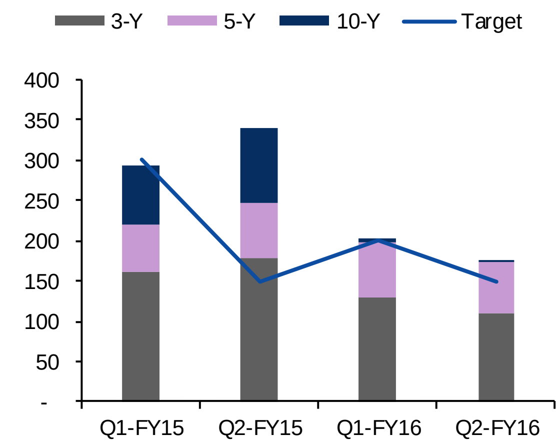
[43] The market offered almost 36 percent in the 5-year paper during H1FY16, in comparison to 18 percent during the same period last year. On the contrary, only 5 percent bids were received in the 10-year PIB

Figure 13: T-bill auctions were held largely to cover maturities
Rs. billion



Source: State Bank of Pakistan

Figure 14: PIBs were the preferred instrument for both the market and the government
Rs. billion



Source: State Bank of Pakistan

Fiscal consolidation efforts and structural reforms are yielding early results, with private sector credit increasing almost 10 percent, year on year

The interest environment has eased with the weighted average lending rate on incremental borrowing down tot 7.3 percent in December 2015 compared to 10.3 percent a year ago. In addition, the government's incremental borrowing requirements have reduced due to fiscal consolidation efforts, allowing more liquidity to potentially be available for the private sector. There are early signs of constraints easing from the government's effort to address structural weaknesses of the economy like power shortages, and law and order. As a result, private sector credit has grown by 9.7 percent as of March 11, 2016 (y-o-y)[44]. Much of the increase among private sector businesses is stemming from the manufacturing sector (particularly chemicals and textile) and construction. Another positive development is the increase in credit for long-term investment purposes, notably in transport[45] and electricity sectors, by Rs. 91 billion in H1FY15 compared to Rs. 37 billion in the same period last year, followed by working capital loans that have doubled during this time (see **Table 8**). On the other hand, consumer financing, while recording a net contraction of 7 percent during H1FY16 as compared to the same period last year due to retiring personal loans[46], has seen a revival in house building loans probably due to healthy construction activity and a rise in auto financing.

The banking system remains robust based on standard solvency indicators, largely

The key driver of robustness in the banking sector has been a shift in risk behavior of banks from private sector loans to risk-free government securities. The banking sector has achieved sizable growth, driven primarily by increased government borrowing. Commercial banks hold about Rs. 6.1 trillion of government domestic debt as of December 2015, which is about 43 percent of

as opposed to 24 percent offers in H1FY15. The market interest for 3-year paper remained intact at almost 60 percent.

[44] The private sector credit contracted by 48 percent same date last March (y-o-y).

[45] Primarily due to land transport for construction and road network under China Pakistan Economic Corridor (CPEC).

[46] Almost Rs. 6 billion were retired during H1FY16 as opposed to disbursements of almost Rs. 5 billion issued during H1FY15.

because of government borrowing

total assets (see **Figure 15**). Furthermore, investments in government securities constitute approximately 90 percent of total banking system investments. As a result of zero risk-rating of government debt for capital adequacy purposes, this significantly reduces the risk-weighted assets of the banking system. For purposes of comparison, the capital to total assets ratio has declined from 10.0 percent to 8.4 percent during January-December 2015, while the capital adequacy ratio has increased from 17.1 percent to 17.3 percent during the same period.

Table 8: Loans to Private Sector by Sector
Flows during Jul-Dec, Rs. billion

	FY15	FY16
Loans to private sector businesses (a…+...h)	210	277
By sector:		
a. Agriculture	18	18
b. Manufacturing	119	158
Textile	*60*	*75*
Wearing apparel, readymade garments	*4*	*2*
Automobiles	*2*	*2*
Food products and beverages	*15*	*5*
Chemicals	*4*	*41*
Leather	*3*	*(3)*
Others	*30*	*34*
c. Electricity, gas and water	(4)	20
d. Ship breaking	7	(6)
e. Construction	12	21
f. Commerce and trade	18	15
g. Transport, storage and communication	10	13
h. Others businesses	29	38
By type:		
Trade financing	86	55
Working capital	77	163
Fixed investment	37	91

Source: State Bank of Pakistan

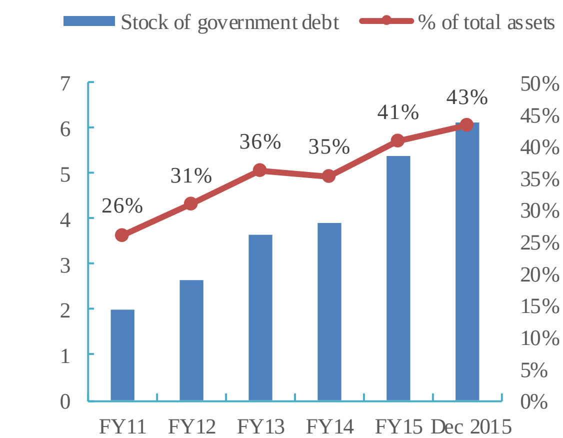
SME credit growth is recovering and non-performing loans are falling in SME and consumer sectors

In another positive sign, there has been a moderate increase in credit to SMEs[47] since 2014, after a downward trend over the preceding five years. Non-performing loans (NPLs) have declined to 11.4 percent of the overall loan portfolio. Because of adequate provisioning, net NPLs also continued to decline, reaching 1.9 percent in December 2015. Year on year, NPLs in small and medium enterprises (SMEs) decreased from 30.5 percent to 26.1 percent of all loans and NPLs in the consumer sector decreased from 11.6 percent to 8.7 percent during January-December 2015 (see **Table 9**).

[47] Advances to SMEs amounted to Rs. 22.6 billion during H1FY16 as compared to Rs. 18.5 billion during the same period last year, exhibiting a y-o-y growth of 3.7 percent.

Figure 15: Commercial banks' exposure to government debt has increased

Stock of government debt measured in Rs trillion (LHS) while commercial bank's exposure to government debt as a proportion of total assets is measured in percent (RHS)



Source: State Bank of Pakistan

Table 9: Selected Key Indicators of the Banking Sector

Measured in Rs. billion

	Dec-14	Dec -15
Profit Before Tax ytd	247	329
Credit to Private Sector	3,552	3,880
ROA Before Tax (%)	2.2	2.5
ROE Before Tax (%)	24.3	25.8
Advances to Deposits Ratio (%)	48.2	46.4
Liquid Assets/Deposits (%)	64.5	73.3
Capital Adequacy Ratio (%)	17.1	17.3
Gross NPLs to Loans (%)	12.3	11.4
Net NPLs to Loans (%)	2.7	1.9
6 month KIBOR (%)	10.2	6.5

Source: State Bank of Pakistan

The equity market's volatility has overshadowed its past upward momentum

Pakistan's equity market exhibited pronounced volatility during 2015 with the KSE-100 Index increasing only 1 percent during the year compared to 25 percent in 2014. The index fluctuated by 20 percent of its value between 28,927 and 36,228 points as a result of changing expectations on monetary policy and equity market reforms. Market capitalization grew to Rs. 7.4 trillion, of which foreign investors represent 10 percent.

The corporate bond market is showing modest recovery, with promising signs in the Sukuk market

The corporate bond market experienced an increase in new listing of debt to Rs. 25 million in CY2015 from Rs. 15 billion in CY2014, however the number of new listings remained lackluster with only two new issues. The Islamic bond market has shown promising signs in the domestic corporate debt market. In February 2015, the capital market regulator issued Sukuk Rules aligned with the Accounting and Auditing Organization for Islamic Finance Institutions, aiming to improve governance standards and strengthen domestic bonds' appeal to international investors. Following the issuance of the new rules, Karachi-based utility K-Electric sold US$ 216 million worth of seven-year Islamic bonds, the largest listed corporate Sukuk in the country.

The outlook for financial sector performance is cautious at best

The financial sector has benefited significantly from the government's heavy borrowing requirement amidst high interest rates in recent years. Profitability remained high without affecting capital adequacy. However, as the government's borrowing declines and the interest rate remains low, the sector is expected to witness less profit on investments and will need to resort to relatively riskier asset classes. Subsequent growth in the sector is unlikely to be driven by government securities, but will reflect the slow recovery in the real economy. The integration of the three stock exchanges of the country to a consolidated Pakistan Stock Exchange (PSX) is now complete, but there is still uncertainty related to divestment of 40 percent of the PSX to a strategic investor in line with Stock Exchanges (Corporatisation, Demutualisation and Integration) Regulations 2012.

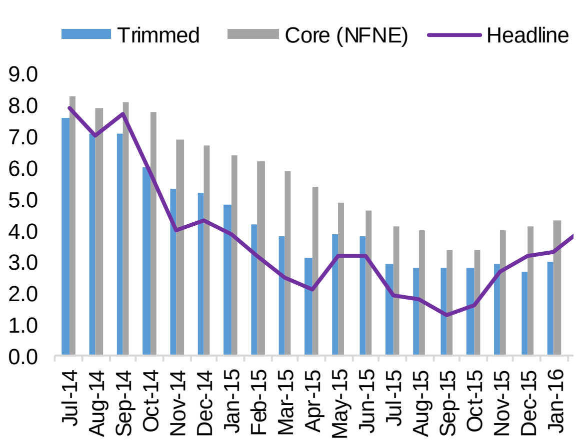
The debt market may potentially see a higher number of issuances since interest rates are low and there have been successful debt raisings in the past year.

Inflation remains low, albeit with a slight up-tick in recent months

Continuing soft international commodity prices supported by prudent monetary management throughout FY15 have allowed inflation to remain subdued albeit with a slight increase in recent months (see **Figures 16 and 17**). Average inflation rose slightly throughout the first eight months of FY16, registering 1.7 percent[48] for Q1 before rising to 2.5 percent in Q2 and 3.7 percent in Q3. This trend indicates a pick-up in aggregate demand and improved supply conditions. Nevertheless, these inflation measures are still far lower than those witnessed in the same period last year.[49]

Figure 16: Y-o-y inflation indicators seem to have bottomed out

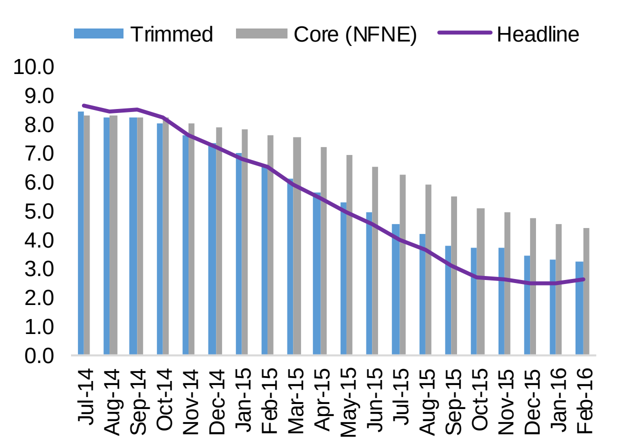
Measured in percent



Source: Pakistan Bureau of Statistics

Figure 17: ...however, 12-month moving average indicators have slowed down

Measured in percent



Source: State Bank of Pakistan

… largely driven by both direct and indirect impact of food factors

Moderate food inflation has been offset by falling transport prices, which are likely to continue to contain inflation in the near future. Representing the largest weight in the CPI basket (almost 35 percent), food and non-alcoholic beverages saw their prices increase by 2.5 percent y-o-y in February 2016.[50] As a result, average food inflation for Q3FY16 increased to 3.3 percent compared to 1.8 percent in Q2FY16. This was driven by an increase in international tea prices, damage to the gram crop and higher federal excise duty on cigarettes. On the other hand, the transport group actually experienced deflation of 8.6 percent in Q2FY16 continuing in Q3FY16 at negative 5.5 percent owing to the lagged impact of two downward adjustments in petroleum prices in Q1FY16 followed by an upward adjustment in November 2015. As international commodity prices

---

[48] CPI inflation reached a 12-year low of 1.3 percent in September 2015.

[49] Headline inflation in Q1FY15 was 7.5 percent falling to 4.7 percent in Q2FY15.

[50] The food items which witnessed the largest y-o-y price increases in February 2016 included onions (76.9 percent), pulse mash (52.8 percent), pulse gram (49.7 percent), besan (44.7 percent), tea (30.1 percent), and cigarettes (26.8 percent) – Pakistan Bureau of Statistics

(especially crude oil)[51] continue to fall, allowing the government to pass on lower oil prices to domestic consumers in February and March 2016, motor vehicle fuel has fallen by a significant 11 percent in Q3FY16. This, together with an abundant stock of major food items, is likely to result in minimal inflation growth during the remaining months of FY16. The subdued inflation outlook is also supported by the results of the January 2016 IBA-SBP consumer confidence survey which depicts a significant decline in inflation expectations.

[51] The price of brent crude continued inching down from US$ 62.34/bbl at start FY16 to US$ 34.20 in February 2016 before increasing slightly to US$ 39.07/bbl in March 2016. WTI crude fell from US$ 59.8/bbl to US$ 37.77/bbl in the same period – Commodity Markets, Prospects Group

B. Outlook and upcoming challenges

1. Outlook

Global growth is expected to recover only modestly

Global growth in 2015 fell short of expectations at 2.4 percent, held back by weak capital flows to emerging and developing countries, weak trade and low commodity prices. A modest increase in global growth to 2.9 percent is expected in 2016, but this is predicated on an orderly rebalancing in China, continued gains in high-income countries, a gradual tightening of financing conditions, and a stabilization of commodity prices. These projections are subject to substantial downside risks, such as a disorderly slowdown in major emerging market economies, particularly China, rising U.S. interest rates, tightening financing conditions, and persistently weak commodity prices. Lower growth and sharply lower commodity prices have narrowed the space for policymakers to respond, especially in commodity-exporting countries, should risks materialize.

Pakistan's mild recovery is expected to continue

The outlook for Pakistan from FY16 to FY19 is for moderately higher economic growth. GDP growth is projected to accelerate from 4.2 percent in FY15 to 4.5 percent in FY16 and 5.1 percent by FY18. Growth acceleration will be gradual, driven by strengthening investment flows and productivity gains in services, large-scale manufacturing and construction. These sectors should benefit from decreased power load-shedding and improvements in the business climate, with construction also profiting from the infrastructure and energy projects associated with the CPEC.

Fiscal consolidation agenda is expected to continue

Fiscal consolidation and a positive external balance should improve financing conditions for the private sector. Provided the upcoming election season does not stall the fiscal consolidation effort, continued fiscal improvement is expected to reduce the government's borrowing needs, reversing the crowding out of private sector credit witnessed over the past few years and creating fiscal space for public investment. Successful fiscal consolidation, gradual rebuilding of the external position and lowering of the country's risk are expected to facilitate external financing and enable the business environment to stimulate private financial flows.

Investment is expected to increase, largely driven by the CPEC

Gross fixed investment is expected to increase from 13.4 percent in FY15 to 14.1 percent of GDP by FY18. Any demand-driven economic expansion as a result of CPEC's implementation is expected to be limited in the short-run as increased investment will likely be offset by a significant increase in imports. However, supply-side effects facilitated by higher power generation capacity and better infrastructure will be beneficial for economy in the medium- to long-term.

While the overall external balance will likely remain positive, the current account deficit is expected to rise

China's investment in coal-based power projects under the CPEC has supported FDI inflows[52]. However, slower growth in China and weak global demand, particularly in the EU, has taken a toll on exports[53] in FY16, revealing Pakistan's vulnerability to a narrow base and high concentration in few products and destinations[54]. Imports also contracted in early FY16 but seem to be recovering since November 2015, particularly in food and machinery. Resultantly, a decline in exports in FY16 (followed by weak export growth forecasts for the next two years) and an expected increase in imports will weaken the trade balance. The current account deficit is projected to increase slightly to 1.3 percent by FY18. The outlook assumes prolonged low oil prices, and subsequently constrained growth in remittances of around 5.5 percent[55], chiefly due to tightening fiscal policies of the Gulf, as well as no large volatility in exchange rates over this period. Financial flows, including strengthening FDI, are expected to augment foreign exchange reserves.

Inflation is expected to rise

Inflation continues in single-digits but expectations are shifting towards a gradual increase. CPI inflation (y-o-y) has started to rise since October 2015, which has moderated the pace of monetary easing in FY16 relative to last year. Going forward, inflation is expected to steadily rise as the base effect diminishes, domestic energy prices increase, and aggregate demand grows. This may lead to a gradual monetary tightening.

---

[52] Almost 58 percent of the net inflows during July-February FY16 are from China, more than doubling the share of Chinese investment in a years' time.
[53] Merchandise exports have contracted by almost 10 percent during July-February FY16, compared to a contraction of 4 percent during same period last year.
[54] Only 10 percent of countries and 3 percent of items account for 75 percent of merchandise exports value.
[55] Against the historical 5-year average of 16 percent.

Table 10: Key macroeconomic indicators 2013-2019
Measured in percent unless otherwise indicated

	2013	2014	2015 e	2016 f	2017 f
Real GDP growth, at constant market prices	4.4	4.7	5.5	4.5	4.8
Private Consumption	2.1	5.4	3.6	3.8	4.5
Government Consumption	10.1	1.5	16.0	6.0	6.2
Gross Fixed Capital Investment	2.6	4.2	8.3	6.0	6.9
Exports, Goods and Services	13.6	-1.6	-2.6	-10.2	-0.5
Imports, Goods and Services	1.8	0.2	-1.1	-7.7	2.4
Real GDP growth, at constant factor prices	3.7	4.0	4.2	4.5	4.8
Agriculture	2.7	2.7	2.9	2.1	2.6
Industry	0.6	4.5	3.6	4.8	5.1
Services	5.1	4.4	5.0	5.2	5.4
Inflation (Consumer Price Index)	7.4	8.6	4.5	4.0	4.5
Current Account Balance (% of GDP)	-1.1	-1.3	-1.0	-1.1	-1.1
Financial and Capital Account (% of GDP)	0.4	3.0	2.0	1.8	1.4
Net Foreign Direct Investment (% of GDP)	0.5	0.6	0.3	0.3	0.4
Fiscal Balance (% of GDP)	-8.4	-4.9	-5.3	-4.7	-4.4
Debt (% of GDP)	64.7	64.7	64.4	63.9	63.1
Primary Balance (% of GDP)	-3.9	-0.3	-0.5	0.0	0.3

Source: World Bank staff estimates
Notes: e = estimate, f = forecast

The government has updated the poverty line and adopted a cost-of-basic-needs methodology, which has identified a poverty rate of about 30 percent in FY14

Poverty has continued to decline in recent years. In a positive step, the government has recently adopted a new, more inclusive poverty line that uses a new methodology and identifies almost 60 million people as targets for pro-poor and inclusive development policies. The new poverty line uses a cost-of-basic-needs approach, which captures both food and non-food needs and is the methodology in most common use. It is based on a minimum caloric intake of 2,350 calories per adult equivalent per day and yields a poverty line of Rs. 3030 per month for each adult. The back-casting of the new line illustrates that the declining poverty trend since 2001 is strictly preserved on both the old and the new threshold. On the old threshold poverty fell from 35 percent in 2001 to about 9 percent in 2014. On the new poverty line, poverty fell from 64 percent to about 30 percent between 2001 and 2014. The declining trend in poverty is likely to continue at least in the short-run, driven by moderate growth in remittances, low commodity prices and relatively low inflation.

2. Next steps on structural reform

The economic reform program of the Government of Pakistan continues to support growth—although more can be done

Over the past two and a half years, Pakistan has successfully implemented an economic reform agenda with a strong focus on achieving macroeconomic stability. The external balance has been positive over the past two and a half years and international reserves have steadily increased to over four months of imports. Fiscal deficits have also declined and debt continues on a downward trajectory. Growth remains well below potential, projected at 4.5 percent in FY16, although addressing some of the key constraints seems to have given a boost to large manufacturing and private sector credit is also beginning to grow. To build resilience in an environment of global uncertainty, Pakistan should continue to focus on a reform agenda that lifts investment and accelerates growth.

Energy sector reforms are paying off—reflected in reduced load-shedding, losses and subsidies and increased investment—but significant investment needs remain

An overloaded electricity network remains one of Pakistan's key economic constraints, particularly affecting the manufacturing sector. Energy subsidies and the accumulation of arrears in the energy sector also pose fiscal costs and risks, which are likely to increase when oil prices recover. Government efforts to reform the energy sector were laid out in a policy approved in July 2013, and include higher electricity tariffs while reducing subsidies and reforms to improve the technical and commercial efficiency of the distribution companies. The government has also managed to attract significant investments into electricity generation, mostly private, which should be complemented by investments in transmission and distribution, altogether close to US$ 60 billion. Investments in transmission will mostly be public, while investments in distribution should be carried out by the private sector after the privatization of the distribution companies.

As well as privatization, there is a need to eliminate subsidies and strengthen competition

In addition to following through with the privatization of the distribution companies, renewed efforts will be needed to eliminate subsidies through the implementation of the circular debt action plan, the establishment of a wholesale market for power that increases competition and a revised regulatory regime for transmission that facilitates private investment. Together these efforts will contribute to improving availability of electricity for consumers while also putting the sector in a much stronger footing (see **Section C2**).

Tax revenues have continued to increase and are on track to reach 12 percent of GDP by the end of the fiscal year—but challenges remain in broadening the tax net

At 11 percent in the past fiscal year, Pakistan has one of the lowest tax to GDP ratios in the world. Significant efforts by the government have increased the tax to GDP ratio by 1.5 percentage points in only three years. Tax administration reforms and the elimination of tax exemptions have contributed most to this increase in tax revenues. Going forward, it will be important to broaden the tax net. A very small number of Pakistani businesses and people pay taxes. A recent scheme by the government to attract traders into the tax net was met by limited take-up. Efforts may need to focus on strengthening the authorities' capacity to monitor and enforce compliance through market analysis, access to data and information as well as increased recourse to tax compliance audits. This should be coupled with renewed efforts to improve governance and reduce corruption in tax administration, since many businesses argue that a corrupt tax administration is the main reason for not joining the tax net.

Improving the business environment will be key to increasing private sector investment

Private investment remains relatively low, although the most recent FDI and private sector credit numbers suggest a timid recovery. While there may be a number of constraints to increase private sector investment, businesses often complain about Pakistan's investment climate. A number of indicators (e.g. the World Bank's Doing Business Indicators) suggest that these complaints by the private sector reflect a weak, and over the past decade worsening, investment climate. Pakistan is currently ranked 138 out of 189 economies on the overall ease of doing business rankings in 2016, having fallen 62 ranks since 2008 and slipped across all Doing Business indicators. To reverse this trend, the Government of Pakistan, together with the provincial governments (since addressing many of the constraints that affect businesses are actually the responsibility of provincial governments), have jointly developed a time-bound action plan to improve the investment climate. This will come on top of recent efforts to address constraints for private sector investment, such as a heavy legislative agenda in the financial sector (Credit Bureau Act, amendments to the SECP Act, the Secured Transactions Bill as well as the Financial Institutions Amendment Bill) to improve access to finance as well as efforts by the FBR to simplify processes to pay taxes.

3. Risks and challenges

Further slowdown in China would be a particular concern

Of all the countries in South Asia, Pakistan is most exposed to China. Almost 10 percent of Pakistan's exports go to China, primarily raw materials like cotton yarn, chromium ores, raw hides, marble and articles of copper. The slowdown in China is already impacting exports which shrank by 12.5 percent in the first eight months of FY16. Further slowdown in China could lead to a further decline. Pakistan expects to receive significant FDI from China under CPEC at a time when the Chinese economy is slowing down. The CPEC, if completed, could be a game changer for Pakistan, but is currently facing high political risks.

Reliance on remittances from GCC is risky

Pakistan remains one of the largest remittances destinations in the world, and remittances are the principal source of financing the trade deficit. More than 60 percent of Pakistan's remittances originate from GCC countries, and this is a source of concern given oil price projections. Remittances from GCC countries have continued to grow in FY16 but at a much slower pace than before[56]. Some of this deceleration is explained by the fact that remittances for Eid in 2014 and 2015 were both captured in FY15 statistics. But persistently low oil prices may eventually affect public investment in GCC countries, and therefore construction where many Pakistani migrants are employed. It will be important to monitor some of the drivers of remittances, such as government budgets in GCC countries and the resulting restrictions on foreign employment. In a sign of growing fiscal pressure, Bahrain, Oman, Saudi Arabia, UAE and Qatar are all expected to post fiscal deficits in 2016, likely reaching 16.3 percent of GDP for Saudi Arabia[57]. Pakistan should also closely monitor oil price projections; expectations have lately been revised down to US$ 37 for 2016 from the earlier projected US$ 51 due to both supply (Iran, US) and demand factors (weak emerging markets growth).

Elections in 2018 pose a risk to fiscal reform

As the election year approaches in 2018, the government may find it difficult to implement difficult decisions, particularly on taxation and energy. This, combined with pre-election spending pressures, poses a risk to prudent fiscal policy.

Job creation should be the focus for poverty reduction

Pakistan's success in poverty reduction is likely to falter if it is driven by remittances or windfalls generated by low commodity prices. Sustainable poverty reduction, including the government's focus on inclusion, requires investment and job creation within the economy combined with efforts to substantially raise agricultural productivity.

The high-growth potential can be unlocked

The recent pickup in growth is encouraging, but at 4.2 percent it remains modest - not sufficient to create jobs for the large number of youth joining the work force every year, and significantly below the accelerated growth path that some countries have taken to become strong and confident middle income countries. GDP per capita in Pakistan only increased by about 50 percent over the past 25 years, which is far lower than most of its peers. GDP growth rates closer to those of China would quadruple Pakistan's GDP per capita within a generation. Given the strong relationship between growth and poverty in Pakistan, strong growth would also allow Pakistan to eliminate extreme poverty within a generation.

---

[56] Total remittances during the first eight months of FY16 grew by 6 percent as opposed to 17 percent growth witnessed same period last year. Remittances received from GCC countries grew by 8.7 percent compared to 21.8 percent expansion respectively.

[57] World Bank, 2016, Macroeconomic and Poverty Outlook, Saudi Arabia

For this to occur, investment is the key

Pakistan will need to invest more to accelerate growth. Pakistan is investing only 15 percent of GDP, one of the lowest investment rates in the world, and about one half the South Asia average. Current government efforts are geared towards addressing some of the constraints to increase investment, such as limited fiscal space for public investment, a weakening investment climate, significant electricity shortages and limited access to finance in order to create more and better jobs for the growing population of Pakistan.

C. Special sections

1. How can Pakistan improve its export competitiveness?

Falling commodity prices and slowing global demand are creating strong headwinds for Pakistan's export performance. The steady decline of Pakistan's share of world trade (see **Figure** 20) suggests, however, that its poor export performance is primarily due to a deterioration of its export competitiveness. Diminished export competitiveness is an outcome of poor trade facilitation, logistics and infrastructure, a protectionist trade policy, and worsening investment climate.[58]

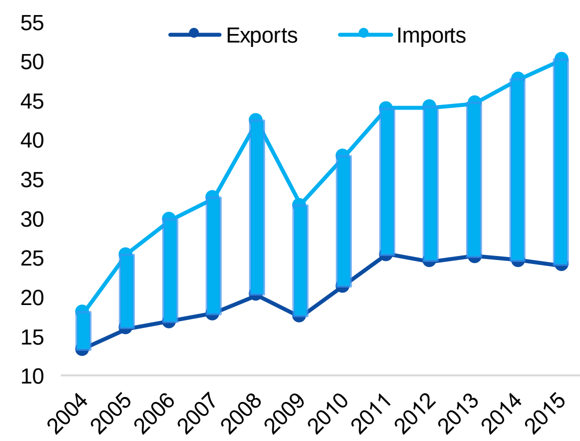
Export performance has lagged behind others in the region

Export performance has been subpar when compared regionally and internationally, both as a percentage of GDP and in absolute terms. In 2000, Pakistan's trade-to-GDP ratio was close to China's. Over the past decade, China's trade-to-GDP ratio has doubled, while Pakistan's ratio has increased by only 2.6 percentage points. Pakistan also 'under-trades' relative to countries at comparable GDP per capita. Pakistan's exports of goods and services rose from US$ 8.6 billion to US$ 19.9 billion (a mere 2.3 times) in 23 years from 1991 to 2014 while those of Bangladesh rose 22 times from just US$ 1.1 billion to US$ 24.3 billion. Over the same period,

[58] This note was prepared by Rafay Khan (Research Analyst, T&C) and Connor Spreng (Senior Economist, T&C)

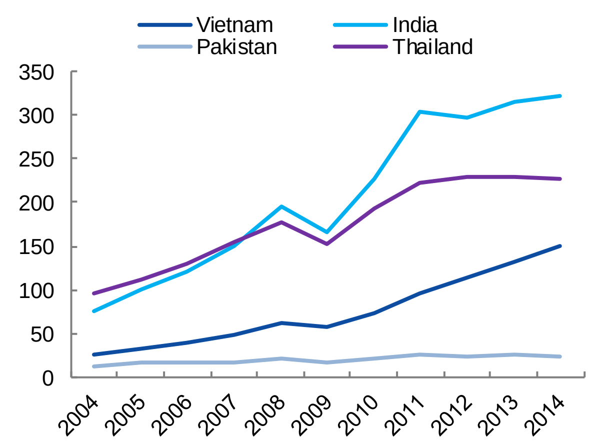
Vietnam's exports grew 33 fold, India's grew 14.5 times and China's by more than 25 times (see **Figures 18 and 19**).

Figure 18: The gap between exports and imports has been broadly growing[59]
Rs. trillions



Source: World Trade Organisation

Figure 19: Pakistan has been overshadowed by competitors' export performance (2004-2014)
Rs. trillions



Source: World Trade Organisation

Dismal export performance is causing Pakistan to lose market share in world trade

Lagging export performance is only partly explained by external factors (a fall in global commodity prices and slowing global demand) and is more directly attributable to Pakistan's declining export competitiveness. Pakistan's market share in world trade has been declining over the years, while that of Malaysia, Mexico, and Thailand has doubled, and China's tripled. Pakistan has lost 1.45 percent annually in export market share over the past decade. In an increasingly globalized world where 80 percent of global trade is carried out through global value chains, developing countries are increasingly focusing on trade competitiveness to exploit opportunities for growth and poverty reduction.

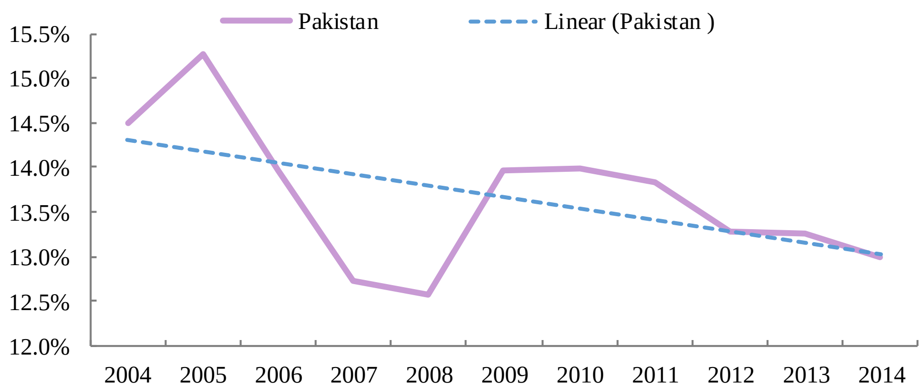
Pakistan's exports are highly concentrated geographically and labor-intensive

Diminished export competitiveness is also indicated through increased export concentration and an export bundle comprised predominantly of labor-intensive and low-tech manufacturing. Pakistan's export bundle is relatively diversified in terms of products[60], but is concentrated at the market level leaving the country exposed to partner-specific shocks. Geographically, the European Union (EU) and United States (US) represent the most important destinations of Pakistan's exports, with the US absorbing 18 percent and the EU absorbing 20 percent of all Pakistani exports. The technological content of Pakistani export is very low; high tech exports constituted less 2 percent of all exports in 2008. This share, for the most part, has remained unchanged over the past 25 years. Larger export firms (the top 1 percent of exporters account for approximately 45 percent of total export value)

[59] Note that the trade deficit fell slightly in H1FY16, although much of this is attributable to a fall in the value of imports rather than export growth. See **Section A3** for further discussion of current external sector developments.
[60] Source: Reis & Taglioni, 2013, Determinants of export growth at the extensive and intensive margins: evidence from product and firm-level data for Pakistan

are less likely to switch export strategies and primarily rely on intensive margins[61] for growth, indicating a lack of dynamism.

Figure 20: The Share of Pakistan Exports in World Trade has Declined (2004-2014)
Measured in percent



Source: World Trade Oraganization

Declining trade performance is explained by three structural factors

The declining trend in Pakistan's relative trade performance and export competitiveness has structural underpinnings anchored in three areas: 1) trade facilitation, logistics and infrastructure; 2) trade policy; and 3) investment climate. The following paragraphs offer a brief discussion of each of the three areas.

Slow processing times and high costs translate to uncompetitive trade facilitation, logistics and infrastructure

Poor trade facilitation, logistics and infrastructure have inhibited export competitiveness and trade growth. Presently, Pakistan's logistics are worse than India's and the South Asian and global averages. South Asia itself lags behind all regions except Sub-Saharan Africa. Given that more than 90 percent of Pakistan's international trade is transported by sea and 80 percent of land transport is over roads, there is a critical need to improve customs and border management for lowering logistical costs, particularly port operations and customs procedures. A journey in Pakistan takes three times longer than the same length journey in Europe. The typical container dwell time at ports in Karachi (95 percent of Pakistan international trade currently goes through one of the two ports in Karachi) is 7 days, three times that of developed countries and East Asia. The vessel call charge in Karachi Port is nearly US$ 27,000, compared to US$ 2,975 in Singapore and US$ 2,890 in Dubai. Inefficient trade facilitation and logistics are leaving Pakistan at steep competitive disadvantage to regional competitors. As of 2015, border and documentary compliance to export from Karachi takes 141 hours, in contrast to 20 hours in OECD countries. Similarly, border and documentary compliance to import takes 294 hours, in contrast with 13 hours for OECD countries.

Pakistan is seeking to improve trade facilitation but these efforts

Reducing trade costs, upgrading service quality, and improving connectivity between domestic and foreign markets can play a decisive role in attaining export competitiveness. Pakistan has initiated a series of reforms in recent years to upgrade its trade facilitation and logistical infrastructure. However, these reforms

[61] Level, growth and market share of existing exports

need to be sustained

will need to be sustained and synchronized with other efficiency enhancing efforts to bear meaningful results.

Protectionist trade policy has limited opportunities for participation in global supply chains

Pakistan's trade policy has reverted to protectionism over the past decade. The country embarked on a major trade liberalization program in the mid-1990s which resulted in reduced trade tariffs, simplification of the overall tariff structure, and abolition of most quantitative restrictions. However, gains made in the 90s and early 2000s have been gradually losing ground to import substitution policies that have discouraged exports. Pakistan is currently the world's seventh most protected economy as measured by the Overall Trade Restrictiveness Index (OTRI)[62]. Pakistan's tariffs are almost twice as high as the world average and three times more than those in South East Asia. Given that 30 percent of international trade is now comprised of re-exports of intermediate goods, import duties on intermediate inputs used by exporters raise production costs and erode processing margins.

Trade policy is growing in complexity…

Pakistan's trade policy has grown increasingly complex and discretionary over recent years. Both the overall level of tariffs as well as the range of different tariffs across sectors and products have increased over time. Services and basic raw materials are mostly free of import restrictions, and products at an intermediate stage of production have moderate tariff levels. By contrast, industries that are competing against imports, especially of finished products, are protected by very high tariff levels. Complexity in the tariff structure is primarily driven by Pakistan's Indigenization Program, which seeks to control and limit the competition and new entrants in specific industries, including through limiting imports. These negative trends have seen some reversal over the past two years. The highest tariff rate has been brought down to 20 percent from 30 percent, and the government is also working on curtailing the use of tariff exemptions and targeted protective tariffs.

…and institutional fragmentation has hindered any moves to remove the complexity in trade policy

Institutional fragmentation within the government has been a challenge in streamlining the trade policy. Key policy level decisions linked to trade in Pakistan are in the domain of multiple government agencies, including the Ministry of Commerce, Federal Board of Revenue and Ministry of Finance. Policy decisions regarding, for example, exchange rate, taxes and refunds are presently driven by fiscal considerations. This partially explains the government's insistence on maintaining tariffs at a high level given that import duties contribute close to 30 percent of Pakistan tax revenues, compared to 2.5 percent in Vietnam and an average of less than 5 percent for comparator countries. Conflict in implementing a coherent public policy is also evident in the delays in GST and duty drawback refunds. Pending sales tax refunds stood at Rs. 97 billion (US$ 970 million) in March 2015, creating a liquidity constraint for exporters.

Pakistan's poor investment climate also affects its competitiveness

Investment climate constraints (see **Figure 21**) continue to impede private sector growth, economic development and competitiveness in Pakistan. Pakistan ranks 138 out of 189 economies in the Doing Business Report 2016, having fallen 62 ranks since 2008. Similarly, Pakistan also ranks 126 out of 148 economies in the World Economic Forum's Global Competitiveness Index 2015-16, a major fall from being 91 out of the 134 economies covered in 2006.

The Doing Business

An increasing cost of doing business in Pakistan, as measured across the three core dimensions of doing business (cost, time and steps), highlights the competitive

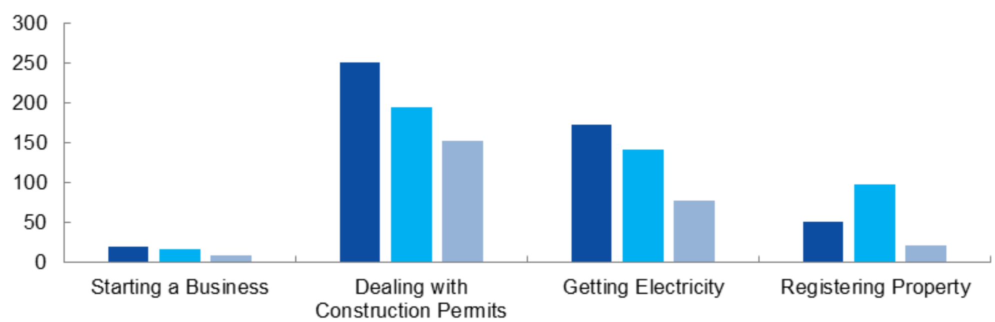
[62] The OTRI quantifies the uninform tariff that if imposed on home imports instead of the existing heterogeneous structure of protection would leave aggregate imports at their current level.

indicators reflect the disadvantage faced by Pakistani businesses

disadvantage of Pakistani businesses. It takes 19 days to start a business in Pakistan, in comparison to the South Asian average of 15.7 days and OECD average of 8.3. Over the last decade, frequency of tax payments for limited liability companies in Pakistan has remained at 47, significantly higher than the South Asian average of 31 and the OECD average of 11 payments per year. The cost of getting an electricity connection for business establishments is approximately twenty times higher in Pakistan than in the OECD high-income countries. This cost has reduced from 1435 percent of Pakistan's income per capita in 2010 to 1225.5 percent in 2016, which is lower than the South Asian average of 1386 percent, but it still remains high for micro, small and medium sized enterprises.

Figure 21: The time involved in doing business in Pakistan is much higher than elsewhere

Measured in hours



Source: Ease of Doing Business, World Bank

The poor investment climate is reflected in low and declining investment

Pakistan's worsening performance on indices measuring the overall investment climate in the country is reflective of the significant costs and perceived risks to investing and operating in Pakistan. This is evident in the declining investment in Pakistan. Total investment as a percentage of gross domestic product (GDP) in Pakistan has declined from approximately 19 percent in 2006-07 to around 15 percent in 2014-15; the annual average for South Asia as a region is almost 33 percent. Private sector investment to GDP has almost halved over the last decade; from a high of approximately 16 percent in 2006 to less than 10 percent in 2015. In recognition of the importance for competitiveness of a conducive investment climate, the government is in the process of initiating a package of reforms at the national and sub-national levels to correct regulatory and institutional level bottlenecks.

Pakistan can improve its volume and breadth of exports by strengthening its competitiveness

Pakistan needs to revitalize and enhance its export competitiveness in order for exports to become a driver of economic growth. Increased export competitiveness will not only allow Pakistan to strengthen its existing range of exports, but also to expand its export basket and improve market diversification. There is a need to institute an enabling environment to increase Pakistan's export competitiveness. This enabling environment, as a starting point, can be improved through the provision of adequate and efficient trade facilitation and logistical infrastructure, streamlining trade policy, and improving the investment climate.

2. Pakistan's electricity sector reform—addressing the funding gap

The Pakistan government plans to increase generation capacity by 33,000 MW to eliminate electricity shortages by 2025. The government has made substantial progress in securing the additional US$ 41 billion required for generation investment. But complementary investments of US$ 11 billion in transmission and US$ 6 billion in distribution are also needed (see **Figure 25**). Private funding will be imperative to closing this gap. To mobilize private investment, further reforms are vital to address the circular debt, create greater competition through the development of a wholesale market, privatize distribution and encourage private participation in transmission.[63]

The government is pursuing a dramatic increase in electricity generation

Electricity shortages have long been identified as a major constraint to economic growth in Pakistan, and the current government has taken significant steps to improve supply. It has raised tariffs and reduced subsidies, while also making efforts to improve the technical and commercial efficiency of the electricity distribution companies (Discos). The government has announced that it is pursuing the development of several thousand megawatts (MW) of new generation capacity. This special section looks at the size and composition of the generation investment and the need for complementary investment in transmission and distribution, and finally highlights four key reforms needed to attract the necessary private capital.

Electricity demand is projected to increase significantly

Peak demand for electricity rose from nearly 14,300 MW in 2005 to 20,300 MW in 2010 and nearly 28,000 MW in 2015. The system fell short of peak demand by 5,500 MW in the summer months of 2015. Demand is projected to continue to grow between 2016 and 2025. Preliminary findings of a generation and transmission system expansion plan[64] forecast peak demand to increase to over 37,000 MW in 2020 and 48,400 MW by 2025 (JICA 2015). Pakistan's program to increase electricity generation capacity to address its power shortage forecasts a net addition of addition of over 32,800 MW by 2025, sufficient to meet peak demand in that year (see **Figure 22**).

Increased generation is contingent on financing and fuel supplies

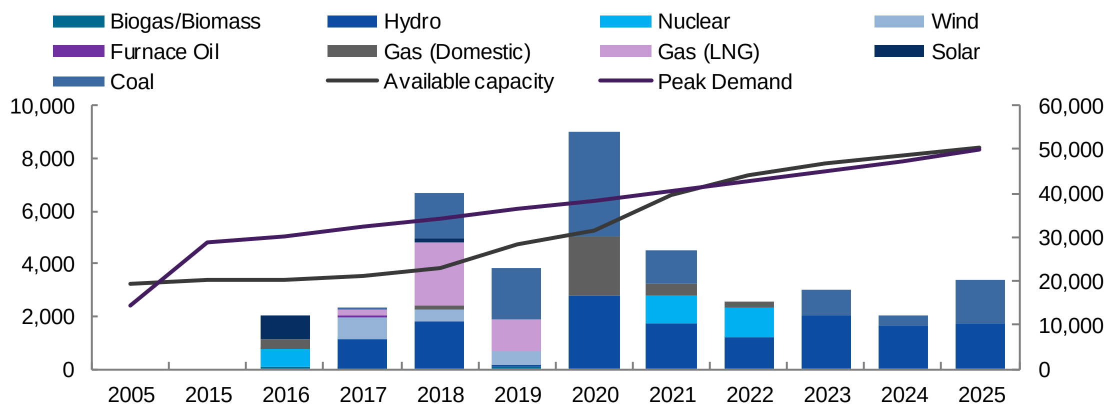
To deliver this program of increased generation capacity, some US$ 41 billion of investment is needed between 2016 and 2020 (JICA 2015) and this fleet of new plants will depend upon:

- significantly increased natural gas supplies to come mainly through LNG imports (6,600 MW);
- initial development of Thar coal fields (3,100 MW) as well as imported coal (4,600 MW);
- additions from hydropower projects under construction (5,700 MW); and
- additions to Pakistan's nuclear power generation fleet (700 MW) as well as new solar (1,050 MW) and wind (1,825 MW) installations.

[63] This note was prepared by Richard Spencer (Lead Energy Specialist, Energy & Extractives) with inputs from Mohammed Saqib (Senior Energy Specialist, Energy & Extractives), Kazim Saeed, Umul Awan, Beatriz Arizu and Roberto D'Addario (Consultants, Energy & Extractives)
[64] Prepared by the National Transmission and Despatch Company (NTDC) with support from the Japan International Cooperation Agency (JICA)

Figure 22: A mix of energy sources are planned to lift capacity to meet peak demand

Energy sources' additional generation capacity measured in MW (LHS) while capacity and peak demand are measured in MW (RHS)



Source: Japan International Cooperation Agency, 2015

Most of the funding has been secured for expanding generation from 2016 to 2020

For the 2016-2020 period, funding commitments of about US$ 36 billion have already been secured. Of this total, over two-thirds or nearly US$ 25 billion is expected to come from the private sector (mostly from IPPs and some from K-Electric). Most of the rest (nearly US$ 10 billion) is expected to be financed by the federal government, donors and International Financial Institutions (IFIs). A similar mix of investment sources is expected for the 2021-2025 period.

But the electricity transmission and distribution networks are also overloaded

In recent years, the capacity constraints of Pakistan's power transmission and distribution networks have become more visible. **Figure 23** shows the number of overloaded 11 kV feeders (which mainly serve neighborhoods) has increased by 57 percent between FY10 – FY14. During the same period, planned and forced outages of inter-city 220 kV and 500 kV transmission lines have increased by 49 percent (see **Figure 24**).

A complementary investment in transmission is required – but only a fraction of necessary funding is available

An expansion of Pakistan's generation capacity will require commensurate upgrades to transmission and distribution networks. JICA estimates Pakistan must invest US$ 11.3 billion in transmission between 2016 and 2020. Against this need, only US$ 3.1 billion of funding is available: US$ 2.6 billion is committed from the public sector and US$ 268 million from donors for the NTDC network. K-Electric plans a little over US$ 400 million for its own transmission lines. There is, therefore, a substantial funding gap of US$ 8.2 billion for 2016-2020. Comparable NTDC expenditures on system expansion between 2010 and 2015 were around US$ 1 billion. Hence even if there is a substantial overestimate of the financing need for transmission expansion, it seems almost inevitable that there will be a significant shortfall.

There is also a sizeable funding gap facing the distribution sub-system

The investment needs in the distribution sub-system are smaller than those of generation, but the funding gap is a much larger proportion of the required funds (see **Figure 25**). **Figure 26** shows the actual investment by DISCOs in FY10-FY15 compared with the petitioned (and NEPRA-approved) investment level for each year. It also shows the total investment requirement associated with the coming rise in generation capacity. In the 2016-2020 period, the JICA-projected investment requirement for distribution is US$ 5.6 billion. Against this requirement, the estimated funding gap is about US$ 3.3 billion given a funding estimate of US$ 2.3 billion including consumer contributions. By comparison, the 2010-2015 period saw an investment of US$ 2.6 billion by the DISCOs compared to their own estimate of an investment need of US$ 3.9 billion.

Figure 23: The number of overloaded feeders in transmission networks has increased…
Measured in number of feeders

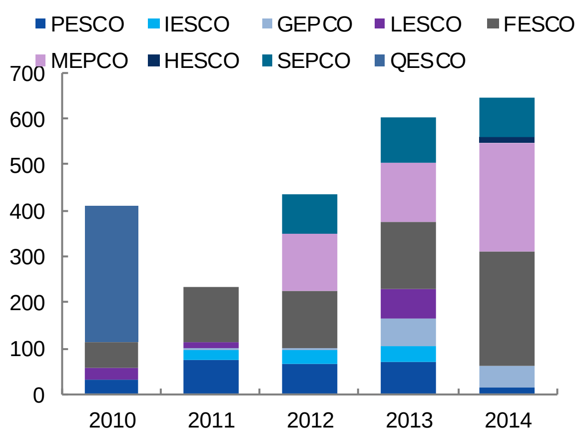
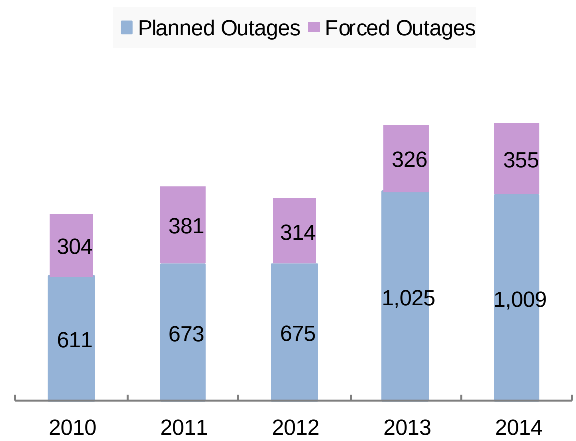


Figure 24: …as has tripping in transmission lines
Measured in number of lines



Source: National Electric Power Regulatory Authority State of Industry Report 2014

Private funding will be necessary to close the funding gaps facing the transimission and distribution sub-systems

The large investment in generation is chiefly expected through private participation. Investment in transmission is largely expected to come from public sector financing but on present plans the amount available is likely to be considerably less than that required. Whether there is adequate investment in distribution hinges on the likelihood and timing of privatization, because the new owners of Discos will be required to implement investment programs as part of the conditions of purchase. It follows that if privatization is delayed, there will be continued dependence on public sector funding, which on present plans will be less than the amounts foreseen in the Discos' five-year investment plans. Underinvestment will lead to a continuing shortage of transmission and distribution capacity. Not only will this result in poor reliability and quality of service, but it also implies that scarce resources will have been misallocated with too much allocated to generation assets and too few to transmission and distribution.

If the investment in generation that is already committed is not to be under-utilized, there must be commensurate investment in transmission and distribution. Public sector funding is limited, and so there has to be a change in the way they are financed, which implies significant reform is required. Four reforms stand out as important and which require bold and timely actions.

Reducing circular debt and eliminating subsidies will make the sector

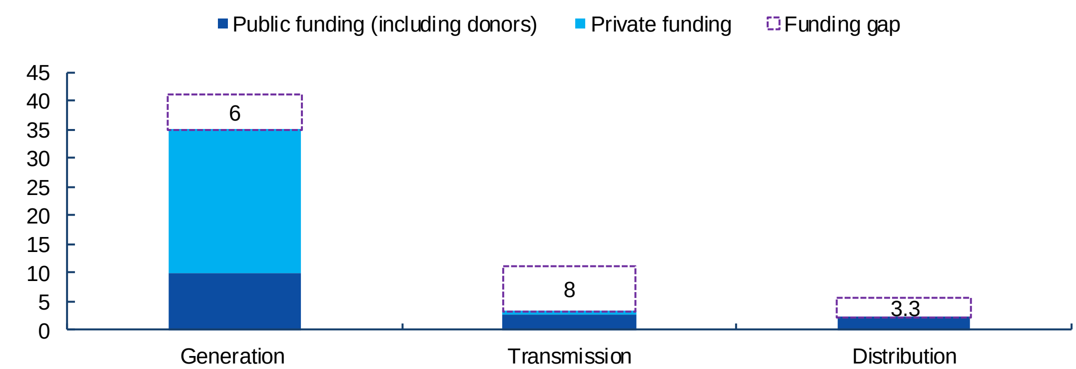
1. Reducing circular debt:

The government has made serious efforts in the last year to reduce the accumulation of overdue payables – the circular debt – in the sector. By December 2015, the stock of debt amounted to Rs. 326 billion and the flows had been reduced to zero. Nevertheless, there remain upward pressures on circular debt and

more attractive to private investment

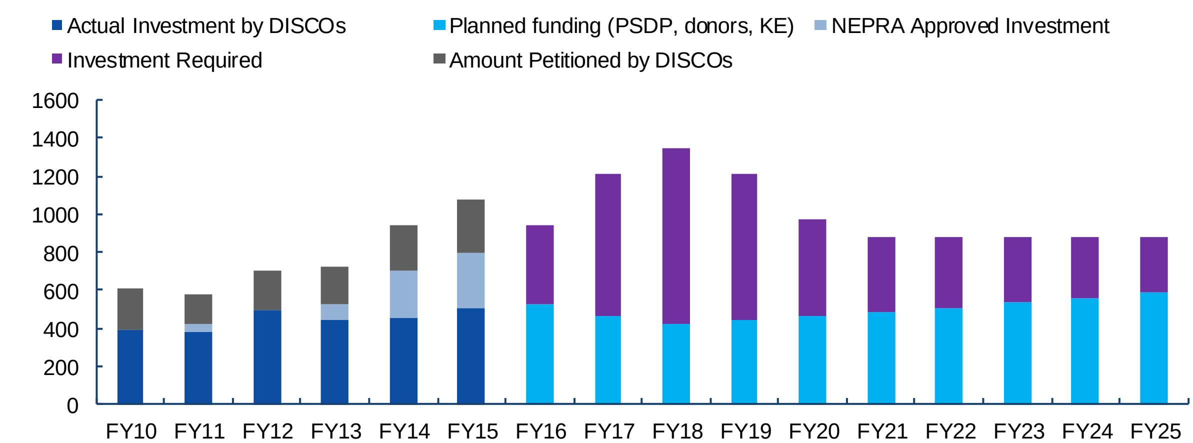
as long as it remains or there is a risk of its re-emergence, the private sector will hesitate to invest or seek guarantees from government. Hence continuing to implement the circular debt action plan[65] remains of vital importance. Further efforts to eliminate subsidies will also be needed. A financially sustainable sector will provide significant comfort to all investors.

Figure 25: The funding gap is a much greater proportion of the transmission and distribution investments
$US billions



Source: JICA

Figure 26: A large funding gaps remains in distribution investment
US$ millions



Source: NEPRA determinations, World Bank estimates and JICA

Introducing competition in generation would improve service delivery and reduce costs

2. Creation of CPPA-G and establishment of a wholesale market for power:

Historically, NEPRA has regulated generation prices but the structures are now in place that would allow a move towards regulation by competition. Competition will improve service delivery and reduce costs. Initially this could be through a direct contract between a generator and a Disco. In addition, the Central Power Purchasing Agency Guarantee Limited (CPPA-G) could act as an agent of one or

[65] 'Managing Circular Debt' – Ministry of Water and Power, Pakistan, September 2015

more DISCOs. In the longer term, a wholesale market is envisaged. Wholesale competition gives greater freedom to investors while also reducing the demand for government guarantees. Essential next steps include further development of the commercial code to allow bulk power consumers to purchase power directly from generators, due consultation with all market participants, standardization of power purchase agreements that reflect the new arrangements, and transparency in the wholesale market cashflow management and in CPPA-G operation and reporting.

Privatizing distribution companies would lead to network improvements and expansion

3. Privatization of distribution:

Privatization of the Discos is expected to attract investment leading to sustainable network improvement and expansion that will result in lower distribution losses, improved service quality for customers and greater commercial discipline in the sector. The privatization experience of K-Electric saw a reduction in transmission and distribution losses of about 12 percent from FY09 to FY15, and there was a 60 percent reduction in transformer tripping from FY09 to FY15. Crucially, distribution network improvements will result in greater amounts of generated power reaching end consumers rather than being lost through inefficient equipment or being stolen.

The government has started seeking private sector participation in transmission

4. Private sector participation in transmission:

The government is now turning its thinking to how to bring private investment into transmission. In 2015 it introduced a transmission policy framework, which sets out a number of legal and regulatory requirements, and in August 2015, NEPRA granted the first transmission license to a private company for a short 132kV transmission line. It is now considering a tariff petition for a 600kV high voltage direct current transmission line.

Further reforms are necessary to maximise private investment in transmission

To take full advantage of the potential for private investment in the transmission segment, further refinements to the regulatory regime and the introduction of a more streamlined and predictable path to investment will be needed. These include: a clear transmission investment plan to be developed based on an optimized generation and transmission expansion plan; more transparent decisions on which new transmission investments (lines and/or substations) are to be solicited from the private sector; the private sector must be required to compete to build and operate the lines; and a regulatory approach must be adopted including establishing the tariffs, quality standards, and third party access to which the new operator will be subject.

3. The opportunities and challenges of Pakistan's urbanization

250 million more people are expected to live in cities in South Asia over the next 15 years. Urbanization provides South Asian countries, including Pakistan, with the potential to transform their economies to join the ranks of richer nations in both prosperity and livability. A new World Bank report finds the region, while making strides, has struggled to make the most of the opportunity. Official statistics show that urbanization is occurring relatively slowly in the region, and particularly in Pakistan, suggesting that cities are struggling to overcome congestion forces. As a result, urbanization has been messy and hidden – manifesting in slums and urban sprawl, and growing most quickly outside metropolitan limits. To address these problems, Pakistan and the rest of South Asia should ensure that infrastructure, basic services and land and housing markets stay abreast of growing urban populations. This will require Pakistan to equip local governments with the discretion, resources and accountability to address local congestion challenges. It won't be easy but such actions are essential in making cities prosperous and livable.[66]

Urbanization presents an opportunity for South Asia, including Pakistan

Urbanization provides South Asian countries with the potential to transform their economies to join the ranks of richer nations in both prosperity and livability, but a new World Bank report, *Leveraging Urbanization in South Asia: Managing Spatial Transformation for Prosperity and Livability*, finds the region, while making strides, has struggled to make the most of the opportunity. With recent elections throughout Pakistan and a new mayor to be named in Karachi, the ability to concentrate on urban reforms with renewed energy is an opportunity that should not be squandered.[67]

The urbanization of vast numbers of people can drive dramatic productivity growth through the agglomeration of people and enterprises

Pakistan has been presented with an enormous opportunity to boost its development trajectory as its population urbanizes in vast numbers. Urbanization can foster productivity through the agglomeration of both people and enterprises in towns and cities. This can produce 'agglomeration economies', which include the benefits arising from, for example, the spillover of ideas and knowledge between firms and workers, the better matching of firms and workers, and the existence of dense networks of local suppliers of intermediate inputs. South Asia's urban population is poised to grow by almost 250 million people by 2030. This could propel the region toward greater economic growth and prosperity. But to realize these benefits, policymakers must effectively manage the congestion forces that can stifle the productivity benefits of urbanization and diminish liveability in cities and towns.

Productivity gains rely on effective management of congestion forces

Agglomeration economies do not accrue indefinitely. As settlements grow and become more dense, pressures grow on infrastructure, basic services, land, housing and the environment. These congestion pressures undermine the exploitation of agglomeration economies and the ability to compete in international export markets. An economy's ability to access the potential gains from urbanization will depend on its management of these forces.

The benefits of urbanization are not being fully realized

According to official figures, urbanization is occurring relatively slowly in Pakistan, suggesting the potential economic benefits of the trend are not being fully realized. The share of the population living in officially classified urban settlements has been growing at only 0.80 percent a year from 2000 to 2010. Throughout South Asia the

[66] This note was prepared by Jessica Schmidt (Urban Specialist, South Asia Urban Unit) with inputs from Peter Ellis (Lead Urban Economist) and Mark Roberts (Senior Urban Economist).

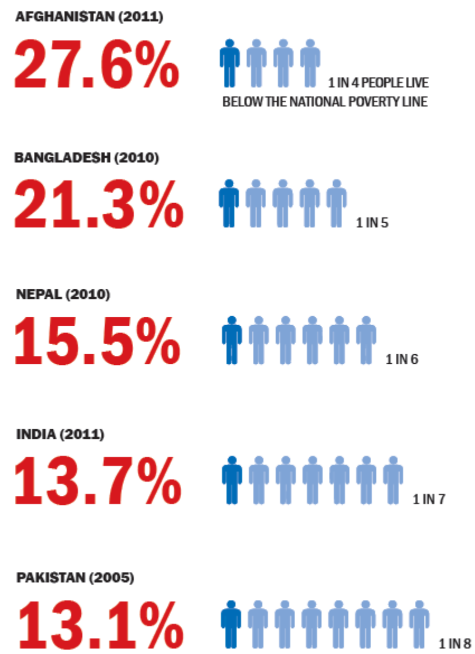
[67] To learn more about Pakistan and the larger region's urbanization past and future, please visit www.worldbank.org/southasiacities to read the full report.

share of the population in official settlements has grown by 1.1 percent a year. By contrast, when it was at a similar urbanization level, China's urban share of population grew 3.1 percent a year, moving from 26.4 percent in 1990 to 35.9 percent in 2000.

High urban poverty rates suggest South Asia's cities are not providing opportunities for all

The persistently high poverty rates in South Asian cities are one indication that the economic benefits of agglomeration are eluding many residents. Although progress since 2000 has been impressive, South Asian cities remain characterized by high levels of poverty, bad housing conditions, and generally poor livability for many of their inhabitants (see **Figure 27**). Around half of Pakistan's urban population lives in slums. For the very poorest in Pakistan, under-five mortality is higher in urban than in rural settings. These vulnerable urban dwellers often live in informal settlements characterized by poor construction, insecure tenure, and underserviced housing plots. The lack of decent, affordable housing not only impairs their welfare, it potentially affects their health, and reduces female labor force participation.

Figure 27: Urban Poverty Comparison for Most Populous South Asian Countries



Pakistan's cities are also producing unhealthy levels of pollution

Pakistan's cities are also producing high levels of pollution, increasing the likelihood of residents suffering from stroke and heart and lung diseases. Analysis of World Health Organization outdoor air pollution in cities data reveals that Karachi has an annual mean of 117 µg/m3, twice the recorded annual mean concentration for Beijing, China.[68]

On an international scale of liveability, Pakistan's cities rank poorly

The struggles of the urban population are also apparent in poor performance in international rankings of cities. One of the most respected measures is the livability index published by the Economist Intelligence Unit (EIU), which assesses cities across five dimensions of a "livable city." The 2015

Table 11: EIU Livability Index (2015), Data reused with permission of the Economist Intelligence Unit

City	Ranking
New Delhi	110
Mumbai	115
Kathmandu	125
Colombo	127
Karachi	135
Dhaka	139
Developing country averages	
SAR	125
All developing exc. SAR	103
EAP	93

[68] This designation is according to data on annual mean concentrations of particulate matter with a diameter of less than 2.5 microns (that is, PM2.5) from the World Health Organization's "Ambient (outdoor) air pollution in cities database 2014" (http:// www.who.int/phe/health_topics/outdoorair / databases/cities/en/).

livability index of the EIU ranked Karachi 135th out of 140 cities in the world (see **Table 11**).[69]

Many of these challenges are driven by the messy and hidden nature of South Asia's urbanization

There are two dominant features of South Asia's urbanization that may illustrate why the region is not yet fully enjoying the livability and prosperity that can accompany growing cities. The process of urbanization in South Asia—and in Pakistan specifically – has been both messy and hidden. Messy urbanization refers to the proliferation of urban sprawl and slums while hidden urbanization, a related concept, refers to urbanization that is not captured in official statistics, often on the peripheries of major cities. The following paragraphs discuss these phenomena in greater detail.

A failure to manage land and housing markets has led to messy urbanization, where cities are growing most quickly on their peripheries

Following a process of messy urbanization, a sizable proportion of South Asia's urban population lives in slums. Cities have grown outward, spilling over their administrative boundaries, rather than upward through the construction of taller buildings. Messy urbanization is reflected in faster population growth on the peripheries of major cities in areas beyond municipal boundaries – this is occurring in Pakistan as it is in much of South Asia. The spillover of cities across their boundaries creates challenges for metropolitan coordination in the delivery of basic services and the provision of infrastructure. Estimates suggest that at least 130 million of South Asia's urban residents live in slums and are disproportionately deprived of basic infrastructure and access to basic services. The prevalence of urban slums in South Asian cities reflects a failure to adequately manage land and housing markets. And with growth occurring beyond city limits, much urbanization has been hidden — a growing number of people in the region live in places that possess strong urban characteristics but that are not officially recognized as urban.

Around 20 percent of all Pakistanis live in urban areas outside administrative boundaries, and are 'hidden' from official figures

Hidden urbanization stems from official national statistics that understate the share of Pakistan's population living in areas with urban characteristics. An alternative measure of urbanization, the Agglomeration Index — which, unlike official measures, is comparable across countries and regions — shows that official statistics may substantially understate the number of people living in areas that look and feel urban, even if they are not counted as such in national population and housing censuses. According to the index, the share of Pakistan's population living in areas with urban characteristics in 2010 was 55.8 percent. This compares to an official estimate of just less than 36 percent, suggesting the existence of considerable hidden urbanization.

This is leading to multicity agglomerations, which present governance challenges but have the potential to yield enormous economic benefits

The combination of messy and hidden urbanization has led to a phenomenon known as multicity agglomerations, defined as a continuously lit belt of urbanization containing two or more cities[70]. As these cities sprawl and grow, they eventually meet, forming a long corridor or mass of development. Pakistan saw a net decline in multicity agglomerations from 12 to 10 during the period 1999-2010 as the formation of new agglomerations was outpaced by the merging of existing agglomerations. The Lahore agglomeration expanded to absorb those of Chiniot, Gujranwala, Gujrat, Lalamusa, and Sialkot. This explains the increase in the average number of cities per agglomeration in Pakistan from four in 1999 to 6.5 in 2010, making Pakistani agglomerations the largest in the region. The fusing of existing agglomerations points to an increasingly connected network of cities across South

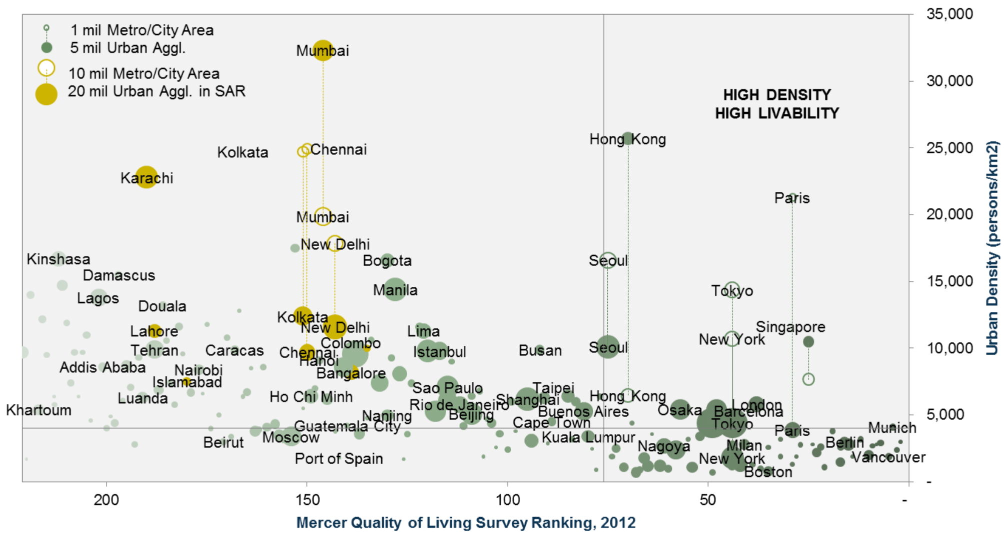
[69] Data reused by permission of The Economist Intelligence Unit. Further permission required for reuse.
[70] The definition also requires each city to have a population of at least 100,000 living within its administrative boundaries in 2010.

Asia. If the challenges that they present for urban governance can be overcome, these agglomerations carry great potential for the exploitation of agglomeration economies and the building of economic prosperity.

It is apparent that Pakistan's cities and towns have been struggling to deal with congestion forces

The challenges outlined above suggest that Pakistan's towns and cities have been struggling to deal with the pressures of population on their infrastructure, basic services, land, housing and environment. The forces that generate agglomeration economies—for example, spillovers between firms and workers—are largely outside of the control of policymakers. The forces of congestion, by contrast, are directly influenced by policy decisions regarding the supply of infrastructure and basic services and the way in which cities are planned. The high congestion costs experienced in Pakistan's cities have constrained both urban growth and agglomeration benefits by making cities less attractive places to migrate to and by encouraging cities to grow outward rather than upward.

Figure 28: Mercer Quality of Life Survey Ranking, 2012



Source: Ranking surveys by Mercer (2012); population density data derived from United Nations Statistics Division (UNSD) (2014) and Demographia (2014).

To manage congestion forces, governments must ensure infrastructure, basic services, and housing markets keep pace with demand

The strength of congestion forces can be largely mitigated if investments in infrastructure and basic services keep pace with demand as more people and firms congregate in urban areas. Without sufficient investment, urban infrastructure and services become stretched, reducing quality and access. Similarly, the effects of congestion forces depend on the ability of land and housing markets to respond to rising demand for urban residential, industrial, and commercial property. This increased demand results in higher density, which, if improperly planned, can lead to a lower quality of life. In **Figure 28**, both Karachi and Lahore have over 10 million people living in their urban agglomerations, and yet tend to rate on the lower end of quality of life surveys. This is partly due to a failure of agglomeration economics to overcome congestion pressures as well as a failure of policy.

Effective urban local governments will be crucial

To address key congestion constraints, policymakers need to equip urban local governments with the tools to manage local congestion pressures as they arise. This means addressing three fundamental urban governance deficits—empowerment, resource and accountability. Addressing these deficits will require empowering urban local governments, identifying practical ways to increase the resources available to them to perform their mandated functions and strengthening the mechanisms that hold local governments accountable for their actions.

Recent reforms are moving in the right direction

The recent local elections in Pakistan are an important step toward reducing these three deficits. The new local government laws, which were enacted in most provinces in 2013, have started to re-empower local governments after the expiration of the 2001 Local Government Act.[71]

However, urban local governments are still disempowered

Most urban local governments in South Asia suffer from unclear institutional roles and limited functional and revenue assignments. That leaves local governments with uncertain authority and limited power to make decisions for most service delivery obligations. They depend greatly on transfers from upper tiers of government, and the reporting requirements for budget approvals are heavy. Functions and resources assigned to Pakistan local bodies are very limited. Only about 5% of Pakistan's public spending is undertaken at the local level.

Institutional roles for each level of government should be clarified

Empowering urban local governments will require a dedicated commitment to clarifying intergovernmental fiscal legal frameworks by amending existing laws, enforcing them, and in some cases, establishing new and simpler laws. In Pakistan's case, it may be necessary to rethink the role of local government to empower them as the primary agent for service delivery, local economic development and economic and social outcomes, which may ultimately require legislative change.

Fiscal transfers to local governments are significant but constrained

Local government revenue mobilization is constrained by established fees and tax rates, as well as by narrow tax bases. In Pakistan, local governments have some formal discretion over setting local tax rates but are generally subject to strong state and provincial revenue regulations and oversight. In addition, most South Asian countries have some type of formula-allocated transfers from central to urban local governments, with relatively large allocations in Pakistan. However, although the transfers are officially unconditional, they often come with higher-level rules and "guidance" on use, limiting the discretion of local governments to determine priorities. Across the region, the key challenge is to design and implement more effective intergovernmental fiscal transfers.

Local government accountability should be strengthened

Formal administrative accountability systems generally exist in the region, but many are fairly weak or little used. The main causes for their infrequent implementation are the fragmentation and lack of clarity in institutional roles and the lack of inter-jurisdictional cooperation. Bridging the accountability deficit will require the development of better systems and practices and building the capacity of both government (at all levels) and citizens. In addition, local elections need to be transparent and sufficiently competitive to give voters meaningful choices. Non-electoral mechanisms—input-oriented processes and feedback mechanisms—can be highly productive if well-designed and appropriately implemented.

Key reform ideas include strenghtening transport links, adopting granular spatial planning,

For Pakistani cities to realize their potential and transform themselves into prosperous and livable centers, they must not only manage the frequently rapid expansion on their peripheries; they must also address existing and future challenges at their cores. See **Figure 29** for an example of the development that occurs when the center of cities are congested. Urban upgrading and infrastructure work can add qualitative value at street level and revitalize areas and neighborhoods. At the

[71] For more information, please see Ming Zhang's blog "Local elections in Pakistan: A chance to improve public services": https://blogs.worldbank.org/endpovertyinsouthasia/local-elections-pakistan-chance-improve-public-services

and rejuvenating city cores

national level, how cities are connected as a system through flows of goods, labor, and ideas is important.

To bolster opportunities for prosperous and livable cities, planners and government decision makers can focus on four strategies:

- The first is to invest in strengthening transport links that improve connectivity between urban areas—between large and secondary cities, and secondary cities and towns. Better transport links will lead to the development of more efficient systems of cities.
- The second strategy is to adopt forward-looking planning approaches to guide expansion where it is most rapid—on city peripheries.
- As a complement, the third strategy is to unlock the potential of city cores, rejuvenating those in decline. The Government of Sindh has started work on a Karachi Transformation Strategy that will ensure a good understanding of the city's structural challenges, investment needs and priorities, as well as focus on the livability and quality of life of its citizens. For example, a pedestrianized street in front of the Custom House opened in December 2015.
- Fourth, to facilitate the formation of more vibrant neighborhoods, granular spatial planning approaches can permit greater variation in land uses and development. Such planning should be flexible, allowing land uses to adapt within a framework that takes a long-term view of a city's development.

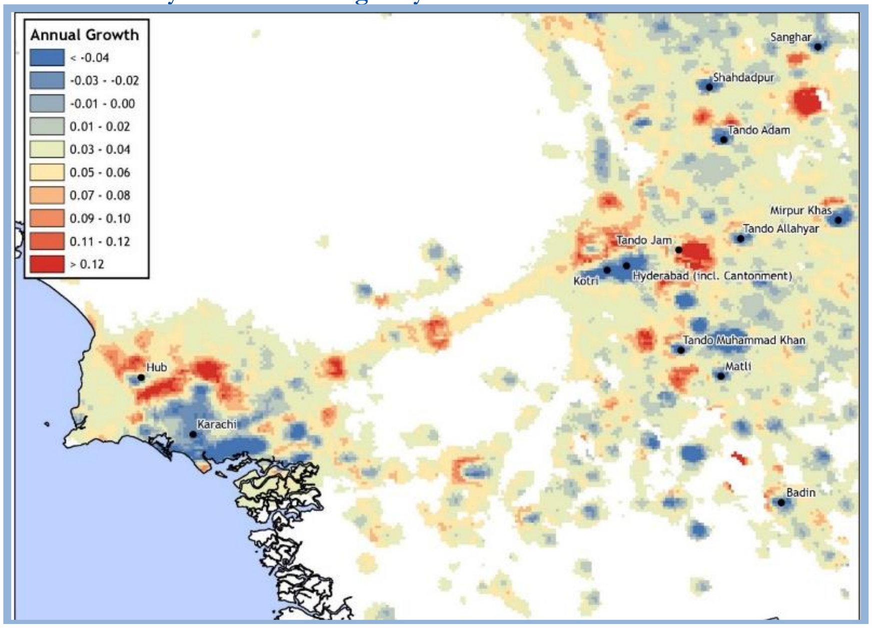
Congestion also requires innovative housing finance and a greater supply of affordable housing

Highly congested land and housing markets are exacerbating an affordable housing crisis and undermining cities' livability. It is not just the poor, but also many middle-income households, that lack access to affordable housing. To turn back the tide of proliferating slums, Pakistani cities must embark on land and housing reforms and foster innovative housing finance. The extent of construction—both formal and informal—on the edge of Karachi is remarkable, creating longer commutes and the need for increased infrastructure. City and suburban governments need to go beyond slum upgrading and embrace measures to stimulate the supply of affordable housing. Also needed are infrastructure to open up land for residential development, easy-to-use land titling and registration systems, and greater access to construction and mortgage finance.

Resilience to disasters and the effects of climate change

By concentrating people and property in disaster risk-prone areas, such as deltas, floodplains, coasts, and the Himalayan belt, Pakistan's cities have increased the exposure of people and property to natural hazards. Cities in Pakistan that lie along the Himalayan range are at risk of earthquakes and many are also at risk of heavy inland flooding. The first step in developing a resilience strategy is to accurately identify and quantify the national, subnational, and city risks. Governments at all levels should conduct risk assessments to identify the vulnerabilities of communities and the potential exposures to given hazards.

Figure 29: Economic activity has followed highway investment rather than traditional urban patterns



Pakistan has so far struggled to deal with congestion forces

Pakistan and the rest of South Asia have so far struggled to make the most of its urbanization. Difficulties in dealing with the congestion forces brought about by the pressure of population on land, housing, infrastructure, basic services, and the environment lie at the heart of the relative lack of its cities' livability. By fostering messy and hidden urbanization, those forces are also constraining the potential of powerful agglomeration economies to bring about faster improvements in prosperity.

With policy reform, Pakistan can realize the potential of its cities

Looking ahead, policy makers face a choice between two paths. The first is to continue with the same policies that have allowed congestion pressures in urban areas to mount, thus undermining the exploitation of agglomeration economies. This path would leave Pakistan on its current trajectory of underleveraged urbanization, structural change, and development. The second path is to undertake difficult and appropriate policy reforms to alleviate both current and future congestion pressures and to facilitate the exploitation of agglomeration economies, thereby enabling the tremendous untapped potential of its cities to be realized. It will not be easy. But it is essential to making the region's cities prosperous and livable.

4. Provincial development spending in Pakistan – the case of Punjab

Provinces have enjoyed a large expansion in fiscal space since the 2010 7th NFC Award. As a result, Punjab—with a population of over 100 million people—now accounts for almost a third of total Pakistan development spending. Punjab's development expenditure has more than doubled since FY11. While such a rapid increase presents enormous opportunities to strengthen infrastructure and services in the province, it also puts considerable pressures on the bureaucratic systems managing the development budget. This section aims to give particular attention to the structural issues impeding the effectiveness of development expenditure in Pakistan's provinces by examining Punjab's Annual Development Plan (APD) as a case study. [72]

Punjab accounts for a large share of Pakistan's overall development spending

One fourth of total consolidated government PSDP-related development spending takes place in Punjab. Over the last four years, average consolidated government budgeted development spending stood at Rs. 919 billion, of which 31 percent was spent in Punjab. This is not surprising given Punjab is the largest province in Pakistan accounting for roughly three-fifths of the country's population and income; and its economy therefore has a major influence on national economic and social indicators.

Development expenditure in Punjab is almost 40 percent higher in FY16

Punjab development expenditure for FY16 is budgeted at Rs. 400 billion or 38 percent higher than FY15 revised estimates. This allocation includes Rs. 67 billion for other development initiatives. The Annual Development Plan (ADP) for FY16 attempts to emphasize projects that are aligned with Punjab Growth Strategy 2018. The thrust of the ADP is towards improvement of infrastructure and investment in the energy sector with extra weight assigned to resources for Southern Punjab.

Punjab has directed its large fiscal increases towards development expenditure

Punjab development expenditure has increased significantly during the period of 7th NFC Award. During FY06-FY10, provincial development expenditure grew by 90 percent, and this growth accelerated to 207 percent during the period of 7th NFC Award (FY11-FY16). In comparison, the growth of recurrent expenditures of the province averaged around 76 percent during the period under the 7th NFC Award compared to 100 percent growth during FY06-FY10. This suggests that the increased fiscal space which became available to the province during the 7th NFC award has been directed towards fulfilling development needs.

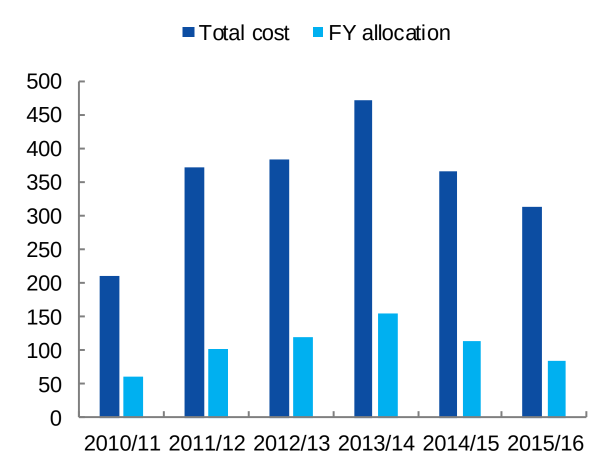
The ADP budget is becoming more fragmented, reversing the postive trend towards consolidation during FY11 to FY14

The fragmentation of the ADP into too many projects is a legacy issue, which has further deteriorated in the past three fiscal years. Between FY11 and FY14, the ADP showed a positive trend toward consolidation: the number of projects in the ADP decreased by 49 percent; the average project size increased by 126 percent; the average allocation per project increased by 157 percent; and the average annual financing ratio per project increased from 29 percent to 32 percent. By contrast, between FY14 and FY16, these trends were reversed: the number of projects increased by 152 percent; the average project size decreased by 34 percent; the average allocation per project decreased by 45 percent; and the average annual financing ratio per project decreased from 34 percent to 27 percent (see **Figures 30 and 31**).

---

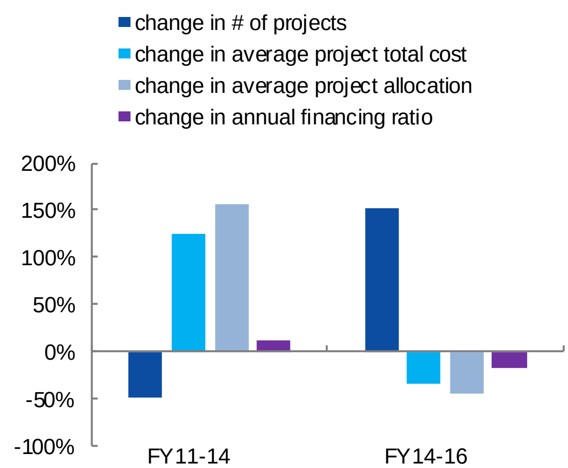
[72] This note was prepared by Saadia Refaqat (Senior Economist, MFM) with inputs from Syedah Mohsina Atiq (Consultant, MFM)

Figure 30: Average estimated cost and average ADP allocations per project
Rs. millions



zSource: FABS, World Bank staff calculations

Figure 31: Trends in ADP composition in the periods FY11-14, FY14-16
Measured in percent



Source: FABS, World Bank staff calculations

There are a large number of new projects in the ADP and allocation to them remains too high

At the same time, the share of new projects in the ADP has increased. With an increasing portion of the development program consisting of new projects, the portfolio is getting younger every year. Between FY13 and FY16, the share of new projects in the ADP jumped from 22 percent 48 percent. On the other hand, in the past two years allocations to *ongoing* projects have exceeded allocations to *new* projects (see **Figures 32 and 33**). In FY16, allocations to *ongoing* projects stood at 53 percent of the total – significantly higher than 38 percent in FY12. This is a positive trend, as it improves the prospects of ongoing projects being completed within schedule.

Figure 32: ADP composition: ongoing vs. new projects
Measured in number of projects

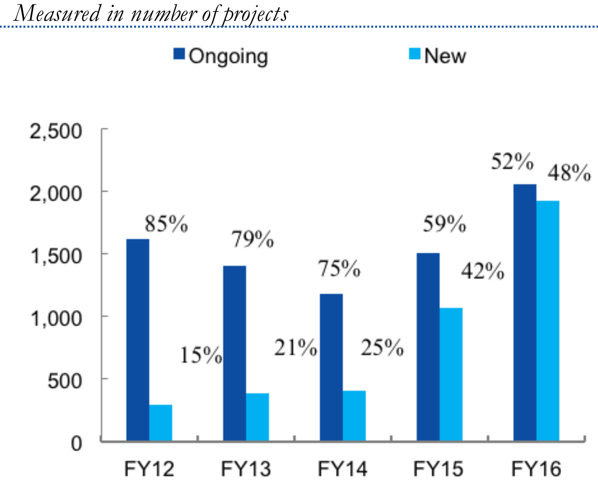
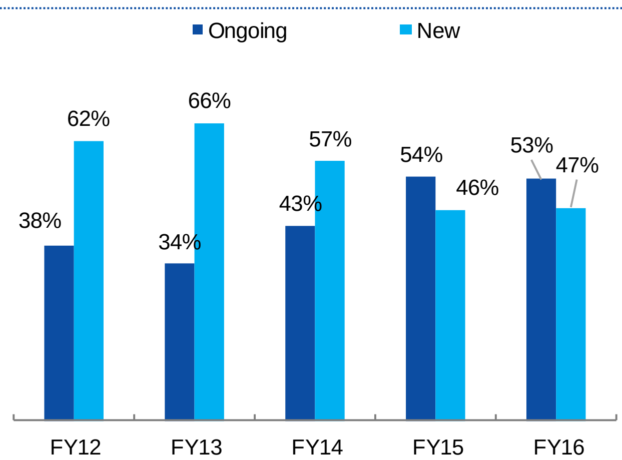


Figure 33: Allocations to ongoing and new projects
Measured in percent of total



Source: Annual Development Plan, Punjab, various years

An increasing proportion of ADP projects are small—under Rs. 50 million

In the past couple of years, the share of small projects in the ADP has also increased. Almost half of the projects in the FY16 ADP have a total estimated cost of less than Rs. 50 million, and micro-projects below Rs. 10 million account for 42 percent of the total, compared to 36 percent and 35 percent respectively in FY14 (see **Figures 34 and 35**). Only 16 percent of all projects in the FY16 ADP had a cost over Rs. 50 million. Most of the micro-projects involve small-scale civil works at separate project sites (e.g., boundary walls, tube wells, drainage works, rural roads). As the decentralization of functions and financing to local government units (LGUs) advances, small projects in areas of LGU competence (school education, primary and secondary health, water supply and sanitation, local roads) will need to be selected and implemented by the LGUs—ideally in consultation with the relevant line departments.

Figure 34: Distribution of allocations within ADP
Measured in percent of projects

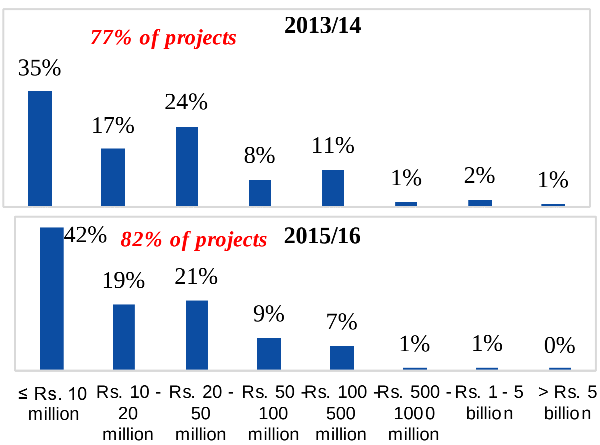
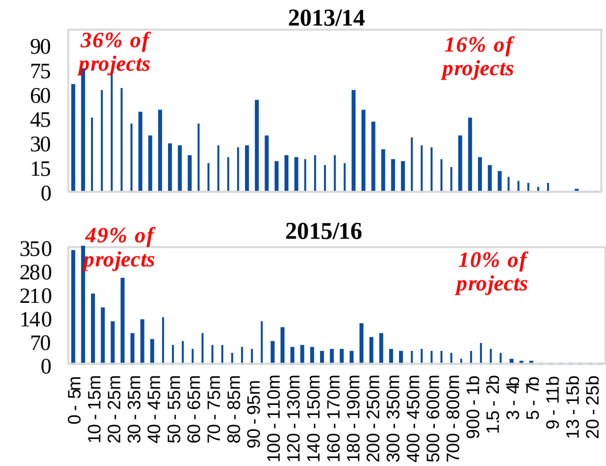


Figure 35: Distribution of project sizes within ADP
Measured in percent of projects



Source: Annual Development Plan, Government of Punjab

Fragmentation in the ADP budget is a serious concern, leading to a lower rate of implementation

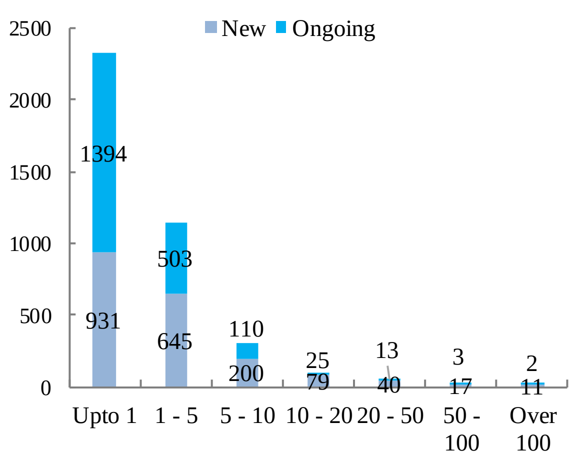
Lower allocations to a larger number of projects are bound to result in longer timeframes for project completion. Despite the inclusion of 1,923 new projects, the ADP assumes that 59 percent or 2,325 projects will be completed within a year. Another 1,148 projects in the development portfolio will take 1-5 years to complete, provided the present level of allocation is maintained. This means almost 87 percent of the ADP portfolio is assumed to be completed within 5 years. On the other hand, allocations for some of the projects are clearly insufficient to ensure timely completion. For instance, there are 104 projects (24 percent of them ongoing) in the FY16 ADP portfolio, which at current levels of allocations would take 10-20 years to complete (see **Figure 36**).

40 percent of projects included in the ADP are unapproved, suggesting low implementation readiness

The ADP also contains a significant number of unapproved projects (approval will be sought during the FY), whose share in the ADP has grown in the past couple of years. Unapproved projects accounted for 41 percent of all projects in the ADP for FY16. This reflects a negative trend since FY2013/14 when only 21 percent of all projects were unapproved. The large number of unapproved projects indicates low implementation readiness, which is likely to result in delays and budget under-execution. For example, in FY16 almost 46 percent of projects were unapproved at the time of presentation of the budget (see **Table 12**).

Figure 36: Projected completion time for projects in the ADP FY16

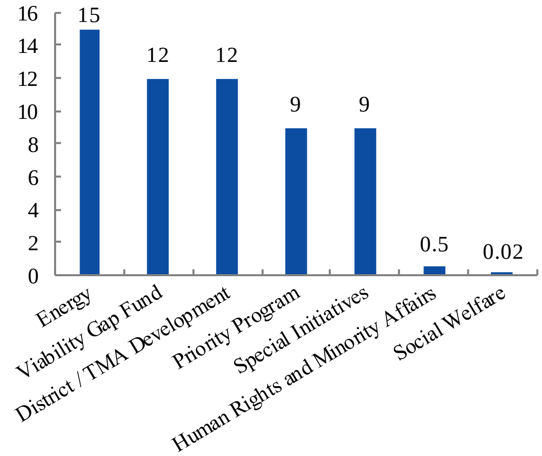
Measured in number of projects and grouped according to years



Source: Annual Development Plan, Govrnment of Punjab

Figure 37: Allocations in block grants, FY16

Measured in Rs. billions



Source: World Bank estimates

Table 12: Approved and unapproved projects in the ADP

	FY14		FY15		FY16	
	No.	Allocation	No.	Allocation	No.	Allocation
Ratio of approved to total	79%	47%	62%	62%	54%	59%
Ratio of unapproved to total	21%	53%	38%	38%	46%	41%

Source: Annual Development Plan, Punjab

Block allocations have reduced

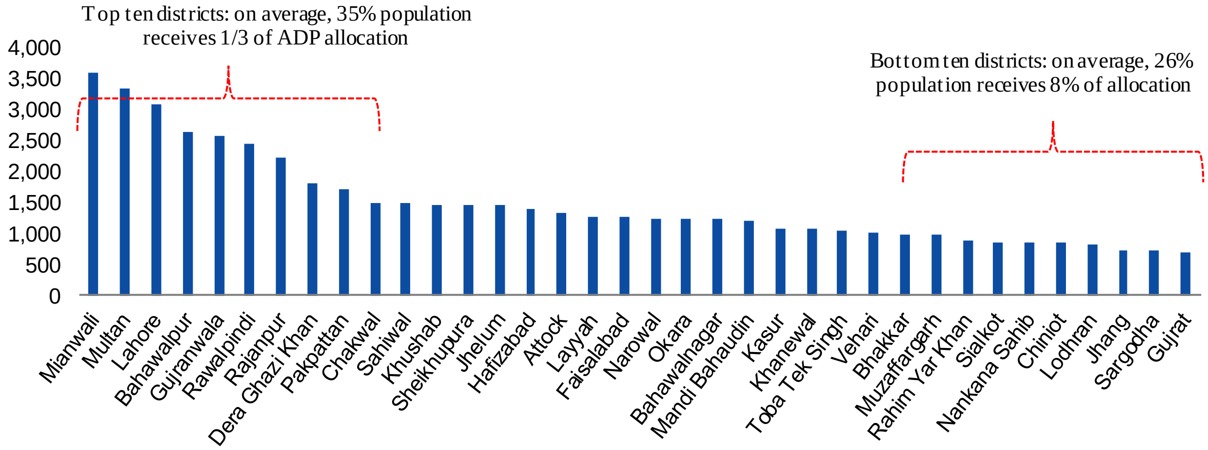
On the other hand, block allocations have declined in recent years. This is a positive trend insofar as it indicates that the planning and preparation of high-profile projects may have improved, and are now reviewed and financed under the regular ADP rather than from block allocations (see **Figure 37**).

Per-capita ADP allocations vary significantly across districts—requiring further policy action

Per-capita ADP allocations vary significantly across districts. Analysis based on per capita average allocation over the past three years shows Mianwali district as the top recipient with Rs. 3,606 per capita allocation, followed by Multan (Rs. 3,331), Lahore (Rs. 3,097), Bahawalpur (Rs. 2,644), and Gujranwala (Rs. 2,569). The districts receiving the lowest per capita allocation include Gujrat (Rs. 691), Sargodha (Rs. 725), Jhang (Rs. 729) and Lodhran (Rs. 829). Moreover, a review of the past three years' average per capita allocations shows that the top ten districts, which account for an estimated 35 percent of the provincial population, receive one third of ADP allocation (see **Figure 38**). By contrast, the bottom ten districts, which account for about 26 percent of the population, received only 8 percent of ADP funds. To address the infrastructure gaps and lagging economic and human development indicators across districts in Punjab, the Government would need to rebalance ADP allocations even further.

Figure 38: Three-year average per-capita allocations across districts

Measured in Rupees



Source: Annual Development Plan, Government of Punjab; Punjab Development Statistics 2014 and World Bank staff calculations
Note (i): Analysis excludes 'Punjab-based projects' (cluster) for which Rs. 137 bn, Rs. 101 bn & Rs. 127 bn have been respectively allocated in FY14, FY15 & FY16.

Several steps can be taken in the short- and medium-term to improve the effectiveness of ADP spending

This analysis suggests a number of recommendations:

- There is a need to review alignment of the ADP in line with the province's medium-term development strategy such as the Growth Strategy.
- Setting a threshold for the size of projects submitted for inclusion in the ADP may improve portfolio consolidation.
- A close scrutiny of non-performing projects is required, particularly those that have not met disbursement and physical milestones for two fiscal years.
- It is essential to minimize or altogether eliminate unapproved projects from the ADP.
- Start preparation for an automated ADP monitoring system. Required functionalities would include: (i) link with FABS for obtaining real-time data on commitments and disbursements; (ii) capacity to include project GIS data and data on physical progress; (iii) coverage of the whole project cycle; and (iv) data aggregation and analysis capabilities, ideally through user dashboards.
- Start preparation of a unified assets register. Ensure that all line departments and LGUs record all new assets, and start tracking movable assets through property numbers (ideally in the form of barcodes) and expand geo-tagging of immovable assets. The Government may also start conducting valuations of newly completed assets and record them in the assets register.

D. Appendix: Pakistan's economy in pictures

Figure 1: GDP growth is steadily increasing and is expected to maintain its modest momentum...

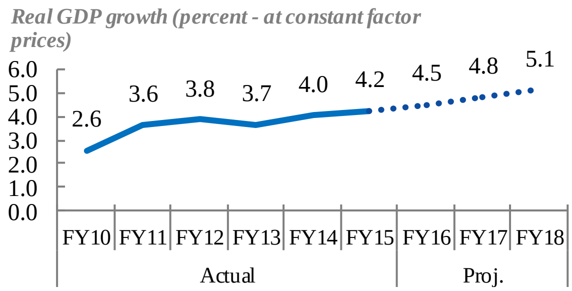


Figure 2: The services sector is the main supply-side contributor to GDP growth

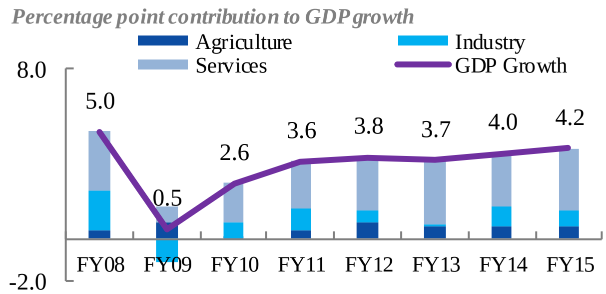


Figure 3: On the demand side, consumption is driving growth....

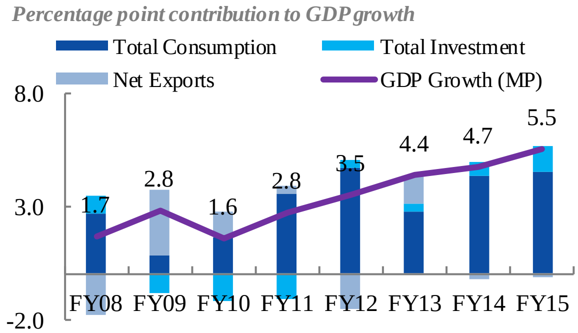


Figure 4 ....with private consumption the main contributor

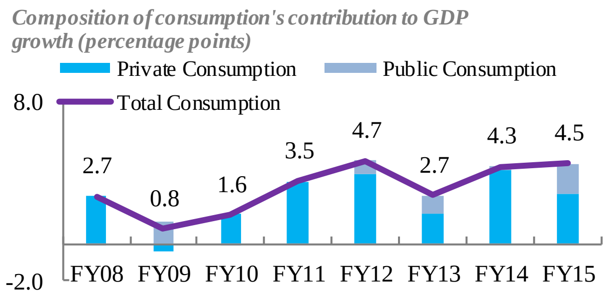


Figure 5: Investment and savings have historically been low, although investment is forecast to grow

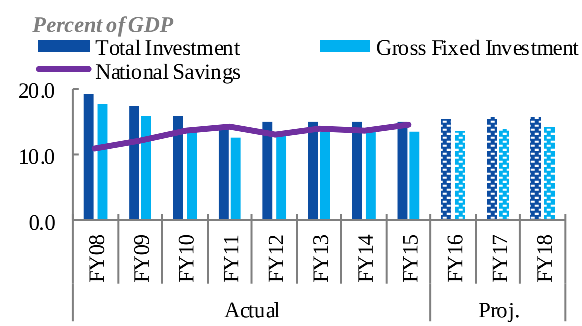


Figure 6: Falling inflation has created space for policy rate cuts

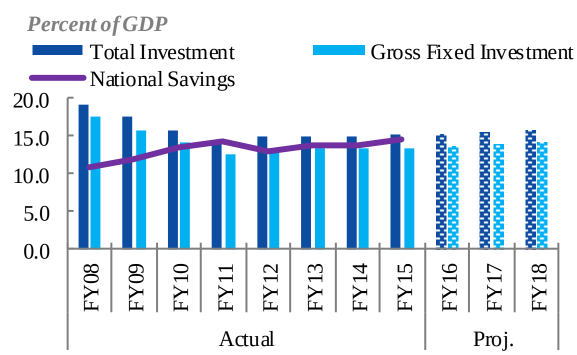


Figure 7: The overall external balance remains positive

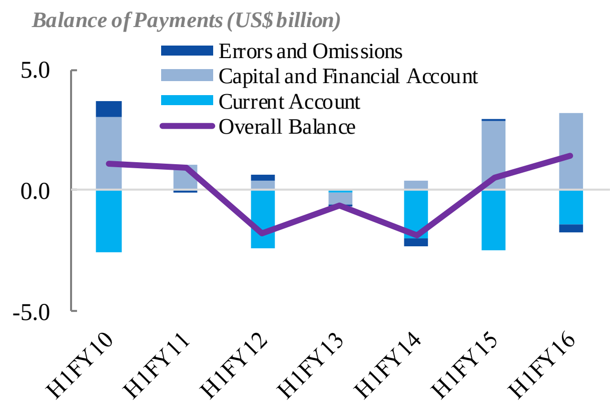


Figure 8: ...while the trade balance has been persistently negative

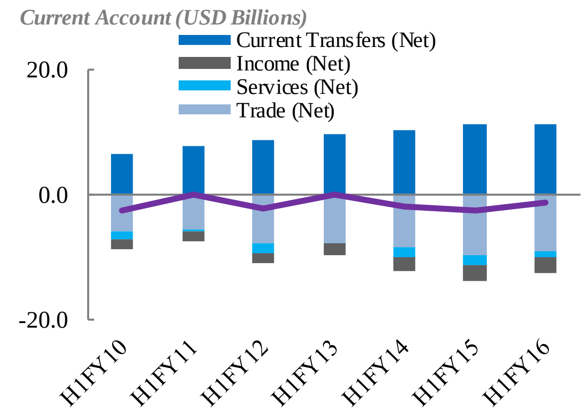


Figure 9: Textiles form the main export…

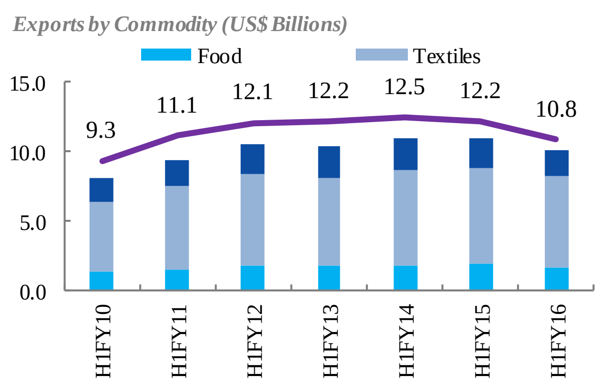


Figure 10: …while imports are broad-based but concentrated in petroleum

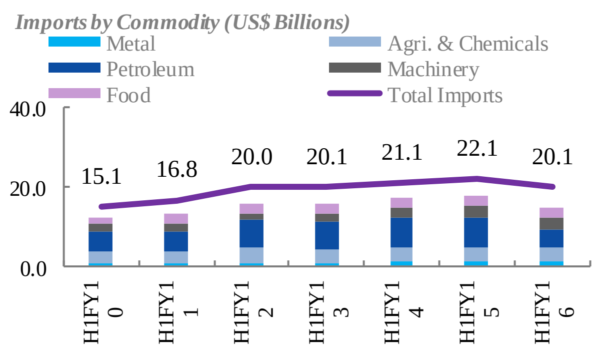


Figure 11: Reserves and remittances remain strong while the exchange rate is stable

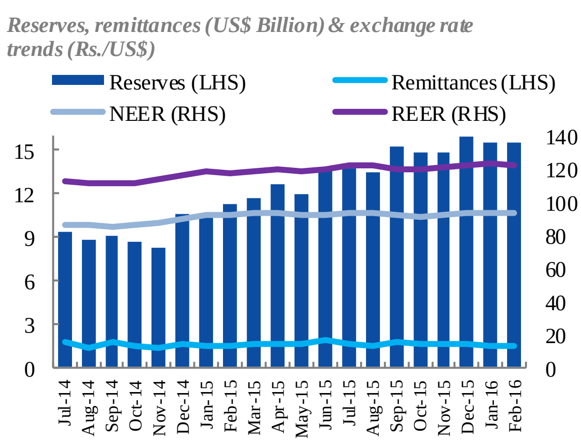


Figure 12: While private deposits are falling, private credit is growing steadily

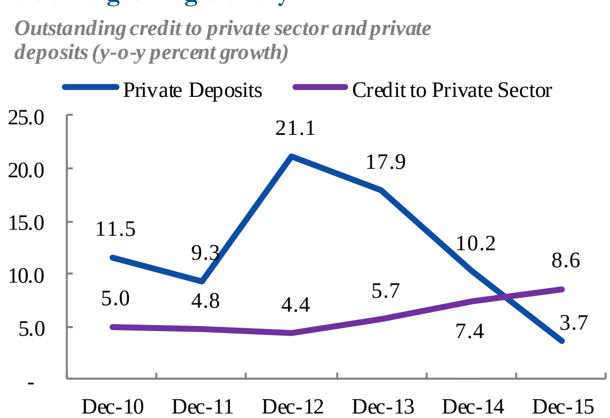


Figure 13: The banking sector appears to be healthy

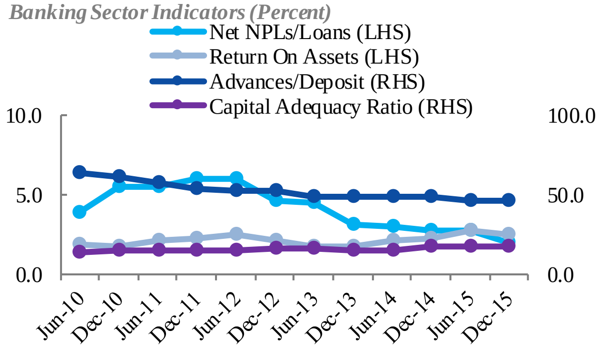


Figure 14: The fiscal deficit is driven by low tax revenues and high recurrent expenditure

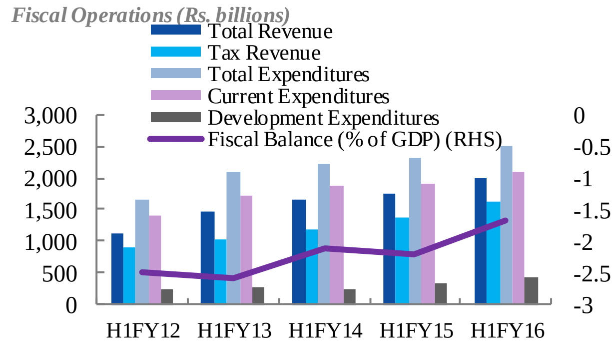


Figure 15: Interest payments have partially driven recent increases in recurrent expenditure

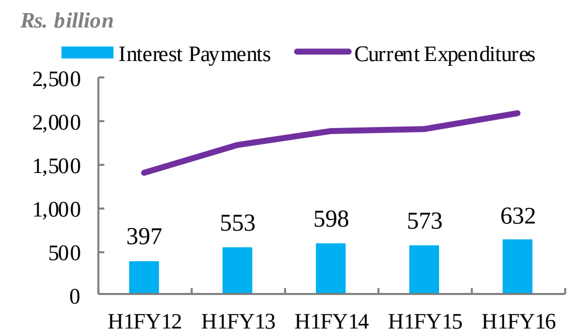


Figure 16: Public debt remains high but has stopped growing

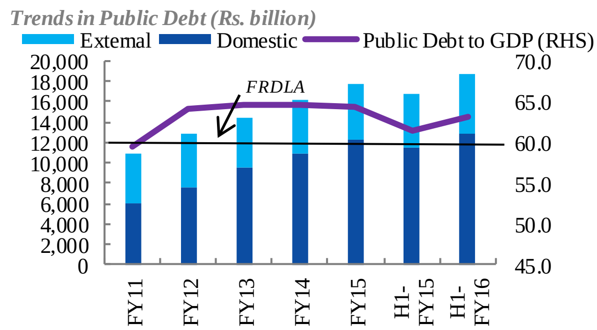


Figure 17: T-bill auctions are covering maturities

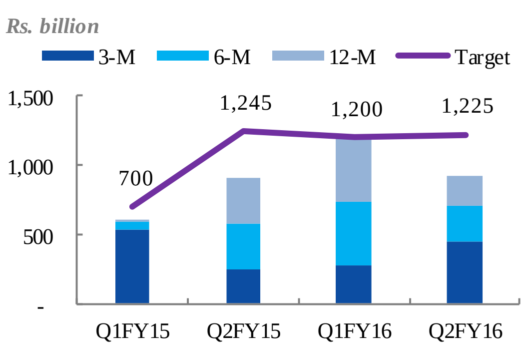
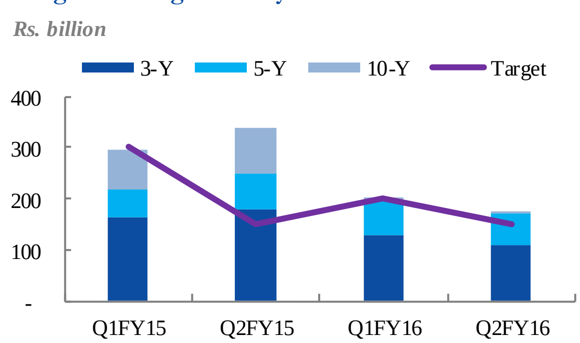


Figure 18: The market's preference for short term debt strengthened significantly in the second half of FY15



urces: State Bank of Pakistan, Ministry of Finance, Pakistan Bureau of Statistics and World Bank staff estimates

20-A Sharah-e-Jamhuriat, G-5/1,
Islamabad 44000, Pakistan.
Ph: +92 51 227964-7, Fax: +92 51 2823295

www.worldbank.org/pk
www.facebook.com/worldbankpakistan

WORLD BANK GROUP