PAKISTAN DEVELOPMENT UPDATE

AT A CROSSROAD

October 2018

THE WORLD BANK
IBRD • IDA | WORLD BANK GROUP

Disclaimer:

Copyright:

PAKISTAN DEVELOPMENT UPDATE

AT A CROSSROAD

October 2018

THE WORLD BANK
IBRD • IDA | WORLD BANK GROUP

Preface

The objective of this report is to update the Government of Pakistan, think-tanks and researchers, the public and the World Bank's senior management on the state of the Pakistan economy and its outlook, together with the structural reforms it requires and the development challenges it faces. The report begins with a chapter on economic developments, with sections on growth, fiscal policy, public debt, the external sector, monetary developments and inflation, and the financial sector. The second chapter provides a medium-term macroeconomic outlook and describes risks faced and upcoming challenges, including structural reform needs. The third chapter concludes by stressing the importance of creating a skilled labor force that is more productive and better able to adopt and adapt to new technologies—the core of Pakistan's growth path.

Acknowledgements

This update was prepared by the Macroeconomics, Trade and Investment Global Practice under the guidance of Patchamuthu Illangovan (Country Director, SACPK) and Manuela Francisco (Practice Manager, GMTSA). Analyses were contributed by Mehwish Ashraf (Economist, GMTSA), who authored the 'Fiscal Account' and 'Debt and its Dynamics' sections. Adnan Ashraf Ghumman (Economist, GMTSA) authored the 'Balance of Payments, and the 'Monetary Policy and Inflation' sections. Zehra Aslam (Research Analyst, GMTSA) authored the 'Real Sector' section. Sarmad Shaikh (Financial Sector Specialist, GFCSN) authored the 'Financial Sector Developments' section.

Adnan Ashraf Ghumman and Zehra Aslam co-authored the 'Outlook' section. Muhammad Waheed (Senior Economist, GMTSA) authored the 'Risks' section. The section on 'Progress and Next Steps on Structural Reforms' was written by Enrique Blanco Armas (Lead Country Economist, GMTSA). The 'Accelerating Human Capital Development' section is a joint effort led by Cristina Santos (Program Leader, SACPK), Ali Nadeem Qureshi (Social Protection Specialist, GSP06) and Mina Zamand (Research Analyst, GSP06). The box on 'Promoting Private Sector Investment in Pakistan' was co-authored by Charles Schneider (Senior Private Sector Specialist, GFCS1) and Amjad Bashir (Senior Economist, GFCS1). The box on 'Options for Efficiency Gains in Public Expenditure' was co-authored by Clelia Rontoyanni (Lead Public Sector Specialist, GGOAP) and Mehwish Ashraf. The box on 'Regulatory Duties, Competitiveness, and Revenues' was authored by Gonzalo Varela (Senior Economist, GMTSA). The box on 'Maximizing Finance for Development' was authored by Namoos Zaheer (Senior Financial Sector Specialist, GFCSN). The box on 'Amended Federal Budget FY19: Addressing the Need of the Hour' was authored by Mehwish Ashraf.

Peter Milne (Consultant) provided useful editorial support. Mehreen Saeed (Communications Officer, SAREC) provided excellent commuications support. Shehreyar Gul (Consultant) developed the cover page, and designed the report. Abid Hussain Chaudhry (Program Assistant, SACPK) provided helpful administrative support. The report benefitted from comments provided by Florian Blum (Young Professional, GMTSA), Shabih Ali Mohib (Program Leader, SACPK), Manuela Francisco, and Enrique Blanco Armas. The overall effort was led by Mehwish Ashraf and Gonzalo Varela, with assistance from Michelle Khilji (Consultant).

Table of Contents

List of Tables, Figures and Boxes

Acronyms and Abbreviations

ABP	Annual Borrowing Plan
ATM	Automated Teller Machine
CAD	Current Account Deficit
CAR	Capital Adequacy Ratio
CCI	Council of Common Interests
CPEC	China-Pakistan Economic Corridor
CRR	Cash Reserve Requirement
CSF	Coalition Support Fund
EU	European Union
FATF	Financial Action Task Force
FBR	Federal Board of Revenue
FDI	Foreign Direct Investment
FED	Federal Excise Duty
FRDLA	Fiscal Responsibility and Debt Limitation Act
FY	Fiscal Year
GCC	Gulf Cooperation Council
GDP	Gross Domestic Product
GSP	Generalized System of Preference
KIBOR	Karachi Interbank Offered Rate
KP	Khyber Pakhtunkhwa
KSA	Kingdom of Saudia Arabia
KSE	Karachi Stock Exchange
LNG	Liquefied Natural Gas
LSM	Large-Scale Manufacturing
M2	Broad Money
MDA	Ministries, departments, and agencies
m-o-m	Month on Month
MRTB	Market Related Treasury Bill
MTB	Market Treasury Bill
MW	Megawatt
NDA	Net Domestic Assets
NFA	Net Foreign Assets
NFC	National Finance Commission
NFNE	Non-Food Non-Energy
NPL	Non-Performing Loan
OECD	Organization for Economic Cooperation and Development
PDHS	Pakistan Demographic and Health Survey
PFM	Public Financial Management
PIB	Pakistan Investment Bond
PKR	Pakistani Rupee
POL	Petroleum, Oil and Lubricants
PSDP	Public Sector Development Program
RD	Regulatory duties
REER	Real Effective Exchange Rate
RM	Reserve Money
ROA	Return on Assets
ROE	Return on Equity
SBP	State Bank of Pakistan
SCRR	Special Cash Reserve Requirement
SME	Small and Medium Enterprise
SOE	State-Owned Enterprise
SRO	Statutory Regulatory Order
UK	United Kingdom
USA	United States of America
US$	United States Dollar
WA	Weighted Average
WDI	World Development Indicators
WeBoC	Web-based One Customs
WHT	Withholding Tax
WTO	World Trade Organization
y-o-y	Year on Year

Executive Summary

The global economy is facing increased uncertainty.

Global growth is expected to decelerate over the next two years, after reaching 3.1 percent in 2018, as the global slack dissipates, major central banks conduct contractionary monetary policies, and recovery among commodity exporters stabilizes. Normalization of monetary policy in the United States, with increases in interest rates leading to a rising US dollar, are likely to dry up the liquidity that had been flowing to emerging markets in recent years, thus increasing rollover risks on foreign-currency denominated debt. Furthermore, trade tensions between the United States and China could add stress to emerging markets. By increasing uncertainty, these tensions could lead to a reduction in global investment demand and a re-shuffling of existing global value chains, with implications not only for trade flows but also for foreign direct investment (FDI).

In this global context, Pakistan's economy continues to expand while vulnerabilities mount.

Economic performance in Pakistan remains robust, with GDP growth in FY18 at 5.8 percent—its highest level in 11 years. While inflation remained below target, imbalances on the fiscal and external fronts mounted, increasing vulnerabilities that could compromise future growth. The fiscal deficit continued to expand on the back of weak revenue growth and large increases in recurrent spending. This, coupled with a large current account deficit (CAD), on the back of the largest trade deficit registered in Pakistan's history, has accentuated the country's vulnerabilities. Energy sector arrears have also been accumulating, as well as fiscal contingencies, due to investment guarantees mainly associated with projects for the China-Pakistan Economic Corridor (CPEC). Taken together, these imbalances imply increased risk and liabilities.

Agriculture, industry and services supported GDP growth from the supply side.

The services sector grew by 6.4 percent in FY18, thanks to sustained growth in wholesale and retail trade. However, growth in backbone services, namely transport, storage and communications, and finance and insurance, which provide key support for other productive activities, contracted. The decline of the former was due to weakening in the government's investment demand in the sector, while the latter was due to a deceleration in bank deposits growth. The agriculture sector grew by 3.8 percent, boosted by livestock and improved production of sugarcane and cotton, while the industry sector posted its strongest growth rate in a decade.

Consumption continues to drive growth, while investment demand remains sluggish.

On the demand side, private consumption contributed 5.4 percentage points to GDP growth, supported by low inflation and interest rates, as well as growing remittances. Booming consumption increased demand for durables, such as automobiles, motorcycles and electronics. Government expenditure contributed 1.7 percentage points to GDP growth, exports contributed 0.9 of a percentage point, while imports dragged GDP growth down by 3.2 percentage points. Investment demand contributed 1.0 percentage point to GDP growth, on the back of public investment, while private investment contracted slightly in FY18, highlighting the need for transformative investment climate reforms.

Accumulating macro imbalances point to vulnerabilities on the external front...

As consumption-driven growth remained strong, imbalances on the external front built up. The CAD increased to 5.8 percent of GDP in FY18. Exports recovered across the main sectors of the economy, supported by a recovery in global demand and the gradual improvement of domestic energy availability. However, imports continued to grow, led by petroleum, automobiles and motorcycles, and machinery. As a result of the widening trade deficit, the authorities imposed regulatory duties on some imports and allowed greater exchange-rate flexibility, resulting in a 17.8 percent depreciation of the Pakistani rupee against the US dollar from December 2017 to September 2018.

The latter boosted export orders and reduced import demand. Indeed, the second half of FY18 showed an acceleration of exports and a deceleration of imports. However, commercial loans, international bond launches and FDI were unable to fully finance the CAD, resulting in a decline of international reserves to less than two months of import coverage by June 2018.

…as well as on the fiscal front…

The fiscal consolidation efforts made during the period FY14-16 were reversed, with the fiscal deficit reaching 6.6 percent of GDP in FY18. Despite a drastic cut in federal development spending, particularly in the final quarter of FY18, total expenditure grew due to high recurrent spending, including defense, interest payments and spending by provinces. Meanwhile, revenue grew only modestly as the Federal Board of Revenue's (FBR) revenue target was not met and federal non-tax revenue returned to its normal level. In addition, the provinces did not contribute with an assumed surplus, instead posting a small deficit, adding to a widening consolidated fiscal deficit.

…with implications on debt levels.

The widening twin deficits resulted in an increase in the public debt-to-GDP ratio to 73.5 percent, the highest level since FY03. One-third of the increase was accounted for by the depreciation of the Pakistani rupee against the US dollar. Public debt continues to be in breach of the Fiscal Responsibility and Debt Limitation Act (FRDLA), which stipulates a reduction of public debt to 60 percent of GDP by FY18. If this trajectory remains, it is unlikely that Pakistan will be able to comply with the Act over the next decade.

Inflation remained within target, with the SBP tightening monetary policy in H2FY18.

The State Bank of Pakistan (SBP) reversed its accommodative monetary policy stance during the second half of FY18. As demand pressures built up, the SBP increased its policy rate by 275 basis points to 8.5 percent between January and September 2018. Monetary aggregates displayed slower growth in FY18 relative to FY17, as net foreign assets in the banking system declined substantially. Headline inflation, in turn, remained low during FY18, while core inflation rose due to rising demand pressure, the Pakistani rupee's depreciation and rising global oil prices. Consumer confidence surveys also suggested increasing inflation expectations.

GDP growth is expected to decelerate in FY19.

Growing macroeconomic imbalances have dampened the growth outlook. GDP growth is projected to decelerate in FY19 due to contractions in private and public consumption, as the authorities tighten fiscal policy and adjust other policy levers to correct the imbalances. Services, the main driver of growth in recent years, will lead this deceleration, albeit continuing to grow, but more in line with growth rates seen in the industry and agriculture sectors.

Structural reforms are needed for long term growth.

Immediate policy adjustments, entailing fiscal consolidation and increased exchange-rate flexibility, are needed to restore and maintain macroeconomic stability. Renewed efforts are essential to advance medium-term structural reforms to shift the growth model away from being consumption-led to one led by investment and productivity.

A sustainable fiscal policy over the medium term requires a credible fiscal consolidation plan today.

The fiscal consolidation measures announced in the mini-budget are a step in the right direction toward short-term adjustments. However, for the fiscal consolidation path to be sustainable, additional interventions will be needed in the areas of tax administration and tax policy; fiscal decentralization; the legislative framework governing public finance; and measures to improve spending efficiency. With lower fiscal deficits, the private sector will have greater access to market borrowing for productive investments than it currently enjoys. To ensure these opportunities can be tapped into, innovative approaches may be needed to leverage private sector funds to maximize financing for development.

Allowing exchange-rate flexibility will help create a buffer and reduce vulnerability to external shocks.

The context of increasing external financing requirements, rising interest rates and tighter global liquidity poses challenges, given that diminished reserves and elevated debt ratios have reduced Pakistan's ability to withstand external shocks. The recent depreciation of the Pakistani rupee that resulted in an acceleration of exports and a deceleration of imports toward the second half of FY18 showed the importance of exchange-rate flexibility to rebalance the external accounts. The depreciation of the Pakistani rupee has helped to switch expenditure away from foreign goods and toward domestic goods, and could partially offset the dampening effect of fiscal consolidation on domestic demand. At the same time, the depreciation of the Pakistani rupee has increased the value of Pakistan's portion of debt liabilities denominated in foreign currencies, and put upward pressure on inflation, mainly through increases in the prices of tradable goods.

Structural reforms conducive to better integration in the global economy are needed for increased productivity and resilience.

Integration into the global economy provides opportunities for Pakistani firms to increase productivity—the fundamental driver of growth. However, on the export front, Pakistan has still to tap into the potential of greater integration. Despite the most recent export growth, the past decade's export performance reflects the worsening competitiveness of Pakistan's economy, particularly compared with the export performance of peer countries. High customs duties shelter Pakistani firms from competition, discouraging them from venturing into export markets. Also, recent increases in regulatory duties increase the costs of accessing key intermediates from abroad. On the investment front, a poor business environment, evidenced by Pakistan's performance in international rankings such as the World Bank's Doing Business indicators, affects private investment and discourages FDI inflows. In this area, reform efforts should be led from the Prime Minister's office and supported by a coordinated federation effort.

Ultimately, the key to improving productivity and long-term inclusive growth is the development of human capital.

With the contribution of human capital in total wealth growing globally, the creation of a skilled labor force that is more productive and better able to adopt and adapt to new technologies is at the core of a long-term growth path for Pakistan. To this end, improvements in education and learning need to go hand in hand with improvements in health and well-being to maximize the cognitive potential of both men and women in the population. Pakistan has made progress on these fronts, but it is uneven and slow. If Pakistan is to grow in an inclusive manner, the government must prioritize and invest equitably in the development of its human capital—the country's most important resource.

A. Economic Update

1. Real Sector

Pakistan's economy continues to grow, amid increasing macroeconomic imbalances.

Pakistan's gross domestic product (GDP) at factor cost grew at 5.8 percent in FY18—an increase of 0.4 of a percentage point over the previous year. Growth was driven by private and public consumption, improved investment demand aided by progress on China-Pakistan Economic Corridor (CPEC) projects, and a marginal recovery in exports. However, it was also accompanied by widening macroeconomic imbalances. During FY18, the current account deficit (CAD) and the fiscal deficit widened to 5.8 percent (4.1 percent in FY17) and 6.6 percent of GDP (5.8 percent in FY17), respectively. Even with relatively stronger export performance than in previous years, the CAD in FY18 increased by 1.7 percentage points due to an upsurge in imports. The fiscal deficit, 2.5 percentage points higher than the budget target, reversed fiscal consolidation efforts of previous years. This was due to limited revenue growth and significant increases in recurrent spending, despite a cut in federal development expenditure. Consequently, Pakistan's public debt reached 73.5 percent of GDP by end-June 2018, raising debt-related risks.

On the demand side, consumption continued to drive growth…

Historically, Pakistan's growth on the demand side has been led by private consumption, which comprised 85.8 percent of GDP in FY18 and contributed 5.4 percentage points to GDP growth (Figure 1). Remittances, an important source of income for consumption, increased by 1.4 percent in FY18 compared with a decline of 2.8 percent in FY17. Higher consumption demand also supported production and imports of consumer durables, including automobiles and electronics. Government consumption was the second-largest component of GDP—at 12.8 percent of GDP in FY18—and contributed 1.7 percentage points to GDP growth. The contribution of export demand to growth was weak at 0.9 of a percentage point, while imports dragged GDP growth down by 3.2 percentage points in FY18. Investment demand, in turn, added 1.0 percentage point to growth.

…while investment remained sluggish...

Pakistan's total investment-to-GDP ratio remains low compared with other countries in the region.[1] In FY18, this ratio increased to 16.4 percent, from 16.1 percent in FY17. This slight improvement was due to the government's focus on CPEC and other public infrastructure development projects. While public investment increased from 4.5 percent of GDP in FY17 to 5.0 percent in FY18 as per provisional estimates,[2] in the same period private investment fell from 10.0 percent of GDP in FY17 to 9.8 percent in FY18—the lowest it has been in the past four years (see Box 1 on government efforts to promote private investment).

…but the decline in domestic saving persisted, increasing dependence on foreign saving.

The low saving-investment position poses a key challenge to Pakistan's long-term economic growth. The significant decline in national saving over the past five years is worrying. In FY17 and FY18, national saving stood at 12.0 percent of GDP, a decline from 13.9 percent in FY16 (Figure 2). In this scenario, the focus on foreign inflows, such as the CPEC initiative, to finance the growing investment-saving gap has increased.[3] While foreign saving helps meet the country's investment needs, low

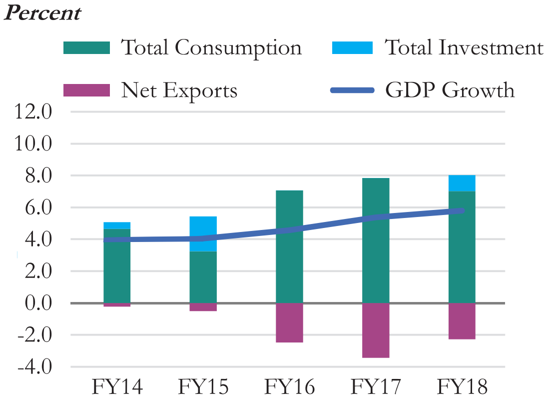
[1] The investment-to-GDP ratio in Bangladesh is 31 percent, India 31 percent, Sri Lanka 37 percent, and Nepal 47 percent.

[2] However, as per the actual fiscal data release, investment spending—a proxy for public investment—decreased from 5.0 percent of GDP in FY17 to 4.2 percent in FY18.

[3] The saving-investment gap at current prices in FY18 reached PKR 1,513 billion, compared with PKR 321 billion in FY14 (Ministry of Finance, *Pakistan Economic Survey 2017-18*, 2018).

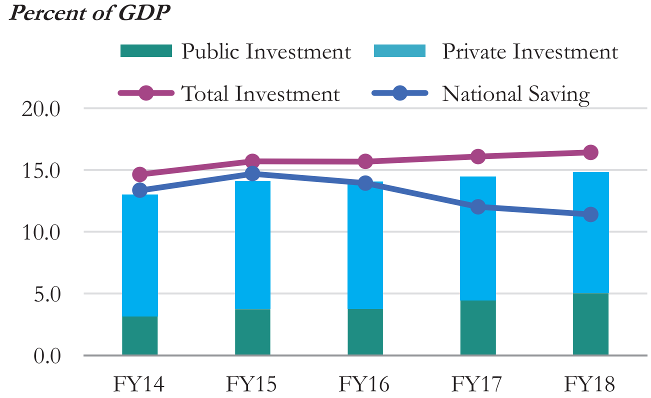
domestic saving imposes a constraint on the level of investment that the country can undertake, particularly if global liquidity dries up.

Figure 1: Point contribution to GDP growth, aggregate demand



Source: Pakistan Bureau of Statistics.

Figure 2: Saving and investment



Note: Total investment does not equal public and private investment in the figure due to non-inclusion of 'change in inventories'. This variable is equal to 1.6 percent of GDP throughout the period under review.

Source: Pakistan Bureau of Statistics.

Box 1: Promoting private sector investment in Pakistan

Unlocking private sector investment is key for the new government in Pakistan. Low levels of national saving and FDI, at less than 1.0 percent of GDP, are simultaneously a cause and a consequence of reduced business confidence. This is reflected in Pakistan's Doing Business ranking of 147 out of 190 countries in 2018, down from 76 out of 178 in 2008. Private investment remains low despite several reforms, such as the enactment of the Companies Act of 2017, the Secured Transactions Act of 2016 and the Special Economic Zones Act of 2012. To improve the business environment, the government automated customs operations through the installation of the Web-based One Customs (WeBoC) system that streamlined procedures for obtaining construction permits, registering a business, and many other procedural areas related to starting and operating a business.

Though many of the legal building blocks for improving Pakistan's investment performance are now in place, sustainable implementation is key for the future. One possible pathway to achieve this is to bring greater transparency in procedures for issuing permits, obtaining investment approvals and repossessing property, among others. The government should continue to strengthen the reform program by focusing on implementation of the legal framework, improving coordination within the government through the establishment of National and Provincial Business Climate Reform Units, and increasing public-private dialogue through national and provincial platforms to ensure that feedback from the private sector is incorporated into the reform process.

On the supply side, the recovery in agriculture extended into its second year…

The agriculture sector grew by 3.8 percent in FY18 (2.1 percent in FY17), surpassing targeted growth of 3.5 percent (Figure 3). After posting a very weak growth rate of 0.2 percent in FY16, the turnaround in agriculture continued into its second year. Impetus for growth came from *livestock* (59 percent of the agriculture sector) and improved production in sugarcane and cotton. Overall, *important crops*[4] grew at 3.6 percent in FY18, compared with 2.2 percent in FY17. Reductions in fertilizer off-take and water

[4] These include cotton, rice, sugarcane, wheat and maize.

availability adversely impacted wheat and maize production, but supportive government policies and an expansion in agriculture credit for quality inputs, such as certified seeds and pesticides, led to an overall improvement in crop performance.[5] Though wheat production contracted (from 26.7 million tons in FY17 to 25.5 million tons in FY18), FY18 still recorded a bumper crop, taking into account rainfall levels that were 40 percent below their long-term averages. This wheat is expected to add to existing government stockpiles.[6] *Livestock* grew at 3.8 percent in FY18 (3.0 percent in FY17). *Cotton ginning* grew at 8.7 percent (5.6 percent in FY17) and *fisheries* grew at 1.6 percent (1.2 percent in FY17), while the *forestry* subsector recorded growth of 7.2 percent in FY18 (-2.4 percent in FY17).

…and growth in industry gained momentum….

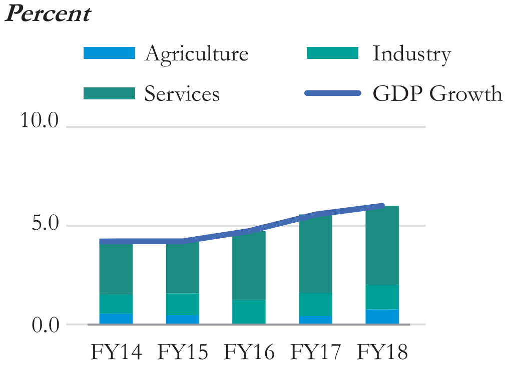
The industry sector grew at 5.8 percent in FY18 (5.4 percent in FY17), though well short of the 7.3 percent growth target. This is the highest rate of growth since FY08 and came on the back of increased manufacturing and construction activities. *Mining and quarrying* grew by 3.0 percent in FY18 after a decline of 0.4 percent in FY17, while *construction* growth fell by 0.7 of a percentage point to 9.1 percent in FY18. *Electricity and gas generation and distribution* growth fell by 4.0 percentage points, from 5.8 percent in FY17 to 1.8 percent in FY18. Higher costs of production due to a rise in international fuel prices and limited revenues impacted growth in this subsector, despite improvements in electricity generation.[7] *Manufacturing*, the largest component of the industry sector, grew by 6.2 percent (5.8 percent in FY17), with large-scale manufacturing (LSM) growth at 5.4 percent (5.8 percent in FY17, Figure 4). Public Sector Development Program (PSDP) spending and CPEC-related expenditure had positive spill-overs on the steel, automobile and cement subsectors. However, growth in the food, beverage & tobacco, fertilizer, textile and pharmaceutical subsectors slowed down in FY18. Due to delays in sugarcane crushing,[8] the sugarcane industry was unable to capitalize on the record production in FY18.

…while the services sector continued its impressive performance.

The services sector grew at 6.4 percent, marginally slower than in FY17 (6.5 percent). The improved performance in the agriculture and manufacturing sectors added impetus to the largest subsector within services, namely *wholesale and retail trade,* which grew at 7.5 percent in FY18 (the same as in FY17). Growth in key backbone services, such as *transport, storage and communications*, declined in FY18 to 3.6 percent from 4.4 percent in FY17, primarily due to a 13 percent decline in gross fixed capital formation by the government in transport and communications during FY18.[9] Growth in the *finance and insurance* subsector also declined significantly, from 10.8 percent in FY17 to 6.1 percent in FY18. Though lower interest rates have continued to affect the subsector's profitability, the decline in FY18 was mainly due to a slower increase in deposits.[10] In contrast, *general government services* accelerated by 5.5 percentage points in FY18 and growth reached 11.4 (5.9 percent in FY17), reflecting rising public-sector wages.

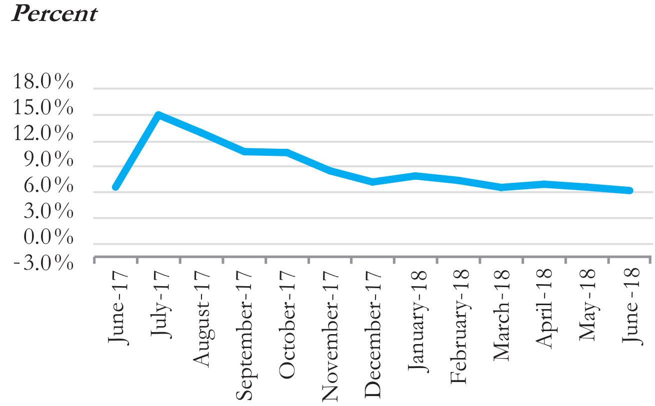
[5] *The State of Pakistan's Economy-Third Quarterly Report 2017-18.*
[6] Estimated wheat stockpile is expected to cross the 10 million ton mark in FY18, Ibid.
[7] *The State of Pakistan's Economy-Third Quarterly Report 2017-18*
[8] The prolonged standoff between sugar mills and sugarcane growers over procurement prices contributed to this delay. *The State of Pakistan's Economy-Third Quarterly Report 2017-18.*
[9] Ministry of Finance, *Pakistan Economic Survey 2017, 2018.*
[10] During FY18, deposits of the banking sector grew by 8.8 percent compared to the 12.4 percent growth witnessed in FY17, *The State of Pakistan's Economy-Third Quarterly Report 2017-18.*

Figure 3: Sectoral contributions to GDP growth, aggregate supply



Source: Pakistan Bureau of Statistics.

Figure 4: Quantum growth in large-scale manufacturing (cumulative growth - July to current month)



Source: Pakistan Bureau of Statistics.

2. Fiscal Account

Fiscal consolidation went off track …

Pakistan registered a consolidated[11] fiscal deficit (excluding grants) of 6.6 percent of GDP in FY18 (Table 1), 2.5 percentage points higher than the target set at the start of the year and 0.7 of a percentage point higher than the fiscal deficit in FY17.[12] This is the second consecutive year of increasing deficit levels, reversing the gains achieved since FY14. Moreover, the primary deficit increased to 2.2 percent of GDP, up from 0.3 percent two years ago.

… due to increases in recurrent spending amid lackluster revenue growth.

Total revenues during FY18 recorded lower growth of 5.9 percent compared with the previous year, as a result of the normalization in federal non-tax revenues. However, total expenditures grew by 10.1 percent (7.2 percentage points less than in FY17). Recurrent spending remained high, but FY18 witnessed a deceleration in development expenditure for the first time since FY11.

The FBR performed better at collecting taxes than last year…

The FBR tax collection grew by 14.3 percent in FY18 compared with growth of 8.0 percent in FY17 (Table 2). The collection amounted to PKR 3,842 billion, equating to 96 percent of the FY18 target,[13] despite large refunds paid out during FY18 (PKR 155 billion in FY18 vs. PKR 87 billion in FY17). Direct taxes and sales tax contributed almost equally to this performance. However, 65 percent of direct taxes was collected through withholding taxes (WHT), rendering most of the direct collection regressive. Substantial sales tax collection during FY18—on account of an increase in domestic petrol prices and higher imports (including of petroleum, oil and lubricants, or POL)[14]—added to the regressive nature of taxation. Moreover, custom duties continued to grow in FY18, as the government imposed regulatory duties (RDs) on imports.[15]

[11] This analysis refers to the consolidated fiscal accounts of federal and provincial governments.
[12] This does not include the energy sector arrears (3 percent of GDP) or the contingent liabilities due to investment guarantees.
[13] This is an improvement compared to the 5-year average of 91 percent (FY13-FY17).
[14] POL products contributed one-third to the sales tax collection during FY18.
[15] Combining the collection from WHT with the one from indirect taxes, one could see that almost 86 percent of the FBR taxes are collected indirectly.

Table 1: Summary of Pakistan's fiscal operations

PKR billion unless mentioned otherwise

				Percent growth	
	FY16	FY17	FY18	FY17	FY18
Total Revenue	**4,447**	**4,937**	**5,228**	***11.0***	***5.9***
Tax Revenue	3,660	3,969	4,467	*8.4*	*12.5*
Federal	3,377	3,647	4,066	*8.0*	*11.5*
Provincial	283	322	401	*13.6*	*24.7*
Non-Tax	787	967	761	*23.0*	*-21.4*
Federal	693	888	614	*28.1*	*-30.8*
Provincial	93	79	147	*-14.8*	*84.5*
Expenditures	**5,796**	**6,801**	**7,488**	***17.3***	***10.1***
Current *of which*	4,694	5,198	5,854	*10.7*	*12.6*
Interest	1,263	1,348	1,500	*6.7*	*11.2*
Defense	758	888	1,030	*17.2*	*16.0*
Development	1,301	1,693	1,584	*30.1*	*-6.5*
Net Lending	13	-13	38		
Statistical Discrepancy	-212	-78	12		
Fiscal Balance	**-1,349**	**-1,864**	**-2,260**		
% of GDP	*-4.6*	*-5.8*	*-6.6*		
Memorandum items:					
GDP (nominal)	29,103	31,862	34,396		

Source: Ministry of Finance.

… but non-tax revenues dragged down total revenues.

Non-tax revenues declined by 21 percent to PKR 761 billion and settled in line with the FY16 level. This was attributable to: (i) the phasing-out of Coalition Support Fund (CSF) receipts; (ii) lower profits, dividends and interest accruing from state-owned enterprises (SOEs); and (iii) the rationalization of the 'Others' category[16] as the 'one-off' items disappeared.[17] Despite the overall decrease in non-tax revenues in FY18, provinces almost doubled their non-tax collection.[18]

Table 2: FBR tax collection

PKR billion unless mentioned otherwise

				Percent growth	
	FY16	FY17	FY18	FY17	FY18
Direct	**1,192**	**1,343**	**1,537**	***12.7***	***14.4***
Indirect	**1,920**	**2,018**	**2,306**	***5.1***	***14.3***
Customs	406	496	608	*22.1*	*22.6*
Sales tax	1,324	1,323	1,491	*-0.03*	*12.7*
Federal excises	191	199	206	*4.2*	*3.7*
Total taxes	**3,112**	**3,361**	**3,842**	***8.0***	***14.3***

Source: Federal Board of Revenue.

Growth in recurrent expenditure further constrained fiscal space…

The federal government was able to restrain spending despite a sizeable increase in interest payments on external debt,[19] large defense spending and higher grants. However, provincial current expenditure grew by almost 20 percent during FY18 (Table 3), denting the efforts of the federal government to rein in spending.

[16] Collection under 'Others' category amounted to PKR 118 billion in FY18 compared with PKR 306 billion in FY17.

[17] During FY17, the government sold a portion of its stakes in the Printing Corporation (PKR 100 billion) and Pakistan Development Fund proceeds worth PKR 64 billion were booked as sale proceeds of two LNG power plants. Furthermore, PKR 20 billion were received following the amendment in rules governing dead accounts of National Savings Schemes.

[18] This was primarily because of net hydel profits that were passed on to KP and Punjab during FY18 by the federal government. Excluding these profits, provincial non-tax revenues grew by 52 percent in FY18 compared with FY17.

[19] Due to exchange rate depreciation of 16 percent in FY18 (point-to-point) as well as additional net increase of US$2.0 billion in foreign currency public debt during FY18 compared with FY17.

… compelling the federal government to cut back development spending in the last quarter of FY18.

In efforts to control the rising bottom line in the final quarter of FY18, federal PSDP spending was reduced by about 21 percent from that of FY17. Given limited fiscal space, the government will need to explore ways of leveraging private sector funds to finance a share of its investments (see Box 4 on innovative approaches to maximizing finance for development in Section 6 on the Financial Sector).

Provinces accelerated the pace of spending.

Nevertheless, provincial PSDP spending continued the previous year's growth trend and reached a record PKR 880 billion in FY18. More importantly, while the federal government scaled back its development expenditure, provinces accelerated their own spending in Q4FY18. This behavior can be explained by the context of the July elections. However, such practices raise questions regarding the quality, efficiency and effectiveness of public spending.

Table 3: Analysis of consolidated spending

PKR billion unless mentioned otherwise

				Percent growth	
	FY16	**FY17**	**FY18**	**FY17**	**FY18**
Total expenditures	**5,796**	**6,801**	**7,488**	***17.3***	***10.1***
Current	**4,694**	**5,198**	**5,854**	***10.7***	***12.6***
Federal	3,144	3,472	3,790	*10.4*	*9.1*
Interest payments	1,263	1,348	1,500	*6.7*	*11.2*
Domestic	1,151	1,220	1,323	*6.0*	*8.4*
External	113	128	177	*13.9*	*38.3*
Pensions	223	304	334	*36.5*	*9.8*
Grants	362	352	384	*-2.7*	*9.0*
Defense	758	888	1,030	*17.2*	*16.0*
Public order and safety	96	128	125	*32.8*	*-2.5*
Health and education	95	106	115	*11.5*	*8.6*
Others	348	346	303	*-0.4*	*-12.6*
Provincial	1,550	1,726	2,065	*11.3*	*19.6*
Development	**1,301**	**1,693**	**1,584**	***30.1***	***-6.5***
PSDP	1,186	1,578	1,456	*33.1*	*-7.7*
Federal	593	726	576	*22.3*	*-20.6*
Provincial	592	852	880	*43.8*	*3.3*
Other dev. expenditures	116	116	128	*0.1*	*10.4*
Net lending	**13**	**-13**	**38**	**-**	**-**
Statistical discrepancy	**-212**	**-78**	**12**	**-**	**-**

Source: Ministry of Finance.

Nonetheless, most of the deficit came from the federal government.

Despite heavy spending, provinces ran a small combined deficit of 0.1 percent of GDP in FY18, as provincial revenues increased considerably and federal transfers improved on the previous year.[20] Sindh contributed a deficit worth PKR 42 billion, while Khyber Pakhtunkhwa (KP) posted a surplus of PKR 34 billion. The other two provinces ran small deficits. This meant that the assumption of a substantial provincial surplus[21] included in the Finance Bill for FY18 failed to materialize, in line with the previous year's outcome. Given this trend, provincial fiscal surpluses as part of a consolidation effort can only be assumed if the federal government coordinates efforts with the provinces through a constitutional forum, such as the Council of Common Interests (CCI).

[20] Due to improved FBR collection relative to FY17.
[21] 1.0 percent of GDP.

The austerity drive of the new government sets the course, but is only a first step in needed interventions for sustainable fiscal consolidation.

The new government's immediate priorities include a top-down austerity code. The measures comprise, among others, cutting government expenses and abolishing discretionary funds. The government has also established a Task Force on Austerity and Restructuring of the Government, which will deliver its recommendations within 90 days. These are steps in the right direction but are expected to yield only limited savings (see Box 2 on options for expenditure efficiencies). To achieve fiscal consolidation on a sustainable basis, the government will need to undertake taxation reforms, as well as improve the effectiveness and efficiency of investment spending. However, given that these are federation subjects, building consensus among the federating units will be the first step in moving ahead. The expected reconstitution of the 9th National Finance Commission (NFC) Award could serve as a platform to strengthen the revenue mobilization framework between federal and provincial governments.

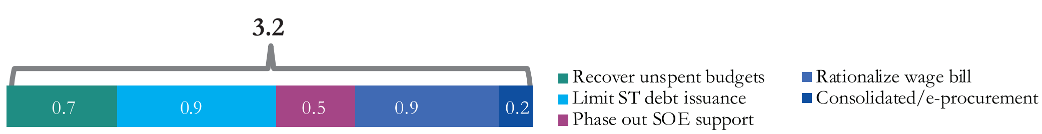
Box 2: Options for efficiency gains in public expenditure

This box presents **five main options** to achieve savings and get better value for money from large expenditure items, while minimizing the impact on public services. A quick back-of-the-envelope calculation points toward a potential saving of 2 to 4 percent of GDP annually[22] from these categories (see graph below).

1. **Recover past unspent budget funds and tie future releases to utilization**. The government can recover funds that were not spent in FY18 to finance expenditures in FY19. Some autonomous entities with one-line budgets do not surrender unspent funds, as required by accounting rules. Likewise, some departments do not surrender development funds but transfer them to accounts in commercial banks.[23] The Ministry of Finance would need to request financial reports of self-accounting entities and statements of commercial bank accounts. These balances (excluding own-source revenues) would then be deducted from the budgets of the respective entities and funds would be released upon proof of utilization.

2. **Reduce debt-servicing costs by proactively managing debt operations**. In FY18, the government paid PKR 300 billion[24] (or 0.9 percent of GDP) in interest on incremental[25] Treasury bills with maturities of less than 12 months.[26] However, the federal government alone had 2.8 percent of GDP worth of cash deposits sitting with commercial banks at the start of FY18. As almost one-third of these deposits pertain to core government (ministries, departments, and agencies, or MDAs), the federal government could have tapped into this cash at a time when the market was unwilling to invest in long-term bonds. Going forward, the government should cover its financing needs through longer maturities (≥ 1 year), and limit short-term borrowing, other than liquidity management, to instances of genuine cash shortfall for impending expenditures—after accounting for cash balances in the Treasury and other government accounts. For this purpose, it is important that an Annual Borrowing Plan (ABP)[27] be

Potential savings in expenditure (percent of GDP)



[22] This estimation is based on the most recent fiscal data and may vary from year to year.
[23] During FY18, government accounts in commercial banks were topped up with PKR 244 billion or 0.7 percent of GDP.
[24] World Bank staff calculations based on SBP data on auctions and domestic debt portfolio.
[25] Issuance over and above the roll-over requirements.
[26] This also includes borrowing from the central bank in the form of MRTBs.
[27] The ABP is usually produced as part of the government budget indicating the gross borrowing requirements for the period and some breakdown of the funding sources. Throughout the fiscal year, the plan is broken down by quarters, with more detailed information on the funding sources and the timing of issuance. These quarterly reports become a navigation tool for a debt management office and serve as the basis for exchanges with those responsible for tapping the different funding sources.

prepared at the start of the year[28] and be revised on a quarterly basis to review and adjust, if necessary, the funding plans. Moreover, it is essential that the ABP and its revision stay in sync with the government cash plans throughout the year.

3. **Phase out budget financing for SOEs.** Budget financing for SOEs in the form of subsidies, grants, and loans accounted for 12 percent of federal spending in FY16,[29] or 1.4 percent of GDP, while the stock of government guarantees on SOE debt reached PKR 937 billion (or 2.9 percent of GDP). This financing disincentivizes profitability and even enables some SOEs to post profits while receiving subsidies. The government can reduce transfers to SOEs with substantial financial assets and/or fixed assets unrelated to their operations. Budget financing can also be made conditional on performance improvement plans (including financial indicators) of SOEs, credit worthiness assessments and regular progress reports.
4. **Allocate the wage bill based on headcounts and index annual raises to inflation.** Salaries and pensions made up 34.4 percent of total spending in FY18, or 5.9 percent of GDP.[30] These expenditures have grown rapidly, with pension costs having more than doubled since FY13. The government can contain future spending to the tune of 0.9 percent of GDP by: (i) indexing annual raises to inflation; and (ii) allocating wage bill funds based on lists of actual employees rather than for approved posts. The current system allows entities to 'save' funds from vacant posts and use them for other purposes such as allowances.
5. **Get better value for money from public procurement.** Spending on procurement of works, goods, and services is estimated at 15.4 percent of total expenditure. Consolidated procurement for common items (e.g., computers, furniture, paper, catering) brings savings from administrative costs and economies of scale (lower unit prices in larger contracts). E-procurement (online bid submission, e-catalogues) also reduces transaction costs and obtains better price/quality ratios from increased competition. E-procurement and consolidated procurement have helped other countries to save from 5 to 30 percent of their procurement budgets, depending on the prior efficiency of their procurement systems.[31]

3. Debt and Its Dynamics

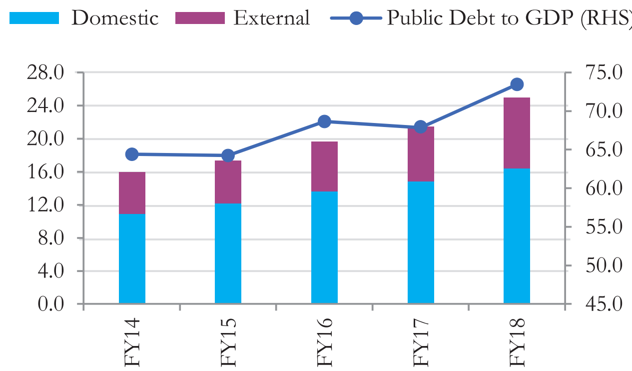
Public debt increased considerably and stood in breach of the amended FRDLA.

As of end-June 2018, total public debt[32] stood at 73.5 percent of GDP, 5.6 percentage points higher than the previous year (Figure 5). This is the highest level since FY03. Almost one-third of the increase in FY18 came from the depreciation of the Pakistani rupee against the US dollar. Had this depreciation stayed in line with historical trends,[33] Pakistan's public debt would have hovered at around 70 to 71 percent of GDP. These levels are still significantly higher than the limit set in the Fiscal Responsibility and Debt Limitation Act (FRDLA) 2005 (amended in 2017), which stipulates a reduction of total public debt to 60 percent of GDP by FY18. The country has been in breach of the Act since FY10. If the current trajectory persists, Pakistan is unlikely to be able to comply with this law[34] over the next decade.

[28] In line with the medium-term debt management strategy.
[29] Latest data available.
[30] Excludes salary bill of district administrations.
[31] Based on multiple case studies published by the OECD, the EU and national authorities.
[32] The public debt-to-GDP ratio is estimated by the World Bank as per the Government Financial Statistics Manual 2014 and is the definition used in this report. This entails including the external debt of SOEs not included in the debt stock defined by the government.
[33] Assuming 3 to 5 percent point-to-point depreciation.
[34] The law's targets are ambitious given recent fiscal and debt trends. These are: (i) federal fiscal deficit (excluding grants) at 4.0 percent of GDP during FY18-FY20, and at 3.5 percent of GDP from FY21 onward; (ii) total public debt at 60 percent of GDP by FY18; (iii) reducing total public debt by 0.5 percent annually during FY19-FY23 and from FY24 onward by 0.75 percent to reach 50 percent of GDP by FY33 and thereafter maintaining it at 50 percent. However, over the past five years the federal fiscal deficit has remained around 6.1 percent of GDP on average, while public debt averaged about 67 percent of GDP.

Figure 5: Trends in public debt

External and domestic debt measured in PKR trillion (LHS), while public debt to GDP is measured in percent (RHS)



Source: State Bank of Pakistan and World Bank staff calculations.

Substantial external debt inflows continued in FY18…

Pakistan received gross disbursements in excess of US$10.0 billion for the second year running (Table 4). In FY18, one-third of these debt inflows came from China, of which over half were disbursed by Chinese banks on commercial terms.[35,36] Furthermore, disbursements from China (both bilateral and commercial) surpassed inflows from multilaterals. However, most of these Chinese loans are frontloaded, as debt service payments total US$6.6 billion (or 2.1 percent of GDP) over the next three years, adding to the country's gross financing needs. In November 2017, Pakistan successfully executed US$1.0 billion five-year Sukuk and US$1.5 billion 10-year Eurobond transactions at profit rates of 5.625 and 6.875 percent, respectively.[37] Pakistan had planned another Eurobond in Q3FY18 but did not go to the market, as conditions were volatile.

… while the domestic debt profile deteriorated further, raising risks.

Rising fiscal deficits over the past two years led to a step-up in borrowing from the domestic market, despite substantial external debt inflows. Weakening macroeconomic fundamentals combined with market anticipation of an interest rate hike attenuated the appetite for medium- to long-term securities, compelling the authorities to raise financing through short-term Market Treasury Bills (MTBs). As a result, the share of floating debt[38] in domestic debt increased from 37 percent in FY16 to 54 percent in FY18, while the share of permanent debt[39] fell from 44 percent in FY16 to 28 percent in FY18. This has posed renewed refinancing and repricing risks[40,41] and is not in line with the strategic guidelines set in the current medium-term debt management strategy.[42] Nevertheless, the introduction of a 10-year floating rate[43] Pakistan Investment Bond (PIB) during Q4FY18[44] could facilitate in lengthening the maturity profile of domestic debt going forward.

[35] To the tune of US$2.2 billion.

[36] These are medium-term loans meant for balance of payments support with an in-built bullet repayment feature, a maturity of 2-3 years and a floating rate based on LIBOR.

[37] Comparable bonds of other countries floated at that time include the following: Iraq raised a six-year bond of US$1.0 billion at 6.75 percent, Ukraine issued a 15-year bond of US$3.0 billion at 7.375 percent, Ghana raised a 15-year bond of US$750 million at 9.25 percent, and Turkey raised a 10-year bond of US$2.0 billion at 6.15 percent.

[38] This refers to short-term domestic debt and is composed mainly of MTBs and Market Related Treasury Bills (MRTBs).

[39] This is medium- to long-term domestic debt and includes Pakistan Investment Bonds (PIBs) and Ijarah Sukuks, among others.

[40] Refinancing risk refers to the risk that debt may be refinanced at an unusually high cost or, in extreme cases, cannot be refinanced at all. Repricing risk refers to the risk of increases in the cost of the debt arising from changes in interest rates.

[41] The latest public debt risk report points toward deterioration in key indicators. For instance, domestic debt re-fixing in one year has increased from 52.8 percent of total domestic debt as of end-June 2016 to 60.1 percent as of end-December 2017 (Source: Public Debt Management Risk Report (various issues), Debt Policy Coordination Office, Ministry of Finance). These levels for FY18 are coinciding with the magnitude witnessed in FY13, implying towards an erosion of gains achieved during the early years of the Pakistan's first debt management strategy FY14-FY18.

[42] Covering FY17-FY19.

[43] Linked to the 6-months MTB weighted average yield plus/minus a margin decided in auction.

[44] Against a target of PKR 100 billion, the market offered PKR 296 billion, of which PKR 34.7 billion was accepted at a cut-off margin of 50 basis points in the two auctions held during the quarter.

Table 4: Gross disbursements – public external debt
US$ billion unless mentioned otherwise

	FY14	FY15	FY16	FY17	FY18
Multilateral	**3,099**	**2,774**	**3,784**	**2,963**	**2,894**
Bilateral	**927**	**1,359**	**1,247**	**1,793**	**2,377**
Of which: China	594	1,161	1,042	1,583	1,811
Commercial	**323**	**150**	**1,381**	**4,368**	**3,716**
Of which: China	-	-	-	2,300	2,200
Eurobonds/Sukuks	**2,000**	**1,000**	**500**	**1,000**	**2,500**
Total disbursements	**6,349**	**5,283**	**6,913**	**10,124**	**11,487**
Memo: China	*594*	*1,161*	*1,042*	*3,883*	*4,011*

Source: Economic Affairs Division, Ministry of Finance, Government of Pakistan.

4. Balance of Payments

The balance of payments remained under pressure.

Pakistan's consumption-driven GDP growth during FY18 came at the cost of high fiscal and current account deficits. The CAD increased to US$18.1 billion (5.8 percent of GDP) in FY18 compared with US$12.6 billion (4.1 percent of GDP) in FY17 (Table 5). Imports grew at a fast pace, widening the trade deficit to record levels. To rein in the trade deficit, the authorities imposed RDs on some imports (see Box 3 on impact of RDs on competitiveness and revenue) and allowed a cumulative exchange-rate depreciation of 17.8 percent (from December 2017 to July 25, 2018). To ease the pressure from the CAD on declining reserves, Pakistan issued international bonds worth US$2.5 billion in November 2017 and borrowed US$3.7 billion in FY18 from commercial lenders. Despite these efforts, financial flows in FY18 were unable to match the widening CAD, causing international reserves to decline to under two months of import coverage by June 2018.

The trade deficit increased to record levels.

Pakistan's merchandise exports grew by 12.6 percent (y-o-y) during FY18, compared with marginal growth of 0.1 percent in FY17. However, merchandise import growth of 14.7 percent (y-o-y) outpaced the recovery in exports, resulting in a large trade deficit of US$31.1 billion (9.9 percent of GDP) for FY18—the highest ever. This widening trade deficit, despite a healthy recovery in exports, indicates growing domestic demand pressure. However, the exchange-rate depreciation is boosting net exports. During the first half of FY18, export growth was at 10.9 percent, while it reached 14.1 percent during the second half. Meanwhile, import growth was 20.1 percent during the first half of FY18, falling to 10.3 percent during the second half.

Table 5: Balance of payments summary[1]

US$ billion unless mentioned otherwise

	FY17	FY18
i. Current account (A+B+C+D)	**-12.6**	**-18.1**
A. Trade balance	**-26.7**	**-31.1**
Export	22.0	24.8
Import	48.7	55.8
B. Services net	**-4.3**	**-5.3**
of which: CSF	0.6	0.0
C. Balance on primary income[2]	**-5.0**	**-5.3**
D. Balance on secondary income[2]	**23.4**	**23.5**
of which remittances	19.4	19.6
ii. Capital account	**0.4**	**0.4**
1. Balance from current and capital accounts (i+ii)[3]	**-12.2**	**-17.8**
2. Financial accounts[4]	**-10.2**	**-12.3**
of which:		
Direct investment	-2.7	-2.8
Portfolio investment	0.3	-2.3
Net acquisition of financial assets	1.2	0.2
Net incurrence of financial liabilities	9.0	7.5
3. Errors and omissions	**0.1**	**-0.7**
Overall balance (-1+2-3)	1.9	6.1
SBP reserves (excl. CRR, SCRR)	16.2	9.9
Memorandum items		
Current account (percent of GDP)	*-4.1*	*-5.8*
Trade account (percent of GDP)	*-8.7*	*-9.9*
Export growth (percent)	*0.1*	*12.6*
Import growth (percent)	*18.0*	*14.7*
Remittance growth (percent)	*-2.8*	*1.4*
Financial account (percent of GDP)	*3.3*	*3.9*

Notes: 1: As per Balance of Payments Manual 6 (BPM6). 2: In BPM6, the income account has been renamed 'primary income', and current transfers renamed 'secondary income'. 3: A negative balance shows that the economy is a net borrower from the rest of the world. 4: A negative balance shows a net increase in the incurrence of foreign liabilities.

Source: State Bank of Pakistan.

Exports began to recover lost ground...

The recovery in exports was broad-based, with improved performance in foods, textiles and other manufacturing groups, and was supported by two key developments: (i) a steady recovery in global demand; and (ii) the gradual improvement of domestic energy availability for the industry. The recovery in global demand in 2017 resulted in the highest global trade increase since 2011.[45] The domestic electricity supply situation has improved gradually. A total of 39 electricity generation projects became operational during FY13-18, adding 12,230 MW generation capacity to the system.[46] Pakistan's rice and textile exports displayed robust growth during FY18. Rice exports grew as exports of non-basmati rice increased by 31 percent in FY18 compared with a decline of 16.4 percent in FY17. Textile exports—54 percent of total exports during FY18—grew by 7.1 percent, compared with a contraction of 2.3 percent in FY17. Textile exports have benefited from the extension of GSP-plus status in the European Union (EU). Among other exports, chemicals, pharmaceuticals, and leather manufactures also displayed healthy growth.

[45] The WTO anticipates merchandise trade volume growth of 4.4 percent in 2018, as measured by the average of exports and imports, roughly matching the 4.7 percent increase recorded for 2017. https://www.wto.org/english/news_e/pres18_e/pr820_e.htm

[46] Ministry of Finance, *Pakistan Economic Survey 2017-18*, 2018. http://www.finance.gov.pk/survey/chapters_18/14-Energy.pdf

Box 3: Regulatory duties, competitiveness and revenues

In recent years, the government has increasingly relied on RDs to curb growth in the trade deficit and to collect revenues. Recent examples include SRO 568 (I)/2014 that instituted RDs on more than 400 tariffs lines, SRO 1035(I)/2017 that consolidated eight previously issued resolutions increasing RDs, and SRO 640(I)/2018, by which RDs on various items increased by 2 to 10 percentage points.[47] Analysis based on FBR data reveals that while 0.4 percent of imports paid RDs in FY13, this increased to 12.6 percent in FY17. Over the same period, the share of RD revenues in total revenues due to import duties increased from 1.9 percent to 17.1 percent.

RDs, as well as other duties on imports, are likely more damaging than beneficial for net exports. By increasing protection, duties on imports shelter incumbent firms from competition, reducing their incentives to increase efficiency and innovate. Moreover, when duties are imposed on intermediates, they increase production costs, hurting export competitiveness, and typically penalizing exceptional performers. Evidence suggests that having access to a wide variety of intermediates of high quality and at competitive costs is crucial for firms that efficiently compete in international markets. No surprise then, that in Pakistan, between 2014 and 2017, firms that relied on imported intermediates were exceptional performers. They displayed larger export values and better diversification patterns (both products and destinations) compared with others that only relied on domestic intermediates.[48] But in Pakistan these firms are penalized with tariffs and RDs on intermediates that substantially increase production costs. For example, in the automobile sector, tariffs on intermediates add an extra 27 percent to the total input cost bill. This makes it difficult to compete internationally, as exporters from competitor countries rely on efficient duty-drawback systems.

By increasing the complexity of the trade policy framework, the effect of increased RDs on customs revenue is ambiguous. Empirical evidence shows that importers have an incentive to understate the value of imports, the higher the import duties are.[49] This is also found in Pakistan. Misreporting—measured as the difference between import values reported by importers in Pakistan and exported values reported by the exporters in the origin country—is systematically higher for import products in which customs duties are also higher. Thus, increasing customs duties may not increase customs revenues as expected.

…while the import bill soared.

Meanwhile, the import bill touched US$55.8 billion (an increase of 14.7 percent) during FY18 compared with US$48.7 billion (an increase of 18.0 percent) in FY17. This double-digit increase for the second consecutive year was a result of higher imports of automobiles and motorcycles, machinery and fuels. Petroleum imports, which contributed around one-quarter of total imports, grew by 25.0 percent in FY18 compared with 26.9 percent in FY17. Under non-fuel imports, the machinery group contributed 15.6 percent to the overall trade value in FY18, growing by 17.4 percent in this period compared with 4.4 percent in FY17, as CPEC project implementation picked up during FY18. The agriculture and textile sectors, which accounted for 22.1 percent of FY18 import value, increased by 15.4 percent, compared with 8.5 percent in FY17. Imports of cars and motorcycles increased by 32 percent during FY18 compared with 5.9 percent in FY17. The authorities took various measures to slow down import growth, such as the imposition of RDs on some imports, the sizeable exchange-rate depreciation in the second half of FY18, and raising the policy interest rate by 175 basis points between January and July 2018.

47 SRO 640 (I)/2018 superseded the earlier SRO 1035(I)/2017.
48 These results are obtained from a firm-level analysis relying on Pakistan's export-transaction data obtained from FBR.
49 Ferrantino, M., L. Xuepeng, and Z. Wang (2012). Evasion behaviors of exporters and importers: Evidence from the US-China trade data discrepancy, Journal of International Economics.

Remittances recovered marginally in FY18.

The balance of secondary income stayed at US$23.5 billion during FY18—slightly higher than FY17. After a contraction in FY17, remittances recovered and grew by 1.4 percent in FY18, primarily due to higher flows from the United Arab Emirates, the United Kingdom (UK), the United States of America (USA), Malaysia and the EU. The gradual improvement in economic prospects of the USA provided the impetus to remittance flows, while remittances from the UK increased as the US dollar depreciated against the British pound. Remittances from the Gulf Cooperation Council (GCC) countries, which accounted for almost 57 percent of all remittances, decreased by 6.4 percent (y-o-y) in FY18, compared with a decrease of 5.0 percent (y-o-y) in FY17. Remittances from GCC countries contracted due to declining flows (11.1 percent decline in FY18) from the Kingdom of Saudi Arabia (KSA), which accounts for the highest share of GCC flows, at about 25 percent.

The increase in financial flows was unable to match the widening current account deficit.

Financial flows increased to US$12.3 billion in FY18 (US$2.1 billion higher than in FY17), as a result of steady FDI inflows, an international bond launch of US$2.5 billion, and commercial loan receipts of US$3.7 billion. FDI inflows have recovered from a low base largely due to the increase in flows from China under CPEC power generation and infrastructure projects. Disbursements of official loans in FY18 increased largely due to heavy commercial borrowing since FY17. Pakistan's amortization touched US$5.1 billion during FY18, which was US$1.4 billion lower than in FY17, mainly due to no Eurobond repayments in FY18. Nonetheless, the increase in overall financial flows was insufficient to match the widening of the CAD during FY18. Consequently, official international reserves declined to US$9.8 billion by end-June 2018 (1.7 months of import coverage), and then further to US$8.4 billion (1.4 months of import coverage) as of September 28, 2018.

Due to the decline in international reserves, the SBP allowed greater exchange-rate flexibility.

The PKR/US$ exchange rate was initially maintained at around PKR 105/US$1.00 from September 2015. However, after the substantial depletion of reserves over the past 18 months, the PKR/US$ exchange rate depreciated by 17.8 percent between December 1, 2017 and July 25, 2018. Post-election, with emerging political certainty, the Pakistani rupee recovered 3 percentage points against the US dollar, and was trading at PKR 124.2/US$1.00 on September 28, 2018. Pakistan's competitiveness, as measured by the real effective exchange rate (REER), had declined in recent years due to currency appreciation. In the past few years, most currencies around the world, both in developing and developed countries, have depreciated against the US dollar. However, Pakistan maintained the nominal exchange rate at a specific level and, as a result, the REER appreciated significantly. The recent exchange-rate adjustments, along with low domestic inflation, will help to correct the REER's path.[50] This, in turn, will boost export growth, particularly of those products that incorporate more Pakistani value-added and tend to be more sensitive to REER depreciations.

[50] This assumption will hold only if the nominal exchange rate remains flexible and Pakistan's inflation remains lower than that of its competitors. Recent projections by the SBP indicate that the inflation outlook remains high.

5. Monetary Policy and Inflation

The accommodative monetary policy stance since FY16 was reversed during H2FY18.

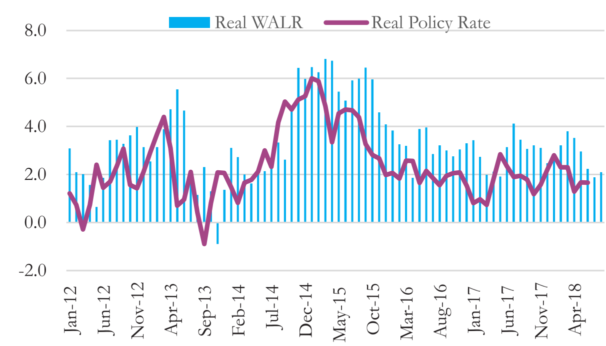
Following a 75-basis-point cut in the policy rate in FY16, the SBP kept the policy rate unchanged at 5.75 percent until January 2018, after which it raised the rate by 275 basis points to 8.5 percent between January and September 2018. The SBP's underlying rationale for the hike involved the increasing demand pressures reflected in a widening CAD, rising core inflation, and a higher-than-expected inflation outlook due to the 17.8 percent depreciation in the nominal exchange rate between December 2017 and September 2018. The market perceived this as the bottoming out of interest rates. Bidding patterns for government papers tilted toward three-month maturity, clearly reflecting these sentiments. However, the real policy rate is still at a relatively low level (Figure 6).

A decline in foreign assets caused broad money growth to decelerate.

Broad money (M2) grew by 9.7 percent during FY18, compared with 13.7 percent in the same period in FY17 (Table 6). This deceleration in M2 growth came amid a decline in net foreign assets (NFA), especially of the SBP. The net domestic assets (NDA) of the banking system grew by 15.9 percent during FY18, compared with 18.3 percent in FY17. The decline in the SBP's NFA also resulted in slower growth in reserve money (RM), which decelerated to 12.7 percent compared with 22.5 percent in FY17. The currency-to-deposits ratio continued to increase following the imposition of a financial transaction tax in FY16 and was 0.38 at end-June 2018, compared with 0.29 at the start of FY16. With increased currency in circulation, the money multiplier also declined from 3.0 at end-June 2017 to 2.9 at end-June 2018. Growth in bank deposits also slowed to 8.8 percent in FY18, compared with 12.4 percent in FY17. All indicators point toward financial dis-intermediation following the imposition of the financial transaction tax in FY16. However, private sector credit grew faster than in preceding years due to lower incremental government borrowing from scheduled banks and low real interest rates since the start of FY17 (see Section 6 on Financial Sector for a detailed discussion on private sector credit).

Figure 6: Real policy and weighted average lending rates

Percent

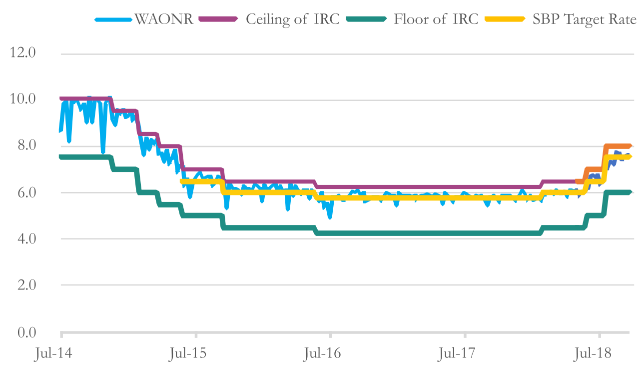


Note: Real rates are calculated using y-o-y inflation.

Source: Data from the State Bank of Pakistan.

Figure 7: Interest rate corridor and WA overnight repo rate

Percent



Source: Data from the State Bank of Pakistan.

Table 6: Monetary aggregates

PKR billion unless mentioned otherwise

	Stock		Flow (July to June)	
	30-Jun-17	**30-Jun-18**	**FY17**	**FY18**
NFA	602.0	(209.3)	(405.5)	(811.3)
of which: SBP	828.9	11.6	(204.1)	(817.3)
NDA	13,978.8	16,206.4	2,161.6	2,227.6
Government borrowing:	8,955.6	10,199.3	1,136.1	1,243.7
Budgetary borrowing	8,282.1	9,392.6	1,087.3	1,110.5
from SBP	2,350.1	3,613.0	907.9	1,262.9
from scheduled banks	5,932.0	5,779.6	179.4	(152.4)
Commodity operations	686.5	819.7	49.9	133.2
Non-govt. sector borrowing:	6,011.3	7,033.9	998.7	1,022.6
Private sector	5,197.5	5,973.0	747.9	775.5
Public sector enterprises	798.6	1,044.0	254.7	245.4
Other items	(988.0)	(1,026.7)	26.8	(38.7)
Broad money (M2)	**14,580.9**	**15,997.2**	**1,756.0**	**1,416.3**
Reserve money (RM)	**5,484.6**	**4,868.0**	**894.3**	**616.7**
Memorandum items				
Currency in circulation	3,911	4,388	*577.5*	*476.5*
Growth (y-o-y)				
M2	*13.7*	*9.7*	*13.8*	*-19.3*
RM	*22.5*	*12.7*	*7.5*	*-31.0*
Currency in circulation	*17.3*	*12.2*	*25.9*	*17.5*

Note: Rounded off to the nearest value.
Source: State Bank of Pakistan.

The SBP managed liquidity.

Overall market liquidity conditions remained tight due to the SBP's active participation in the foreign-exchange market. The overnight interbank rates hovered very close to the ceiling of the interest rate corridor (Figure 7). Liquidity injections via open market operations thus kept the market sufficiently fluid.

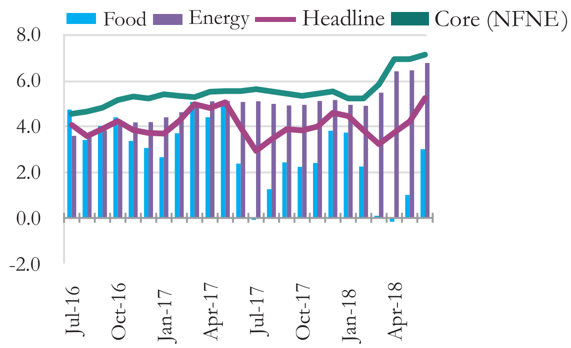
Headline inflation remained low due to low food inflation.

Pakistan experienced another year of moderate inflation with average inflation touching 3.9 percent in FY18 compared with 4.2 percent in FY17. Average food inflation increased by 1.8 percent during FY18 compared with 3.8 percent in FY17, whereas non-food inflation was recorded at 5.4 percent in FY18 compared with 4.4 percent in FY17. Food inflation remained low due to the normalization of supply of perishables, including vegetables and an excess supply of sugar and pulses.

However, core inflation is on the rise.

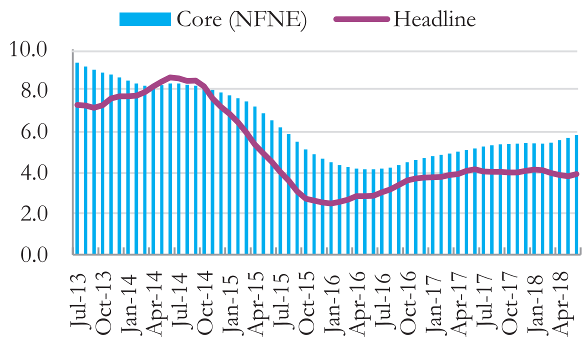
Core - non-food non-energy, or NFNE - inflation remained at 5.8 percent (average) in FY18 compared with 5.2 percent (average) in FY17 (Figure 8). Core inflation rose sharply in Q4FY18, highlighting the underlying demand pressure, as well as the second-round impact of exchange-rate depreciation in December 2017 and March 2018, together with rising global oil prices. Furthermore, the annual revision of house rents in April 2018 also contributed to core inflation. Nonetheless, Pakistan's headline inflation remains below historical levels, albeit enabled by low core inflation (Figure 9).

Figure 8: Headline inflation (y-o-y)
Percent



Source: State Bank of Pakistan.

Figure 9: Month-on-month moving average of core and headline inflation
Percent



Source: State Bank of Pakistan.

6. Financial Sector Developments

Private sector credit continued to grow.

Private sector credit has been growing since FY17 in the low-interest-rate environment, despite weakening macroeconomic fundamentals. Private sector credit grew by 16.8 percent in FY17 and further by 11.5 percent in FY18. Growth was a result of stable monetary variables and decreases in incremental government borrowing requirements, allowing for more liquidity to be available for the private sector. The weighted average lending rate on incremental borrowing has increased in recent months, reaching 7.5 percent in June 2018, after having remained stable in the range of 6.9 to 7.0 percent during January-December 2017, in sync with the hike in the policy rate.

Loans to private sector businesses, SMEs and individuals have continued to grow but with sectoral shifts.

Loans to private sector businesses grew at a slower pace, registering an increase of 11.1 percent in FY18 compared with 21.3 percent in FY17. Utilities, real estate and consumer financing were major borrowing sectors in FY18. In contrast, in FY17 the manufacturing and construction sectors were major sources of increases in credit, followed by wholesale and retail trade. Moreover, there have been continuous gains in financial inclusion.[51] Similarly, access points continued to expand and facilitate payments and credit flows. Bank branches, ATMs and agents grew at 4.7, 10.5 and 6.0 percent, respectively, in FY18.

The banking system remains robust…

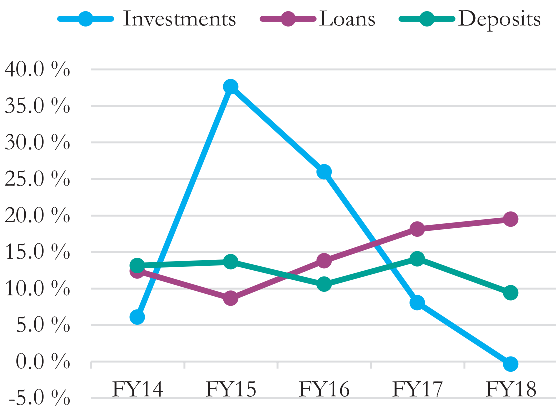
The banking sector has achieved sizeable growth, driven primarily by increased government borrowing during FY12-15, but since FY15 this trend has reversed (Figure 10). Overall soundness of the banking sector remains strong due to robust capital adequacy, improved asset quality and ample liquidity. The capital adequacy ratio (CAR) is at 15.9 percent, well above the minimum regulatory requirement of 11.275 percent, while gross and net non-performing loans (NPLs) have dropped to 10-year lows of 7.9 and 1.1 percent, respectively. At the same time, the advances-to-deposits ratio increased from 48.7 percent in June 2017 to 53.1 percent in June 2018.

…but profitability is declining.

Earnings have tapered off in the prevalent low-interest-rate regime. The pressures on bank profitability in the low-interest-rate environment have been eased to some extent by a decline in deposit rates. As a result, the return on assets and return on equity of the banking sector were still healthy, at 1.5 percent and 19.0 percent, respectively, during FY18 (Table 7).

[51] According to Findex, 21 percent of adults had a bank account in 2017, compared with 13 percent in 2014.

Figure 10: Commercial banks' balance sheet growth
Percent



Source: State Bank of Pakistan.

Table 7: Selected key indicators of the banking sector
PKR billion unless mentioned otherwise

	Jun-17	Jun-18
Profit before tax ytd	150	129
Credit to private sector	5,197	5,796
ROA before tax	1.8%	1.4%
ROE before tax	21.9%	18.5%
Advances to deposits ratio	48.7%	53.1%
Liquid assets/deposits	74.9%	71.3%
Capital adequacy ratio	15.6%	15.9%
Gross NPLs to loans	9.3%	7.9%
Net NPLs to loans	1.6%	1.1%
6-month KIBOR	6.2%	7.0%

Source: State Bank of Pakistan.

The legal framework is being strengthened, but Pakistan's inclusion on the FATF grey list has undermined perceptions.

The government has pursued a series of policy reforms to improve the legal framework of the financial sector. Recent laws include the Consumer Information Bureau Act, the Secured Transactions Act, the Financial Institutions Recovery Ordinance, and the Deposit Protection Corporation Act. The regulatory and supervisory framework is also being reinforced, through phased implementation of Basel III standards for the banking sector and modernization of the framework for non-bank financial institutions. However, despite these improvements, in June 2018, Pakistan was added to the Financial Action Task Force's (FATF) grey list. In response, Pakistan authorities are preparing an Action Plan acceptable to the FATF for addressing the deficiencies/gaps identified. These deficiencies are primarily outside the formal economy and the financial sector, and hence the impact on macro-financial variables is expected to be minimal.

The equity market has regained its upward momentum.

Pakistan's equity market remained volatile during January-August 2018 with the KSE-100 Index oscillating in a wide 19.2 percent band. However, despite this volatility the index posted a 2.9 percent increase during the period, after losing 15.7 percent in 2017.

The corporate bond market is under-developed, but the regulatory framework is in place.

The secondary corporate bond market witnessed limited activity, with only one debt listing occurring in 2016 (PKR 10 billion) and one in 2017 (PKR 10.5 billion). The primary debt market is dominated by government securities and, though sizeable, it lacks efficiency, depth and liquidity. Nonetheless, the regulatory framework and market infrastructure is in place and can sustain a higher investor and instrument base. This should help to ensure the channeling of finance to productive investments using innovative approaches (see Box 4 on maximizing finance for development through leveraging private sector).

Box 4: Maximizing finance for development

Given the government's limited fiscal space and the resulting reductions in federal development expenditure, there is a critical need to leverage public assets more effectively. Traditional sources of financing, from banks and governments, as well as multi-national financial institutions, cannot meet the country's growing financing needs, partly because of the large volumes of funding required, the high levels of perceived risk, and because of constraints that banks and governments face—from regulatory limitations and weakened fiscal situations. Funds from the private sector should be crowded in using financial products that can offer proper risk allocation among all stakeholders. Development of new financing channels (bond/Sukuk markets, non-bank financial institutions, institutional investors, etc.) and pairing these channels with the right financial instruments and risk mitigation measures can help to better harness (local and international) commercial funding sources and promote private sector participation to maximize value of money and financing for development. There are many public assets that have yet to be deployed effectively to raise financing. Undeveloped or underdeveloped public land is a prime example of unproductive state wealth which, if harnessed effectively, could be used to crowd in private capital.

B. Outlook and Upcoming Challenges

1. Outlook

GDP growth is projected to decelerate in FY19 followed by a recovery in FY20.

Rising macroeconomic imbalances have dampened the growth outlook. GDP growth is projected to decelerate to 4.8 percent in FY19 as the authorities tighten fiscal policy and adjust other policy levers to correct the imbalances. However, growth is expected to recover in FY20 and reach 5.2 percent as macroeconomic conditions improve (Figure 11). This recovery is conditional upon the restoration of macroeconomic stability and a supportive external environment, including relatively stable international oil prices and a strong recovery in exports.

Slower but continued growth in services and industry is expected to support the growth recovery.

The contraction in domestic demand due to the tighter fiscal policy is expected to decelerate growth in the services sector, which was the key growth driver in FY18. As a result, the services sector is projected to expand by 5.1 percent in FY19 compared with 6.4 percent in FY18. Agriculture sector growth is projected to normalize at 3.5 percent after a growth rate of 3.8 percent in FY18. The industry sector is projected to grow at 5.0 percent in FY19 compared with 5.8 percent in FY18 (Table 8). However, continued growth in services and industry is expected to support a recovery in overall growth to 5.2 percent in FY20.

External account pressure will persist.

The CAD is expected to decline moderately, while remaining at elevated levels, given that the trade deficit is projected to also remain elevated during FY19 and FY20. Increased exchange-rate flexibility should support an increase in exports and a deceleration in imports in FY20. Remittances will continue to partly finance the CAD. Nonetheless, slower growth in GCC countries will affect migrants' employment opportunities and growth in remittances. FDI, multilateral, bilateral, and private debt-creating flows are expected to be the main financing sources in the medium term. To meet external financing needs, the government will need to continue accessing international capital markets. During the first two months of FY19, the CAD stood at US$2.7 billion (or 0.9 percent of GDP) compared with US$2.9 billion (or 0.8 percent of GDP) in the same period in FY18.

The fiscal deficit is expected to decline, leading to a decreasing public debt trajectory.

The consolidated fiscal deficit is projected to narrow in FY19 due to post-election adjustments and fiscal tightening (see Box 5 for a summary on mini-budget measures announced by the new administration). Public investment spending at the federal and provincial levels is expected to be scaled down and an increase in revenue collection is projected through tax-base expansion and other administrative measures. Fiscal consolidation is, in turn, expected to improve debt dynamics, but the public debt-to-GDP ratio is expected to remain at around 70 percent of GDP until FY20—the debt burden benchmark for emerging markets.[52]

Inflation is expected to rise in FY19 and remain high in FY20.

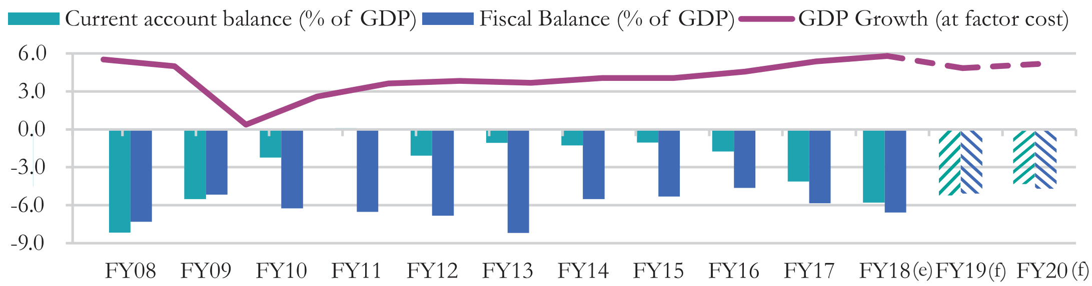
Inflation is expected to rise in FY19 and remain high in FY20. The increase in prices will be driven by exchange-rate pass-through to domestic prices and a moderate increase in international oil prices.[53] During the first quarter of FY19, inflation increased by 5.6 percent compared with a 3.4 percent in the same period in FY18.

[52] As per the IMF Market-Access Countries (MACs) public debt sustainability analysis (DSA).

[53] The empirical evidence suggests that a nominal depreciation has moderate effect on domestic prices in Pakistan. The pass-through is primarily concentrated in commodities including fuel, wheat, cotton, and sugarcane. For details, please see Choudhri et al. (2002), Hyder et al. (2004), and Jaffri (2010).

Figure 11: Real GDP growth and twin deficits

Percent



Source: Data from Pakistan Economic Survey and World Bank staff estimates.

Table 8: Key macroeconomic indicators

	FY15	FY16	FY17	FY18 (e)	FY19 (f)	FY20 (f)
Real GDP growth, at constant factor prices (%)	4.1	4.6	5.4	5.8	4.8	5.2
Agriculture	2.1	0.2	2.1	3.8	3.5	3.4
Industry	5.2	5.7	5.4	5.8	5.0	5.7
Services	4.4	5.7	6.5	6.4	5.1	5.5
Inflation (Consumer Price Index)	4.5	2.9	4.2	3.9	8.0	7.5
Current account balance (% of GDP)	-1.0	-1.7	-4.1	-5.8	-5.2	-4.2
Exports of goods (% growth)	-3.9	-8.8	0.1	12.6	15.0	16.0
Imports of goods (% growth)	-0.7	-0.2	18.0	14.7	3.3	5.0
Remittances (% growth)	18.2	6.4	-2.8	1.4	2.8	3.0
Financial and capital account (% of GDP)	2.0	2.5	3.5	4.1	5.3	5.3
Net foreign direct investment (% of GDP)	0.3	0.8	0.9	0.9	1.7	2.0
Fiscal balance excluding grants (% of GDP)	-5.3	-4.6	-5.8	-6.6	-5.1	-4.7
Primary balance excluding grants (% of GDP)	-0.6	-0.3	-1.6	-2.2	0.1	-0.1
Total public debt (% of GDP)	64.3	68.7	67.9	73.5	72.6	69.6

Source: World Bank, Macroeconomics, Trade and Investment Global Practice.

Note: e = estimate; f = forecast.

Box 5: Amended federal budget FY19: Addressing the need of the hour

On September 18, the minister of finance presented to the National Assembly with amendments to the budget for FY19, as the new administration considered the budget targets unachievable,[54] particularly in the aftermath of the FY18 fiscal outcomes. The government plans to embark on a path of fiscal consolidation and announced a combination of relief and revenue measures that would reduce the consolidated fiscal deficit from 6.6 percent of GDP in FY18 to 5.1 percent in FY19. This reduction hinges mainly on cutting the federal development envelope (excluding CPEC projects) by PKR 225 billion relative to the budgeted target and revising down the FBR's target by PKR 45 billion. If the full revenue impact does not materialize, the fiscal deficit may end up being 0.3 to 0.4 percent of GDP higher than expected.

New revenue measures worth PKR 183 billion have been put in place. Half of these are to be generated through administrative efficiency by using technology. The rest of the measures[55] revolve around increasing duties (RD, customs and Federal Excise Duty, or FED) on non-essential imports, raising WHT on non-cash banking transaction for non-filers to 0.6 percent, revoking tax relief to salaried individuals and increasing income tax rate for the highest slab. As part of the measures, the government removed RDs on 82 tariff lines that pertain to raw materials and inputs for export-oriented sectors, as well as announced a PKR 44 billion textile package for industries in Punjab, PKR 6-7 billion in urea subsidy for the *Rabi* season and PKR 4-5 billion for low-cost housing.

These short-term measures will need to be accompanied with a solid reform plan to address medium-term structural constraints to accelerating and sustaining investment and growth.

2. Risks

Macroeconomic risks are higher with growing fiscal and external imbalances.

Immediate macroeconomic adjustments are required to correct the large twin deficits. Pakistan exhibits high gross external financing requirements. Together with diminished reserves and elevated debt ratios, this weakens Pakistan's ability to withstand external shocks in a context of high global uncertainty.

Global trade frictions and the US Federal Reserve's interest rate increases exacerbate challenges on the external front.

Pakistan's ability to raise financing from global markets could be impacted by further interest rate increases by the US Federal Reserve, and by contagion from recent challenges faced by some large developing economies such as Turkey and Argentina which, taken together, could squeeze liquidity away from emerging markets. In addition, the recent recovery in exports may be thwarted by the likelihood of a no-deal 'Brexit'—the UK being one of Pakistan's largest trading partners—and by the increased uncertainty that the United States-China trade tensions are bringing to the markets. However, these tensions could also provide an opportunity for Pakistan, if multinationals opt to relocate production facilities away from China to avoid the adverse effects of tariffs. It is unclear to what degree Pakistan might be able to gain from such a relocation, however, given the poor state of its business environment.

A sustainable fiscal policy needs to be put in place.

The large deviation of the actual fiscal deficit from the target indicates the difficulty faced by the federal government in running a credible fiscal policy if provincial governments are not legally bound to contribute to such a target. If this issue is not resolved, prudent fiscal policy will not be possible, and Pakistan will be exposed to another cycle of fiscal slippages. Simultaneously, the government needs to tackle other structural fiscal issues. These include the power sector's circular debt, loss-making

[54] As per the minister, the fiscal deficit will increase to 7.2 percent if no corrective actions are taken.

[55] Some of the measures such as an increase in duties or an increase of WHT on banking transactions can have adverse impacts on export competitiveness or financial sector development, as discussed above.

SOEs, inefficient public investment management, and the contingent liabilities arising from investment guarantees. Indeed, most of the energy projects under CPEC have contractual minimum-revenue guarantees, the realization of which could add to the already elevated public and external debt levels.

Appropriate policy responses are needed to maintain macroeconomic stability.

Fiscal discipline and increased exchange-rate flexibility—using the SBP's foreign exchange interventions to reduce volatility, rather than to defend a particular PKR/US$ parity level—to ensure that an effective buffer to external shocks is in place, are urgently required to restore stability. Any delay in implementing such measures will only serve to increase downside risks and could entail substantial economic costs.

3. Progress and Next Steps on Structural Reforms

Pakistan is once again facing an all too familiar boom and bust cycle—with a period of higher growth followed by a slowdown.

The policy adjustments needed to correct macroeconomic imbalances, and restore and maintain macroeconomic stability are also likely to slow down growth. Some of this adjustment has already started. The Pakistani rupee depreciated against the US dollar by almost 18 percent in the second half of FY18, monetary policy is being tightened, and the new government has prepared an amendment to the FY19 Finance Bill that will slash federal development spending. Some of the tax relief measures provided in the original FY19 Finance Bill are being rolled back. The imposition of new RDs will probably have some impact on the volume of imports, while also affecting inflation and the economy's export competitiveness. While these short-term adjustments are necessary, Pakistan also needs to implement a medium-term reform agenda with the same sense of urgency if it is to avoid finding itself in the same situation five years from now. Pakistan's macroeconomic challenges are structural in nature, not cyclical, though poor policy choices and a weak external environment have not helped matters. The structural challenges are related to low investment rates and the difficulty Pakistan has in increasing investment sustainably, given inadequate financing options: limited fiscal space for public investment, low saving rates and limited FDI for private investment. A medium-term reform agenda would need to focus on addressing these constraints to create the conditions for a new growth model based on investment and productivity.

The authorities have taken a number of measures aimed at avoiding a macroeconomic crisis.

The new government's recognizes the increasing risks of a macroeconomic crisis unfolding, and restoring and maintaining macroeconomic stability has been high on the agenda from day one. This is reflected in the new government's priorities, the composition of the Cabinet with the appointment of an Advisor for Institutional Reforms and Austerity (with ministerial rank), and the focus of the work of the new finance minister. The proposed amendments to the Finance Bill FY19 seek to tighten fiscal policy through a number of revenue-generation and expenditure-reducing measures, with initial estimates suggesting additional revenue of PKR 183 billion and a reduction in development spending of PKR 225 billion. Additional import duties will be imposed on over 5,000 goods, aiming to curb import growth. Attempts over the past year to curb imports through increased exchange-rate flexibility and regulatory duties have had mixed success, with international reserves estimated at only 1.4 months of imports of goods and services in end of September. These short-term policy adjustments will need to be complemented with structural reforms that create the necessary fiscal space and improve the economy's competitiveness.

Fiscal management reforms are needed...

Fiscal management reforms to increase fiscal space, but also to improve the efficiency of public spending, will need to tackle four areas: (i) tax administration and tax policy; (ii) fiscal decentralization; (iii) the legislative framework governing public finance; and (iv) measures to improve spending efficiency.

...to improve revenue mobilization...

Revenue as a share of GDP continues to be very low and a large share of the revenue is generated through indirect taxation. The tax system is highly complex, which increases compliance costs, thereby affecting the business environment. The fragmented tax administration between the federal government and the provinces also contributes to the complexity and often causes double taxation. Needed reforms to domestic revenue mobilization include efforts to enhance the capacity of both federal and provincial authorities, legally binding coordination mechanisms, automated risk-based audit systems, improved compliance and enforcement, and making use of the available data on filers and non-filers, arrears management, and an independent appeals function. Despite the political difficulties, the fragmentation of the tax base also needs to be addressed. Reforms, particularly as they relate to the need for improved coordination, could be supervised by a high-level constitutional body, such as the CCI.

...to reap the benefits of decentralization...

Fiscal decentralization holds tremendous potential for improving service delivery, empowering local authorities, and improving transparency and accountability in public service delivery and financing. But it also requires improved coordination in several areas. In the current set-up, fiscal policy lacks credibility because the responsibility for it rests solely with the federal government, while the ability to manage fiscal policy rests jointly with both the federal and provincial governments. The provinces together receive 57.5 percent of the divisible revenue pool. To enhance the credibility of fiscal policy, Pakistan needs to establish a binding legal framework of fiscal responsibility that ties all government levels. Improved coordination would also be necessary in tax policy and administration, the regulatory environment and key national policies.

...to enact a framework for public financial management...

Pakistan does not have an organic Budget Law that governs public finance. Instead, public financial management (PFM) is regulated by various ad hoc rules (e.g., Treasury Rules and National Accounting Manual), which contain contradictions and gaps. One major gap, for example, is that supplementary budgets are provided to the federal and provincial assemblies after the fact, which limits the National Assembly's role in budget approval. A comprehensive Public Financial Management Law would address such gaps and inconsistencies, and contribute toward improved PFM and efficiency in public expenditure.

...and to enhance spending efficiency.

Options for improving the efficiency of public spending are discussed in Box 2 in Section 2 on Fiscal Accounts. Particularly relevant is the need to reform SOEs and better manage fiscal risks. Subsidies and other types of support to SOEs added 1.4 percent of GDP to the deficit in FY16. Sovereign guarantees for SOE debt reached 2.9 percent of GDP. Investments as part of CPEC will continue to add to the country's debt stock and the accumulation of contingent liabilities, as a number of private investments have benefited from explicit government guarantees or implicit ones such as power purchase agreements in the energy sector. Improved public investment and fiscal risk management will be necessary to maximize the benefits from CPEC and ensure that emerging risks are well managed.

Competitiveness reforms are needed...

Pakistan's relatively poor export performance over the past decade reflects the declining competitiveness of its economy. While South Asia's exports increased by 165 percent from 2005 to 2017, Thailand's by 136 and Vietnam's by an impressive 519 percent,

Pakistan's exports increased by only 50 percent, including a continuous decline and stagnation from FY11 until FY17. Two areas stand out as negatively affecting the economy's competitiveness: (i) anti-export macroeconomic and trade policies; and (ii) a poor investment climate.

...to reduce trade costs...

The Pakistani rupee appreciated in real terms by 29.7 percent between 2008 and 2017, as a result of both nominal exchange rate appreciation and high domestic inflation. The appreciation was particularly fast over the past few years, at a time when the currencies of many of Pakistan's peers were depreciating, adversely affecting Pakistan's export performance. In addition to the currency appreciation, high import tariffs—that increase costs of accessing key intermediates—and poor trade facilitation have contributed to the disappointing export performance. In addition to maintaining a competitive and market-determined exchange rate, Pakistan could adopt a simple and transparent tariff structure, with reduced tariffs and clear rules to limit the excessive use of regulatory duties. Improving trade logistics would entail the adoption of the National Single Window for trade, addressing infrastructure bottlenecks, particularly at the borders, and a simplification of procedures to reduce the time it takes to import and export.

...and to improve the investment climate.

Pakistan underperforms most other countries in the region in international rankings measuring the ease of doing business and in terms of an economy's competitiveness. This adversely affects private investment, reflected in the low investment rates or Pakistan's low FDI levels. A complex regulatory environment, cumbersome procedures for paying taxes, and the high costs and unreliability of electricity access all adversely affect the economy's competitiveness. Pakistan is implementing a series of reforms to address the adverse business environment, at both the federal and provincial levels. It will be important to maintain and increase these efforts, bearing in mind that results may materialize only with a time-lag (e.g., in the areas of access to and reliability of electricity). Reform efforts should be led by the Prime Minister's office—a strategy that has proved effective in other countries—and be supported by improved coordination to ensure that this is a 'whole of government and federation' effort, and not one of a single agency.

C. Accelerating Human Capital Development

Investment in human capital is needed to create a more skilled, technologically savvy labor force...

Human capital is the most important contributor to the increase in wealth globally.[56] The contribution of human capital to total wealth has increased over time as more educated youth have joined the labor market. The creation of a skilled labor force that is more productive and better able to adopt and adapt to new technologies is at the core of the growth path for Pakistan. To this end, improvements in education and skills need to go hand in hand with improvements in health and well-being to maximize the cognitive potential of both men and women in Pakistan's population.

…and to improve productivity.

Achieving Pakistan's growth potential requires an increase in productivity, which cannot take place without major investments in human capital. A simple way to comprehend the link between human capital and productivity is by asking: given poor health and education conditions in Pakistan, *how much human capital will a child born today acquire by the end of secondary school?* To address this question, one must focus on three core components: *survival*, *education*, and *health*.

Survival is the first pre-condition…

Fewer children die before the age of five today, as the country has seen an average annual reduction of 2.2 percent in under-five mortality over the period from 1970 to 2016. However, this is not enough: in 2016, there were still 79 under-five deaths per 1,000 live births (about 400,000 children under-five died in 2016[57]). This points to the need for Pakistan to accelerate investment in basic medical services, including vaccinations, nutrition, and access to clean water and sanitation. Further investments must also take into account existing health disparities across regions and income groups. For example, while the overall immunization rates for children between the ages of 12 and 24 months have improved, only about 33 percent of children in the poorest wealth quintile are immunized compared with 94 percent of children in the richest wealth quintile.

...followed by school enrolment and learning outcomes.

Enrolment rates have increased consistently over time. However, the pace of improvement has been persistently slow. Pakistan still has a very large number of children out of school: an estimated 22.8 million children are not attending school, 18 million of whom are between 10 and 16 years old.[58] But being in school does not necessarily mean that children learn very much. In 2016, in rural areas of Pakistan, 48 percent of Class 5 students and 83 percent of Class 3 students could not read a Class 2 story in Urdu/Sindhi/Pashto; 54 percent of Class 5 students and 85 percent of Class 3 students could not read Class 2 sentences in English; and 52 percent of Class 5 children could not do two-digit division.[59] The education system not only needs a targeted focus on increasing enrolment but also, and most importantly, needs to ensure that learning outcomes are commensurate with the age-group benchmarks. Low basic skills hamper the development of higher level skills and the ability to increase individual productivity, either as employees or as self-employed individuals.

[56] Lange, Glenn-Marie, Quentin Wodon, and Kevin Carey, eds. 2018. *The Changing Wealth of Nations, World Bank, 2018: Building a Sustainable Future.* Washington, DC: World Bank.
[57] UN Interagency Group for Child Mortality Estimation, 2018 Report: Levels and Trends in Child Mortality.
[58] AEPAM. 2017, Pakistan Education Statistics 2016/17.
[59] ASER. 2016, Annual Status of Education Report National, South Asian Forum for Education Development, Lahore, Pakistan.

Investment in health and nutrition is key to further learning and employability.

Skills accumulation through formal education depends on investing in a child's health, nutrition, and adequate stimulation. Stunting is a fundamental development challenge in Pakistan. After four decades of stagnation, the country has made progress in improving nutrition, but stunting rates remain very high. Preliminary results from the Pakistan Demographic and Health Survey (PDHS) 2017/18 indicate a reduction in rates for stunting from 44 percent (FY11) to 37 percent.[60] The challenge is to continue this progress in reducing stunting and enhancing nutrition across the country, and across income levels. While life expectancy continues to increase, the existing weaknesses in the health-care system and high out-of-pocket medical expenses serve as a deterrent for Pakistanis to seek medical assistance and treatment regularly, and when it is most needed. These are key issues that need to be addressed and resolved to ensure a healthy and more productive work force.

There is an urgent need to invest in Pakistan's most valued asset: its people.

Moving forward, if Pakistan is to grow in an inclusive manner, the government must prioritize and invest equitably in human capital development, as the economic potential of the country can only be unlocked by embracing its population as its most valued asset for sustained growth.

[60] National Institute of Population Studies (NIPS) [Pakistan] and ICF. 2018. Pakistan Demographic and Health Survey 2017/18. Islamabad, Pakistan, and Rockville, Maryland, USA: NIPS and ICF.

THE WORLD BANK
IBRD • IDA | WORLD BANK GROUP

20-A Sharah-e-Jamhuriat, G-5/1,
Islamabad 44000, Pakistan.
Ph: +92 51 9090000, Fax: +92 51 2827040
www.worldbank.org/pk
www.facebook.com/worldbankpakistan