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Table of Contents

Executive Summary	1
Recent Economic Developments	3
The risk of a balance of payment crisis has been minimized.....	3
The highlight of the economic program was significant fiscal consolidation.....	5
As a result, public debt sustainability improved	7
Fiscal consolidation and improved business confidence produced strong recovery in credit to private sector.	8
Price stabilization followed, supported by reduced external vulnerability and improved fiscal performance	9
And growth recovery finally took place, driven by industrial and services sectors.....	10
Financial sector developments supported growth recovery	12
Structural reforms took off on solid ground and played their part at stimulating growth.....	13
The preliminary outlook for FY2014/15 remains cautiously sanguine	15
But the overall impact of August political events on the economy is yet uncertain	16
Box 1: Government's Tax Reform Strategy	17
Box 2: Doing Business Indicators	18
Annex 1: World Bank Support to Pakistan	19
Annex 2: Pakistan Data Sheet.....	20

Cover Photo: *The Satpara Lake is located in Skardu, Gilgit Baltistan, Pakistan, at an elevation of 8650ft above sea level. (Credit: Nadeem Khawar)*

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List of Acronyms

3G/4G	Third/Fourth Generation	PIB	Pakistan Investment Bonds
ADB	Asian Development Bank	PPL	Pakistan Petroleum Limited
BISP	Benazir Income Support Program	PSBs	Private Sector Businesses
BOP	Balance of Payments	PSDP	Public Sector Development Programs
CAD	Current Account Deficit	Q1	First Quarter (of the fiscal year)
CCTs	Conditional Cash Transfers	REER	Real Effective Exchange Rate
CGT	Capital Gains Tax	RM	Reserve Money
CPI	Consumer Price Index	ROA	Return on Asset
CRR	Cash Reserve Requirement	ROE	Return on Equity
CSF	Coalition Support Fund	RSP	Rural Support Programs
DPC	Development Policy Credit	Rs.	Pakistani Rupee
EFF	Extended Fund Facility	SAARC	South Asian Association of Regional Corporation
EMBI	Emerging Market Bond Index	SBA	Stand-By Arrangement
EU	European Union	SBP	State Bank of Pakistan
FBR	Federal Board of Revenue	SMEs	Small and Medium Enterprises
FDI	Foreign Direct Investment	SOEs	State Owned Enterprises
FY	Fiscal Year	SROs	Statutory Regulatory Orders
GCC	Gulf Cooperation Council	TA	Technical Assistance
GDP	Gross Domestic Product	UAE	United Arab Emirates
GIDC	Gas Infrastructure Development Cess	UBL	United Bank Limited
GIS	GoP Ijarah Sukuk	USA	United States of America
GoP	Government of Pakistan	US\$	United States Dollar
GSP	Generalized System of Preferences	WALR	Weighted Average Lending Rate
GST	General Sales Tax	y-o-y	Year-on-Year
G&S	Goods and Services		
H1	First Half (of the fiscal year)		
H2	Second Half (of the fiscal year)		
IDA	International Development Association		
IMF	International Monetary Fund		
KIBOR	Karachi Interbank Offered Rate		
KSE	Karachi Stock Exchange		
LSM	Large-scale Manufacturing		
M2	Broad Money		
MAF	Million Acre-Feet		
MFI	Microfinance Institutions		
MTDS	Medium –Term Debt Management Strategy		
MTBs	Market Treasury Bills		
NDA	Net Domestic Asset		
NER	Nominal Exchange Rate		
NFA	Net Foreign Asset		
NFNE	Non-food, non-energy		
NPLs	Non-performing Loans		
OICCI	Overseas Investors Chamber of Commerce and Industry		
PBS	Pakistan Bureau of Statistics		
PDF	Pakistan Development Fund		

Fiscal Year in Pakistan (July 1—June 30)

Executive Summary

- ***In just a few weeks, since mid-August, economic conditions that had improved so much during FY2013/14 weakened a bit due to a succession of political events.*** Progress last year was indeed significant supported by a solid economic reform program of the Government of Pakistan. An IMF Extended Fund Facility (EFF) and two World Bank Development Policy Credits with a focus to restructure the energy sector, foster private and financial sector developments and improve social protection and revenue mobilization have reinforced the reform program. The risk of a balance of payment crisis was minimized with a significant strengthening of the international reserves position. This mainly resulted from strong remittances and significant foreign capital inflows, which also brought stability in the foreign exchange market. A strong fiscal consolidation achieved; the fiscal deficit was contained at around 5.5 percent of GDP—due to improved tax collection, high non-tax revenues, and restricted (current and development) expenditures. Price stabilization followed with average inflation remaining in single digits. This environment favored growth recovery, with GDP growth rate above 4 percent for the first time in seven years—driven by dynamic manufacturing and service sectors supported by better energy availability and improved investors' expectations. As a result, performance under the IMF program remained satisfactory, with the Third Review concluded on June 27. However, since mid-August, the ongoing political uncertainty has negatively affected the macroeconomic stance and may modify the pace and depth of reforms. Some salient features of FY2013/14 economic performance were:
 - ***Growth re-emerged.*** GDP growth rate was 4.1 percent in FY2013/14, primarily driven by the manufacturing and services sectors. Industrial sector growth was based on a sharp turnaround in construction, electricity generation and gas distribution and better performance of large scale manufacturing (LSM) growth (of about 4 percent). In addition, services contributed to about 60 percent of growth through relatively better performance in wholesale and retail trade; and transport, storage and communication (which together accounts for half of services value added). Agricultural growth, however, was slower compared to the previous year.
 - ***Increased remittances, capital and financial inflows supported a buildup of reserves.*** Remittances touched US\$ 15.8 billion. The capital and financial account registered a sizeable surplus of US\$ 7.07 billion in FY2013/14 compared to only US\$ 0.8 billion in FY2012/13. Official reserves coverage increased to about two month of next year's projected imports of goods and services on June 30, 2014. Foreign inflows led to a mild appreciation of the real effective exchange rate.
 - ***A significant correction of a previously loose fiscal stance took place.*** The government reduced the fiscal deficit from 8.3 percent of GDP in FY2012/13 to 5.5 percent of GDP in FY2013/14. Tax revenues increased by almost 1 percent of GDP and expenditures compressed by 1.3 percent of GDP.
 - ***Fiscal consolidation and improvement in business confidence produced a strong recovery in credit to the private sector, after five years of muted growth.*** The lower demand for commercial bank credit by the government due to a lower fiscal deficit provided necessary space to the private sector to borrow from the banking system.
 - ***Price stability – with CPI inflation in single digit – was preserved.*** Better food supply conditions, reduced external vulnerability and fiscal consolidation contributed to the softening of underlying inflationary pressures.
- ***Progress on the structural reform agenda was promising.*** The government reduced power subsidies, by adjusting power tariff towards cost recovery level. In order to overcome inter-corporate circular debt issue, the stock and flow of payables at all levels of the energy sector will now be identified by a technical and financial audit and a roadmap to limit the accumulation of new arrears and reduce their

stock has been designed. Government also completed capital market transactions by selling shares of United Bank Limited (UBL) and Pakistan Petroleum Limited (PPL) in June 2014; and successfully auctioned 3G telecoms licenses. Under a three-year program to phase out concessionary tax exemptions, the FY2014/15 budget approved a package of revenue measures to expand the tax base, including the elimination of tax exemptions and adjustments to the sales and excise tax rates for special categories so as to raise additional revenues equivalent to above 1 percent of GDP. In addition, the government reduced statutory Custom tariff slabs from eight to six, which will subsequently be brought to four in the next two years. It expanded the coverage of beneficiaries and significantly increased the benefits of the Benazir Income Support Program (BISP) cash transfer program while introducing conditional cash transfers supporting school enrolment. To build reserves and in a sign reflecting investors' confidence toward these reforms, after a gap of seven years, the government raised US\$2 billion by placing sovereign bonds in international debt markets.

- ***The political events following the mid-August Long-March and Sit-in may have affected the economy.*** The Bank is in no capacity to make judgments of the possible outcomes of these events and their medium term impact on the economy. However, besides appraising its short-term effects, two questions left are how much the business-prone investor-friendly image that Pakistan was carefully rebuilding has been compromised, and how quickly reform momentum can be recovered. Signs of partial deterioration of the economy are multiple and mixed. On the one hand, growth may have slowed down in the first quarter of FY2014/15 as the virtual paralysis of the government machinery may have affected trade, construction and services. The international reserve position has suffered small losses. Accelerated rupee depreciation of 3.0 percent in August 2014 forced the State Bank of Pakistan (SBP) to intervene by about US\$375 million. Investment decisions and visits by China and Sri Lanka presidents were postponed. On the other hand, on the public expenditure side, the cost of additional security, as mentioned by the government, has rather been small (Rs 357.6 million equivalent to 0.1 percent of GDP), and tax receipts kept robust, growing at 25 percent last August despite a call for civil disobedience made by the demonstrators.
- ***It also remains to be determined how much the pro-reform momentum, so carefully gathered during the past fiscal year and entering a decisive second year, will be affected by the civil unrest; but new investors' confidence-building measures will have to be nurtured to reinvigorate the reform agenda.*** Due to the political situation, the government might find difficult to implement certain structural reforms needed for growth acceleration and poverty reduction or might consider delaying them. In an early sign of the ongoing difficulties, and unlike the past three favorable and timely reviews of the IMF program, the fourth review initially scheduled for Board presentation by the end of September is at a standstill. At least three areas of reform may get delayed or modified: approval of adjustment in power tariffs; the privatization agenda; and reforms requiring legislative approval. Alternatively, the government may consider strengthening some areas of the program such as power, with more decisive and less incremental actions, inclusion and governance. Strengthening media communication efforts on the benefits of reforms may also contribute to regaining the momentum.

Recent Economic Developments¹

The risk of a balance of payment crisis has been minimized.

1. *The foreign exchange reserve position improved considerably.* Notwithstanding a mildly higher current account deficit of US\$2.9 billion (1.2 percent of GDP), Pakistan's overall external balance improved considerably; a surplus of US\$3.8 billion in FY2013/14 balanced against the deficit of US\$1.99 billion in FY2012/13. This was due to resilient growth in workers' remittances, which offset a chronically negative trade balance, receipts from Spectrum auctions and a substantial increase in the capital and financial account. It was supported by receipts under the Pakistan Development Fund (PDF), US\$2 billion in Eurobond receipts, and higher inflows in general government loans (see Table 1). Moreover, successful continuation of the IMF's EFF program helped compensate for sizable amortization of previous debt with the IMF. Foreign inflows led to the rupee's rise by about 7 percent in nominal terms during the second half of FY2013/14 (H2-FY2013/14).

2. *The appreciation of the rupee (both nominal and real) somehow contributed to the widening of the trade deficit.* Export competitiveness suffered from the nominal appreciation of the rupee (see below), and registered an anemic growth of 1.4 percent. In parallel, imports grew by 3.9 percent. Further decomposition of export performance reveals

that the year-on-year exports growth during the second quarter decelerated sharply to -0.17 percent compared to 3.1 percent during the first half of FY2013/14 (H1-FY2013/14). Overall, export growth was mainly driven by textile products (raw cotton, knitwear, bed wear and other textile made-ups), the petroleum group (solid fuel, naphtha), and rice exports as a result of both increased quantity and unit value. Pakistani exports continued to be highly concentrated in textile exports (see Figure 1) and likely to benefit from GSP plus status from the European Union,² the largest export market with a share of 25 percent in total exports. On the other hand, non-textile exports, particularly other manufacturing group (machinery and transport equipment, gems and jewelry, handicrafts, cement and cement products etc.) witnessed a sharp decline³ due to the power shortages and the fall in international prices.

Table 1: Balance of Payment Summary

US\$ billion	FY13	FY14
i. Current account (A+B+C+D)	-2.50	-2.93
A. Trade balance	-15.43	-16.63
Export	24.80	25.16
Import	40.23	41.78
B. Services net	-1.47	-2.53
of which: CSF	1.86	1.15
C. Income net	-3.69	-3.92
D. Current transfers net	18.09	20.11
Of which Remittances	13.92	15.83
ii. Capital and Financial A/c	0.81	7.07
of which:		
Direct investment	1.26	1.48
Portfolio investment	0.03	2.77
Other Investment Assets	-0.31	0.30
Other Investment Liabilities	-0.42	0.68
iii. Errors and omissions	-0.31	-0.30
Overall balance	-1.99	3.84
SBP reserves (excl. CRR, sinking fund)	6.05	9.17
Memorandum Items		
Current A/c Balance (% of GDP)	-1.1	-1.2
Trade Account (% of GDP)	-6.6	-6.7
Export growth %	0.40	1.45
Import growth %	-0.58	3.85
Remittance growth %	5.6	13.7
Financial & Capital A/c (% of GDP)	0.35	2.86

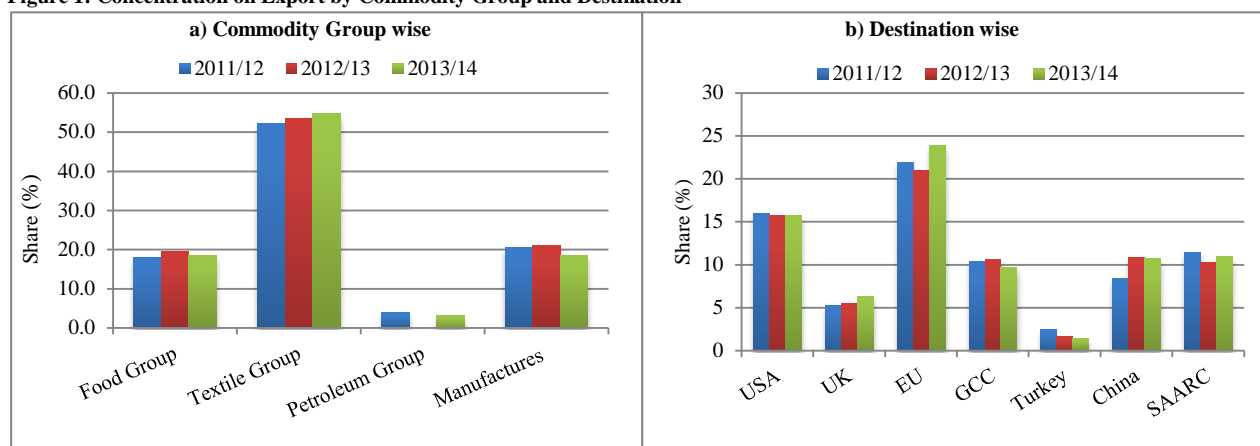
Source: State Bank of Pakistan

¹This assessment focuses on recent trends, supported by most recent available data. The preliminary impact of the August-September political events is treated separately at the end of this document.

²Pakistan export to EU mainly comprises textile and clothing, accounted for 75 percent of total exports to EU. Nevertheless, a competitive and less volatile exchange rate is imperative.

³Growth declined from 5.8 percent in FY2012/13 to -10.1 percent in FY2013/14.

Figure 1: Concentration on Export by Commodity Group and Destination



Source: Data from State Bank of Pakistan

3. **Import growth was mainly driven by improved domestic production rather than consumption.** Imports of machinery,⁴ particularly power generation, textile, construction and electrical machinery, grew by about 26 percent. The increased import of textile machinery reflects the revival of the textile industry in response to getting GSP plus status while imports of construction and power generation machinery are attributable to ongoing work on various power and construction activities in the country. In addition, due to higher economic activity, higher demand for some of industrial raw materials such as plastic materials, fertilizers, iron and steel scrap and synthetic fiber contributed to the import growth (see Table 2).

Table 2: Major Imports with Decrease/Increase in Quantum and Prices

US\$ million	2013/14	Abs. Change from 2012/13	% change in quantity from 2012/13	% change in price from 2012/13	Quantum impact in US\$ million	Price impact in US\$ million
Plastic Material	1,673.3	247.8	22.8	-4.4	324.3	-76.5
Fertilizer Manufactured	532.4	32.3	61.7	-34.2	308.8	-276.5
Iron and Steel Scrap	769.6	136.2	15.5	5.2	98.4	37.7
Synthetic Fiber	438.6	47.0	20.7	-7.2	80.9	-34.0
Soybean oil	110.9	36.5	84.8	-19.4	63.2	-26.7
Palm Oil	1,859.2	-103.7	2.5	-7.6	49.7	-153.4
Iron and Steel	1,397.5	-215.5	-8.5	-5.3	-136.5	-79.0
Petroleum Crude	5,775.9	383.8	-3.4	10.9	-185.3	569.1
Raw Cotton	573.4	-307.7	-38.4	5.6	-338.3	30.6
Petroleum Products	9,053.8	-455.9	-8.8	4.4	-837.9	381.9

Source: Pakistan Bureau of Statistics

4. **Current transfers (mainly remittances) continued to be a source of comfort.** Current transfers at US\$ 20.1 billion more than compensated for US\$ 19.2 billion deficit in trade of goods and services. Workers' remittances registered a sharp growth of 13.7 percent⁵ against 5.6 percent last year. Country wise data shows that remittances from all major countries increased except the United Kingdom,⁶ which contributes about 14 percent in total remittances. The share of Saudi Arabia in overall remittances was the largest (30 percent); with the United Arab Emirates (20 percent) and the United States (16 percent) having the second and third largest shares, together contributing 65 percent in total remittances⁷; while member countries the Gulf Cooperation Council (GCC) contributed about 12 percent. Remittances from the European Union countries grew significantly, by 20 percent against a contraction of 2 percent last year. However, the European Union contributed just 3 percent to the remittance flow, thereby contributing only marginal influence on volume and growth in remittance.

⁴Import of machinery contributed about 15 percent in total import bill.

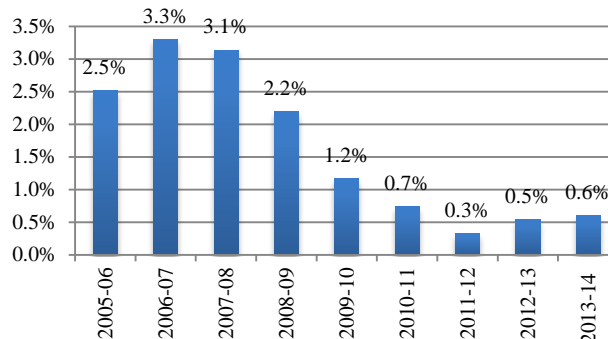
⁵The significant growth can be largely explained by the initiative of channelizing international remittances through banks and other money transfer service under Pakistan Remittances Initiatives (PRI).

⁶Growth rate decreased from 28 percent in FY2012/13 to 12 percent in FY2013/14.

⁷Remittances from Saudi Arabia, UAE and USA grew by 15 percent, 13 percent, and 12.7 percent respectively in FY2013/14.

5. **The Capital and Financial account registered a sizeable surplus of US\$ 7.07 billion in FY2013/14 compared to only US\$ 0.8 billion in FY2012/13.** This was mainly attributed to the grant receipts of US\$1.5 billion in the PDF; US\$2 billion against the sale of Eurobonds in the international bond market; UBL privatization proceeds of US\$ 0.3 billion and increases in net loans from multilateral organizations (US\$1.2billion). Foreign direct investment (FDI), which peaked at 3.3 percent of GDP in FY2006/07, is stagnant at around 0.5 percent of GDP over last four years (see Figure 2). With low domestic savings, there is need to improve the business environment to attract foreign investors. It is expected that FDI will grow in the future due to likely investment in infrastructure, such as power generation.

Figure 2: FDI as % of GDP

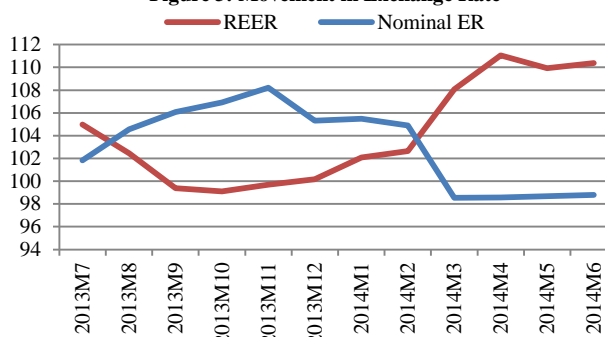


Source: Data from State Bank of Pakistan

6. **Overall, official reserves increased to US\$ 9.71 billion by June 30, 2014 compared to US\$6.0 billion at end of FY2012/13.** This translates into 2.1 months of import coverage (reserves sufficient to import next year's projected import of goods and services). Moreover, based on positive external outlook, improved financial indicators and with a steady economic performance, Moody's changed Pakistan's external ratings from negative to stable.

7. **Reserves buildup brought a shift in expectations in foreign exchange market.** The rupee remained under stress during the first five months of FY2013/14, due to continuous drawdown of official reserves as sizable payments of external debt were made. However, this trend shifted after November 2013 with the receipt of US\$1.5 billion in the PDF. The reversing trend was reinforced with the successful issuance of US\$2 billion Euro Bonds, continuation of the IMF program, auction of the telecom spectrum, and disbursement of loans from the World Bank, Asian Development Bank (ADB), etc. As a result, the rupee appreciated by 9.9 percent during last seven months of FY2013/14 (see Figure 3). This resulted in the appreciation of the Real Effective Exchange Rate (REER) by 10.2 percent. This appreciation in REER suggests deterioration in the economy's export competitiveness.

Figure 3: Movement in Exchange Rate



Data Source: IMF's International Financial Statistics

The highlight of the economic program was significant fiscal consolidation

8. **Pakistan's fiscal situation continues to improve.** The new government made a strong attempt to reestablish fiscal stability. Supported by the IMF's EFF program, the government aimed at lowering the consolidated fiscal deficit from 8.3 percent of GDP in FY2012/13 to 5.8 percent of GDP in FY2013/14 by raising tax revenue by almost 1 percent of GDP and constraining expenditures by another 1.3 percent of GDP. In addition, the federal government agreed with the provinces to maintain a sizeable fiscal surpluses (of 0.2 to 0.5 percent of GDP) to achieve this substantial reduction in consolidated fiscal deficit. The provisional data for FY2013/14 indicates that the government was able to exceed this target by lowering the fiscal deficit (excluding grants) to 5.5 percent of GDP (see Table 3). The actual budget financing was 4.7 percent of GDP because of higher-than-anticipated availability of grants (at Rs. 206 billion compared to programmed amount of Rs. 67 billion).

9. *The reduction in the fiscal deficit was achieved with a mix of increases in federal tax collection, albeit lower-than-expected, and receipts of more than projected non-tax revenue.* Despite strong efforts from the government, tax collection improved but below expectations. Against a collection target of 9.3 percent of GDP, Federal Board of Revenue (FBR) collection fell short by Rs. 79 billion (close to 0.4 percent of GDP). Non-FBR taxes too fell short of the target. This shortfall in tax collection, however, was more than compensated by an increase in non-tax revenue, which exceeded the target by 0.5 percent of GDP. This increase in non-tax revenue was mainly due to a few one-time accruals, which became available to the government⁸. In order to increase tax revenues, government is taking very significant measures as part of overall reform program (see Box 1).

10. *Expenditure compression provided a rather marginal support to fiscal consolidation.* Overall government expenditures amounted to 19.8 percent of GDP and were broadly on target. Current expenditure exceeded the program target by 0.1 percent of GDP. Development expenditure exceeded the target by 0.6 percent of GDP solely on account of federal government (net) lending to finance the development programs of State Owned Enterprises (SOEs). Both increases were offset by the statistical discrepancy, item that registered the proceeds from the Saudi grant.⁹

11. *Provinces contributed significantly to lowering of fiscal deficit.* With the increase in the share of provinces in shared revenue, fiscal consolidation has become both complicated and difficult. With its drastically reduced revenue share and expenditure rigidities, the federal government, on its own, cannot reduce the fiscal deficit to the desired level. In FY2013/14, the federal government requested the provinces to show a combined fiscal surplus of 0.2 percent of GDP, and provided incentives in the form of additional grants to the provinces to achieve this objective. The fiscal outcome shows that the provinces generated a gross fiscal surplus of 0.6 percent of GDP, which is significantly higher than what the federal government requested and the surplus generated in FY2012/13 (see Table 4).

Table 3: Summary of Fiscal Operations

(Percent of GDP)	2012/13	2013/14	
	Actual	Prog.	P. Actual
Revenue and Grants	13.3	14.4	15.1
Revenue	13.1	14.1	14.3
Federal	9.3	10.1	9.6
FBR Tax Revenue	8.6	9.3	8.9
Other Tax Revenue	0.7	0.8	0.7
Provincial	0.7	0.7	0.7
<i>Nontax Revenue</i>	<i>3.2</i>	<i>3.4</i>	<i>3.9</i>
Federal	2.9	3.1	3.7
Provincial	0.3	0.3	0.2
<i>Grants</i>	<i>0.2</i>	<i>0.3</i>	<i>0.8</i>
Expenditure	21.5	19.9	19.8
<i>Current Expenditure</i>	<i>16.7</i>	<i>16.6</i>	<i>16.7</i>
Federal	11.8	11.8	12.1
Interest Payments	4.4	4.6	4.5
Domestic	4.1	4.2	4.2
Foreign	0.3	0.4	0.3
Defense	2.4	2.5	2.5
Grants	1.6	1.6	2.1
Subsidies	1.4	1.3	1.2
Provincial	4.9	4.8	4.6
<i>PSDP and Net lending</i>	<i>4.7</i>	<i>3.3</i>	<i>3.9</i>
PSDP	3.1	3.3	3.5
Federal	1.4	1.7	1.8
Provincial	1.7	1.6	1.7
Net Lending	1.6	0	0.4
<i>Statistical discrepancy</i>	<i>0.1</i>	<i>0</i>	<i>-0.9</i>
Financing	8.1	5.5	4.7
Domestic	8	4.6	3.5
Bank	5.9	3.7	1.3
of which: SBP		3.5	0.6
Non-Bank	2.2	0.9	2.2
Memo Item:			
Nominal GDP	22,489	25351	25402

Data Source: Ministry of Finance

Table 4: Provincial Fiscal Surpluses, 2012/13 – 2013/14

(Percent of GDP)	Fiscal Balance (Gross)		Federal Loans (Net)		Fiscal Balance (Net)	
	2012/13	2013/14	2012/13	2013/14	2012/13	2013/14
Punjab	0.00%	0.20%	0.00%	0.10%	0.00%	0.10%
Sindh	0.20%	0.20%	0.10%	0.10%	0.10%	0.10%
Khyber Pakhtunkhwa	0.00%	0.20%	0.00%	0.10%	0.00%	0.10%
Balochistan	0.10%	0.00%	0.00%	0.00%	0.10%	0.00%
All Provinces	0.30%	0.60%	0.10%	0.20%	0.20%	0.40%

Source: Ministry of Finance, GoP

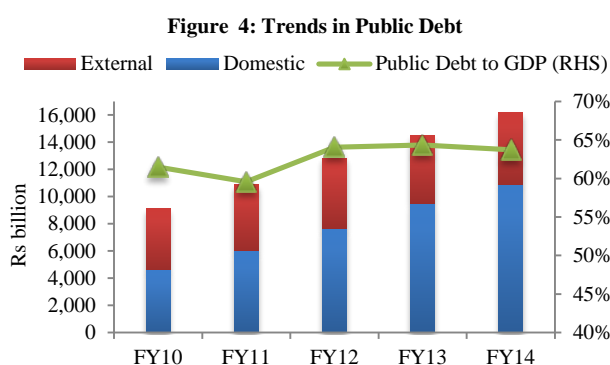
⁸These include additional revenue of Rs. 90 billion in profits of the State Bank of Pakistan and recall of monies deposited in Universal Access Fund.

⁹A peculiar accounting protocol was adopted by the government for the Saudi grant of Rs. 157 billion (0.6 percent of GDP). The amount was deposited in the Pakistan Development Fund and accounted as recurrent expenditure (as federal grant). To balance this expenditure, the same (but negative) amount was added to the statistical discrepancy. This implies that had it not been for this accounting protocol, the recurrent expenditure of the government would have fallen short of the target by 0.4 percent of GDP. At the same time, the statistical discrepancy would have reduced to only -0.3 percent of GDP.

12. *Beside a lower fiscal deficit, improvement was also made in the mode of financing.* Since FY2007/08, Pakistan had been running high fiscal deficits with decreasing external financing. This caused the government to resort to heavy borrowing from the banking system, including the central bank, to finance them. Excessive reliance on domestic borrowing had exacerbated inflationary pressures and crowded-out bank credit for private investment. In contrast, the FY2013/14 fiscal consolidation program was able to restart donors' budget support operations, including US\$1 billion provided by the World Bank and about US\$500 million provided by the ADB and Japan. Hence, against the program target of 3.7 percent of GDP, the government borrowed only one-third of that amount (1.3 percent of GDP) domestically from the banking system.

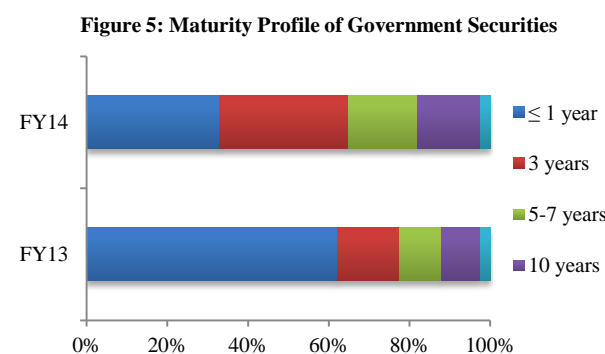
As a result, public debt sustainability improved

13. *Public debt ratio to GDP has marginally improved to 63.7 percent in FY2013/14, an improvement of 0.6 percent over the previous year (see Figure 4).* However, it is still higher than the 60 percent limit stipulated in the Fiscal Responsibility and Debt Limitation Act of 2005¹⁰. The substantial fiscal consolidation, marginal appreciation of local currency,¹¹ and relatively high growth in nominal GDP contributed to this improvement. Whereas the overall composition of public debt remained skewed towards more expensive domestic debt (with 67 percent share), the maturity profile of domestic debt improved (see Figure 5).



Source: State Bank of Pakistan and staff calculations

14. *Debt maturity shifted towards the longer end of the yield curve, thus reducing rollover (and refinancing) risks.* More specifically, Rs. 1.2 trillion worth of short-maturity treasury bills were retired and replaced with long-maturity Pakistan Investment Bonds (PIB) issuance of Rs.1.8 trillion.¹² This shift in funding sources has increased the share of permanent debt¹³ to 37 percent from its ten-year average of 21 percent.¹⁴ These developments have improved Pakistan's debt sustainability. Preliminary results of the Debt Sustainability Analysis (DSA)¹⁵ show that Pakistan's risk of debt distress on external and public debt remains low. Moreover, gross financing needs are projected to decline over the medium-term once the IMF SBA is fully repaid and total interest payments average around 29 percent of total revenues



Note: Government securities include MTBs, PIBs and GIS.

Source: State Bank of Pakistan

¹⁰ The FRDLA allows a departure from the threshold provided the Finance Minister specifies the reasons and the measures government intends to take to return to the threshold over an estimated period of time [Section 3 (4) of the FRDLA 2005].

¹¹ As a result, PKR appreciated by 0.3 percent against USD during FY2013/14. The currency appreciation was last witnessed in FY2002/03.

¹² About 55 percent of this increase is in three-year paper, followed by 23 percent and 21 percent in five and 10-year tenors respectively.

¹³ Medium-to-long term domestic debt that primarily includes prize bonds, Pakistan Investment Bonds (PIBs) and Ijarah Sukuks (GIS).

¹⁴ In line with the recommendation of the joint World Bank-International Monetary Fund TA report on Pakistan-Developing a Medium-Term Debt Management Strategy (MTDS), February 2014.

¹⁵ World Bank Debt Sustainability Analysis, March 2014.

(including grants) over the projection horizon.

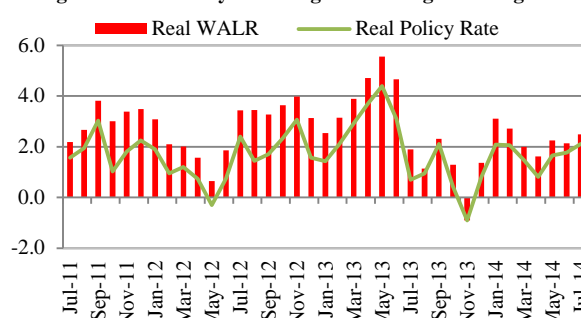
15. **Net external debt inflows contributed to an increase in their stock after two years.** Pakistan entered into a three year US\$ 6.64 billion Extended Fund Facility (EFF) with the IMF in September 2013. This arrangement enabled a healthy inflow of multilateral and bilateral monies. Of the 18 new loans signed during FY2013/14, two World Bank International Development Association (IDA) Development Policy Credits (DPCs) and an ADB budget support operation added US\$ 1.4 billion to the external debt stock. Moreover, the Government was able to place US\$ 2.0 billion Eurobonds issuance in April 2014¹⁶. It is worth mentioning here that the new loans are mostly designed in a ‘front-loaded’ modality with a disbursement to loan ratio of about 61 percent.

Fiscal consolidation and improved business confidence produced strong recovery in credit to private sector.

16. **The monetary policy stance remained tight during FY2013/14.** After raising the policy rate, by 50 basis points (bps) successively in September and November 2013, to deal with a continued deterioration in the balance of payments position in first half of FY2013/14, and a worsening of inflation outlook during the first quarter of FY2013/14 (Q1-FY2013/14), SBP maintained its policy rate at 10 percent. Real weighted average lending rates remained positive until mid-year (see Figure 6). The Karachi Interbank Offer Rate (KIBOR), which is used as a nominal benchmark for loans to the corporate sector, remained marginally above policy rate.

17. **The change in the budget financing mix in favor of external sources also produced changes in the monetary aggregates (see Table 5).** The year-on-year growth in broad money (M2) decelerated to 12.5 percent in FY2013/14 from 15.9 percent a year earlier. This is the lowest monetary expansion during the last three years and is mainly due to a significant deceleration in growth of Net Domestic Assets (NDA) of the banking system due to lower budgetary borrowings¹⁷. Specifically, the government borrowed Rs303 billion for budgetary support from the banking system during FY2013/14, which is around 21 percent of Rs1446 billion borrowed in FY2012/13¹⁸. However, part of the impact of this slowdown in NDA was offset by a considerable expansion in Net Foreign Assets (NFA) of the banking system during the same period due to substantial foreign financial inflows. After

Figure 6: Real Policy and Weighted Average Lending Rates



Real rates calculated using YoY inflation

Source: State Bank of Pakistan

Table 5: Monetary Aggregates (Flow since end-June)

Rs. billion	Flow	
	2012/13	2013/14
Net Foreign Assets	-258	332
of which: SBP	-256	357
Net Domestic Assets	1474	778
Government borrowing:	1479	327
Budgetary borrowing	1446	303
from SBP	507	197
from Scheduled banks	940	106
Commodity operations	32	25
Non-govt. sector borrowing:	11	438
Private sector	-19	384
Public Sector Enterprises	31	54
Other Items	-16	13
M2	1216	1110
Growth (YoY)	15.9	12.5
RM	346	326
Growth (YoY)		
Currency in circulation	265.5	238.6
Demand and Time Deposits	949.9	868.0

Source: State Bank of Pakistan

¹⁶Pakistan entered international financial markets after a gap of almost seven years, raising US\$ 1.0 billion each in 5 and 10 years tenors – five year bonds at a fixed rate of 7.25 percent (5-year UST + 558bps) and 10 year bonds at a fixed rate of 8.25 percent (10-yr UST + 556 bps) – both issues with an in-built bullet repayment feature.

¹⁷Fiscal consolidation coupled with higher external inflows and increased reliance on non-bank sources of financing during H2-FY2013/14 substituted part of government borrowings from the banking system.

¹⁸The quantitative limits set under the IMF program on NDA such as ceiling set on government borrowings from SBP and indirect impact of restrictions on the fiscal deficit contributed to this slowdown in NDA.

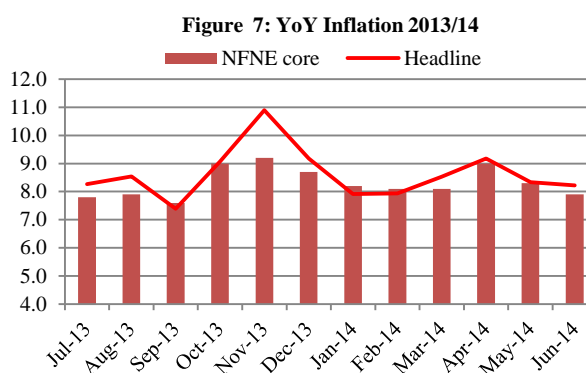
continuously contracting for past two years, NFA increased by Rs332 billion compared to a contraction of Rs258 billion in FY2012/13.

18. **The lower demand for commercial bank credit by the government provided necessary space to the private sector to borrow from the banking system.** Private sector credit has increased by 11.4 percent year-on-year to Rs. 384 billion during FY2013/14 compared to a small contraction of half a percent in FY2012/13—highest in last six years. Similarly, loans to private sector businesses (PSBs) have increased by Rs.298 billion. This upward trend in credit uptake along with growth in LSM of 3.9 percent (year-on-year) during FY2013/14 indicates the revival of economic activity and improved business climate after current government took office. Analysis of loans by type shows that while a bulk of credit was available for working capital (Rs 228 billion); a sizeable amount was also utilized for capital formation (Rs. 70 billion or 0.3 percent of GDP). This welcome rise in credit is attributable to uptakes by textiles, energy, agriculture, telecom, food and beverages, metals, and retail trade and petroleum products. The telecom sector is investing in expanding its infrastructure after obtaining 3G/4G spectrum. Energy and textiles are possibly modernizing and expanding their production due to expected higher demand. In addition, the sugar sector is investing in bagasse based Co-Generation Power Projects. The government aims to continue enhancing investors' confidence by focusing on doing business indicators (see Box 2).¹⁹

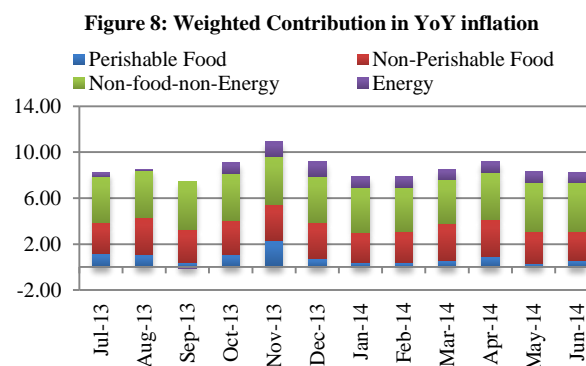
Price stabilization followed, supported by reduced external vulnerability and improved fiscal performance

19. **For the second consecutive year, average Consumer Price Index (CPI) inflation remained in single digit, but increased to 8.6 percent from 7.5 percent in the preceding year.** Year-on-year inflation, on the other hand, witnessed high volatility, especially during H1-FY2013/14, due to adjustments in administrated prices such as electricity and fuels (see Figure 7). Specifically, from the low of 5.9 percent in June 2013, year-on-year CPI inflation rose to 10.9 percent by November 2013; it then, decelerated in subsequent months before rising again to 9.2 percent in April 2014. Since then, it again receded to 8.2 percent by June 2014, and further to 7 percent in August 2014. In addition to adjustments in administrative prices, volatility in the prices of perishable food items owing to supply chain disruptions also contributed to higher than usual variation in year-on-year inflation (see Figure 8). Food group's weighted contribution to overall year-on-year inflation remained higher than its simple weight of 37 percent throughout the year.²⁰

20. **Nevertheless, core inflation declined.** Despite relatively a high average CPI inflation rate of 8.6 percent in FY2013/14 compared to 7.5 percent in FY2012/13, both measures of core inflation, Non-Food-



Source: Data from Pakistan Bureau of Statistics



Source: Data from State Bank of Pakistan

¹⁹Pakistan's ranking has improved by 4 places in GCI rankings in 2014/15. Nonetheless, it still ranks lowest among SAARC countries.

²⁰Within food group (37 percent weight in CPI), much of the volatility was a result of higher inflation in perishable segment (5 percent weight in CPI). For instance, during November 2013, perishable segment's weighted contribution in y-o-y inflation was about 22 percent (see Figure 8)

Non-Energy (NFNE) and 20 percent trimmed mean, exhibited gradual easing during FY2013/14. This indicates moderation of underlying inflationary pressures in the economy largely due to improvements in supply conditions and marginal softening of aggregate demand relative to the available productive capacity.²¹ In general, the supply conditions improved in FY2013/14. This is reflected in higher growth of industrial goods and non-perishable food items, such as sugar, rice, and wheat contributed to this trend. This improvement in supply conditions along with moderate aggregate demand partly due to government's fiscal consolidation helped in containing inflationary pressure buildup in FY2013/14. In addition, general deceleration in international commodity prices, including oil prices, and appreciation of the rupee has also dampened imported inflation component.

And growth recovery finally took place, driven by industrial and services sectors

21. ***Pakistan's real GDP growth is picking up.*** It grew by 4.1 percent in FY2013/14—higher than last year's growth of 3.7 percent (see Table 6).²² It exceeded the 4.0 percent mark for the first time since FY2008/09, sustaining the growth trajectory in an increasing trend. The government has set a growth target of 5.1 percent for FY2014/15.

22. ***For the second consecutive year agriculture sector performance remain below the target despite strong growth of the major crops.*** Agriculture sector (with a share of one-fifth of the GDP) in FY2013/14 and FY2012/13 grew by 2.1 percent and 2.9 percent compared to targeted growth of 3.8 percent and 4.1 percent respectively. Major crops rebounded strongly — posting a growth of 3.7 percent in FY2013/14 compared to 1.2 percent growth registered in FY2012/13. Bumper crops for wheat, sugarcane, and rice more than compensated for declines in cotton production (see Table 7). The drag in the agriculture sector's performance in fact came from minor crops and the livestock sector (the latter with almost a 50 percent share in agriculture value added). Minor crops in FY2013/14 contracted by 3.5 percent,²³ compared to growth of 6.1 percent in FY2012/13, due to unfavorable weather conditions. The performance of the livestock sector, which showed a dip for the third consecutive year (2.9 percent in FY2013/14, compared to 4.0 percent in FY2011/12) is a concern. This declining trend however is surprising given significant technological upgrades in this sector in recent years.²⁴

23. ***The industrial sector (with 21 percent share of GDP) contributed significantly to growth based on a sharp turnaround in construction, electricity generation and gas distribution and better performance of large scale manufacturing (LSM).*** LSM (with a share of 52 percent in the overall industry) grew by 3.9

Table 6: Contribution to Growth (in percent)

	2011/12	2012/13	2013/14
Agriculture Sector	0.78	0.62	0.44
Industrial Sector	0.53	0.28	1.20
Services Sector	2.52	2.82	2.49
GDP Growth	3.84	3.70	4.14

Source: Staff Calculations

Table 7: Performance of Major Crops

	Production (million tons)			Growth	
	2013/14 T	2013/14	2014/15 T	FY14/ FY14 ^T	FY15 ^T / FY14
Cotton*	14.1	12.8	15.1	-9.2%	18.0%
Sugarcane	65.0	66.5	65.5	2.3%	-1.5%
Rice	6.2	6.8	6.8	9.7%	0.0%
Wheat	25.5	25.3	25.8	-0.8%	2.0%

T: Target

Note 1: *Million Bales

Note 2: Targets based on Annual Plans, 2013/14 & 2014/15, Planning Commission, GoP.

Source: Pakistan Bureau of Statistics and Staff estimates

²¹ Aggregate demand, which was 108 percent of GDP in FY2011/12 declined marginally to 106 percent in FY2013/14. The marginal increase in GDP growth to 4.1 percent in FY2013/14 is mostly a reflection of better utilization of spare capacity.

²² These are official provisional estimates based on 10 months data.

²³ Drag especially came from potato crop.

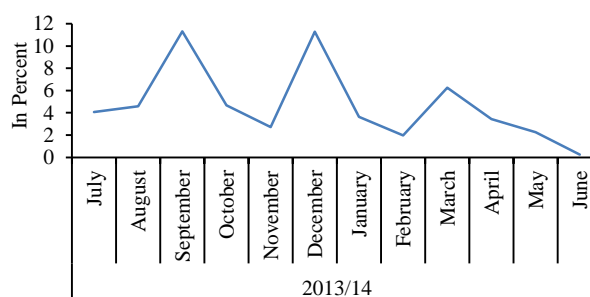
²⁴ This sector has undergone significant technological upgrade in recent years, with vertical integration in supply chain of meat and dairy products, and the focus on new processing techniques that are based on international hygiene and health standards. However, the hard data on livestock may not reflect such trends, as the share of the formal segment is still very low compared to the informal market. Currently, gross value addition in the livestock sector is computed on the basis of past surveys or by applying fixed parameters (Source: SBP third quarterly report FY2013/14).

percent during FY2013/14 (see Figure 9).²⁵ Moreover, growth appears to be broad-based with more than half of the sub-sectors showing single or double-digit expansion (see Figure 10). Eleven sub-sectors contributed to this growth²⁶. However, in most sectors, barring sugar, fertilizers, leather, and chemicals, growth remained lower vis-à-vis last year, primarily due to higher base effect.

24. Two sub-sectors, *agro-based* (food, beverages and tobacco) and *textiles*, accounting for almost half of LSM value added, featured strongly in LSM growth. Agro-based industries grew by 7.2 percent compared to 9.8 percent growth last year. However, growth remained largely concentrated in sugar. Performance of textiles, the biggest sub-sector with one-third share in the manufacturing sector value-addition, remained positive but slightly below last year's growth of 1.6 percent. Weakening external demand for cotton yarn²⁷ (with 62 percent weight in the textiles sector) is leading to a gradual slow-down; cotton-yarn grew by 1.6 percent in FY2013/14 compared to 2.1 percent growth in FY2012/13. Fertilizer sector showed remarkable growth of 16.5 percent as a result of better gas availability and a higher off-take of fertilizer. The electronics sub-sector also registered strong growth of 9.5 percent, reflecting bullish consumer sentiments. The drag on the manufacturing sector growth came from sub-sectors such as automobiles, engineering and wood products. The LSM sector could have surpassed its FY2012/13 growth of 4.0 percent but the hike in the power tariff for industrial users, in September 2013, and imposition of Gas Infrastructure Development Cess (GIDC, including gas dependent industries such as textiles, fertilizers, cement and paper)²⁸ in January 2014, increased the cost of production for many industries, taking some steam out of LSM growth.

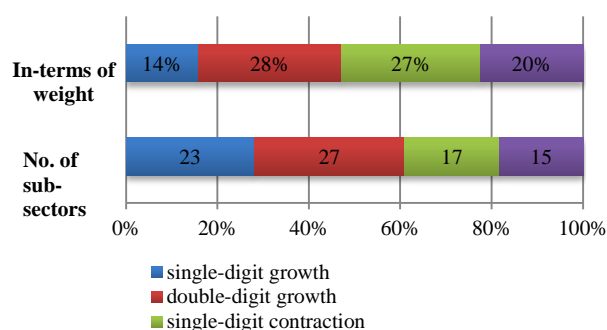
25. **Services sector performance in FY2013/14 remained relatively weak.** This sector has been on a mixed growth trajectory – 4.9 percent in FY2012/13 and 4.3 percent in FY2013/14. Relatively modest performance during FY2013/14 was largely driven by the finance and insurance and general government services sub-sectors (almost 17 percent share in services value added) whereas wholesale and retail trade and transport, storage and communication (which together accounts for half of services value added) continued to provide impetus to overall growth in services.

Figure 9: Growth in Quantum Index of LSM (Y-o-Y)



Source: Pakistan Bureau of Statistics

Figure 10: Performance of LSM sectors, 2013/14



Source: Pakistan Bureau of Statistics and Staff calculations

²⁵As per July-June data released by Pakistan Bureau of Statistics. This number is lower than the 5.1 percent growth rate used in Economic Survey FY2014/15, which is based on nine months available data only.

²⁶These include textiles, agro-based industries, paper and board, iron and steel products, coke and petroleum products, chemicals, fertilizers, electronics, leather, rubber products, and non-metallic minerals.

²⁷Chinese government announced a lower target price in the new cotton policy (March 2014) compared to the support price in the older policy. Under the new policy, Chinese government instead of buying cotton at higher than market prices would pay a differential to farmers if market price falls below the target price.

²⁸GIDC was first introduced in 2011 through "Gas Infrastructure Development Cess Act 2011," primarily to finance the infrastructure development for the import of natural gas. In July 2013, Peshawar High Court suspended the collection of GIDC by the government. This suspension was challenged by the government in the Supreme Court, which set aside the High Court decision, resulting in the resumption of GIDC. The government increased the GIDC on fertilizer feedstock from Rs 197 / mmbtu to Rs 300 / mmbtu and on power and industrial sector, from Rs 50 / mmbtu to Rs 100 / mmbtu in January 2014.

26. Consumption in FY2013/14 (private and public) registered at 89.8 percent of GDP, compared to about 88.6 percent in FY2012/13, a growth of about 7 percent, based on FY2005/06 base year prices. Private sector consumption remained high at 78 percent of GDP and contributed significantly to current period economic growth on the back of sustained growth in remittances, increase in rural income due to higher production of crops and better growth in small-scale manufacturing. Public consumption expenditures showed a marginal increase in share and reached 12 percent of GDP in FY2013/14 compared to about 11 percent of GDP in FY2012/13. This increasing consumption trend, particularly private consumption leaving fewer resources for investment as investment to GDP ratio, has been declining during the last three fiscal years—from 15.1 percent of GDP in FY2010/11 to 13.8 percent of GDP in FY2013/14.

Financial sector developments supported growth recovery

27. *Monetary policy was kept tight, and banks made sizeable profitable investments in government securities and, contrary to past years, also in private sector credit.* The State Bank of Pakistan has kept the policy rate unchanged at 10 percent since November 2013 to anchor inflation expectations amidst relatively stable macro-environment fundamentals.

As a result, the benchmark interest rate (six-month KIBOR) hovered at 10 percent in the past year. While stocks of government securities contributed to healthy profitability in the sector, there has been a decreased demand for bank financing from the government. This provided necessary space to the private sector to borrow from the banking system.

28. *The banking sector remained cautious in terms of risk appetite for private sector credit, but there were initial signs of improving credit quality (see Table 8).* Non-performing loans (NPLs) declined to 12.8 percent of the overall loan portfolio. Given adequate provisioning, net NPLs ratio was at 2.9 percent in June 2013. NPLs in Small and Medium Enterprises (SMEs) remain high representing 33.9 percent of loans, followed by agriculture sector (14.8 percent) and consumer sector (12.4 percent). However, there has been a decrease in NPLs across the corporate, SME, agriculture, and consumer sectors between July 2013 and June 2014, indicating improvements in credit quality.

29. The microfinance sector continued to refine its products and platforms, introducing innovations in branchless banking channels. In the last year, the sector registered a 19.3 percent increase in active borrowers, 31.2 percent growth in gross loan portfolio, 40.6 percent increase in savers, and 26.2 percent in value of savings (see Table 9). The introduction of formal microfinance banks into the sector increased growth in deposits. Micro-insurance policyholders also showed slow yet consistent growth, of 5.0 percent in the past year. Despite gradual improvements, outreach indicators show that there remain significant gaps in the form of underserved and unserved geographical areas and population segments. Portfolio at Risk declined significantly to 1.2 percent mainly due to improvement in recoveries by microfinance institutions (MFIs) and a rural support program (RSP) peer group.

Table 8: Selected Key Indicators of the Banking Sector

	Jun 2013	Jun 2014
Profit Before Tax (Rs. billion)	82.1	112.5
Δ Private Sector Credit (Rs. billion)	-19	384
ROA Before Tax (%)	1.7	2.1
ROE Before Tax (%)	18.5	23.5
Advances to Deposits Ratio (%)	48.1	47.7
Liquid Assets/Total Deposits (%)	63.7	60.6
Capital Adequacy Ratio (%)	15.5	15.1
Gross NPLs to Loans (%)	14.8	12.8
Net NPLs to Loans (%)	4.4	2.9
6 month KIBOR (%)	9.1	10.2

Source: Quarterly Banking System Compendium, June 2014: SBP.

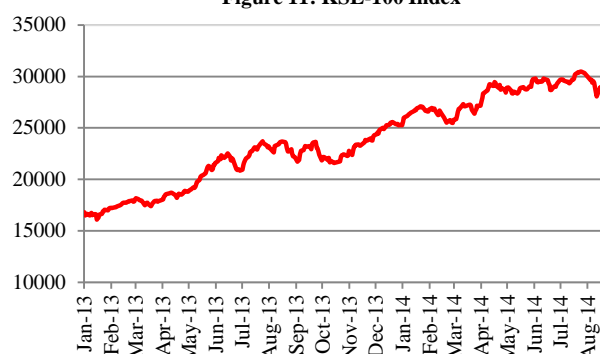
Table 9: Microfinance Sector in Pakistan

	June 2012	June 2013
Active Borrowers	2,635,312	3,144,199
Gross Loan Portfolio (Rs. millions)	46,626	61,193
Average Loan Size (Rs.)	26,004	28,277
Number of Savers	5,207,397	7,323,609
Value of Savings (Rs. millions)	30,010	37,880
Micro-insurance policyholders	3,169,511	3,329,085
Portfolio At Risk >30 days	2.0%	1.2%

Source: Micro WATCH Issue 28 and 32: Pakistan Microfinance

30. **The equity market carried its upward momentum in 2014 with macro-environment fundamentals showing signs of stability.** The Karachi Stock Exchange-100 (KSE-100) Index registered a growth of 18 percent between January and July 2014 with portfolio investments increasing, but declined by 6 percent during August 2014, due to uncertainty in the political environment (see Figure 11). The KSE-100 index crossed 30,000 points in July 2014 with a market capitalization of over Rs 6,000 billion in July 2014. The upward trend in turnover volumes and the KSE-100 index was driven by the monetary policy stability, foreign portfolio investment, resilient corporate profitability, and a number of capital market reforms including revamping of capital gains tax (CGT) regime, introduction of a revised Code of Corporate Governance and demutualization of the stock exchanges. The market continued to demonstrate an attractive investment case, with Price/Earnings ratio of 7.9 and Return to Equity of 24 percent.²⁹

Figure 11: KSE-100 Index



Source: Karachi Stock Exchange.

Structural reforms took off on solid ground and played their part at stimulating growth

31. **Progress on the structural reform agenda is promising.** In a move that implicitly acknowledged favorable investors' confidence toward these reforms, and after a gap of seven years, the government successfully raised US\$2 billion by placing sovereign bonds in international debt markets in a bid that was three times oversubscribed. The government:

- Reduced power subsidies, supported by power tariff adjustments aimed at gradually phasing them out while bringing tariffs to cost recovery level.
- Identified the stock and flow of payables at all levels of the energy sector using a technical and financial audit.
- Designed a roadmap to limit the accumulation of new arrears and reduce their stock.
- Successfully completed capital market transactions by selling shares of United Bank Limited and Pakistan Petroleum Limited in June 2014.
- Listed for divestiture or sale the first transactions among 31 identified state-owned companies.
- Auctioned 3G telecoms licenses.
- Approved under a three-year program to phase out concessionary tax exemptions, a package of revenue measures to expand the tax base, including the elimination of tax exemptions and higher income, sales and excise tax rates for special categories, and raise additional revenues equivalent to above 1 percent of GDP.
- Initially reduced statutory tariff slabs from eight to six in a three-year program that will further reduce to four.
- Expanded the scope and significantly increased the benefits of the BISP cash transfer program while introducing conditional cash transfers supporting school enrolment.

²⁹Compare to India 16.5 and 17 percent; Indonesia 16.6 and 22 percent; Malaysia 17.6 and 15 percent.

32. The agenda of key structural reforms was well defined and included the following five priorities:

- 1) Reforming the power sector is the first and top sector priority as lack of adequate power inhibits business, and subsidies contribute to the massive deficit. Measures adopted were part of a new energy policy approved last July 2013. The government committed to go further including (i) adoption of a new tariff pricing formula, (ii) an improved operating efficiency and reduced losses within power distribution companies, and (iii) incentives for investments, including stronger efforts to develop gas production.
- 2) Raising revenue from below 10 percent of GDP to 14 percent over five years is a second priority. Last year measures adopted raised the tax ratio by about 0.6 percent of GDP. The goal is to increase revenue by broadening the tax base, while strengthening compliance with a solid set of tax administration reforms and a reinvigorated and performance-based tax administration. Recent measures adopted are part of a new tax reform strategy approved last February. As part of the strategy they approved (i) completing the three-year program of elimination of tax exemptions and concession supported by Statutory regulatory orders (SROs), (ii) transferring FBR legal empowerment to approve concessionary tax exemptions, based on SROs to Parliament, (iii) successfully implementing new income and sales tax registration schemes, and (iv) significantly enhancing enforcement and auditing capacity supported by an integrated and performing IT system at the Federal Board of Revenue.
- 3) A third critical reform is consolidating the re-launching of the privatization process, especially dealing with loss-making SOEs. This remains essential to improve service delivery, and reduce fiscal losses. A list of 31 loss-making enterprises has been approved by the Cabinet Committee on Privatization. The government completed the capital market transactions scheduled for the first calendar year.
- 4) A fourth critical reform is enhancing the business environment, as part of a comprehensive ongoing effort at improving Pakistan's ranking in doing business indicators. This is needed to foster private investment and attract investors, and requires federal and provincial measures. They launched the preparation of the One Stop Shop for business registration and submitted the credit bureau law to Parliament. Government is also preparing a National Financial Inclusion Strategy and a comprehensive plan designed to improve Doing Business Indicators, initially centered on getting electricity, paying taxes, enforcing contracts, starting businesses, trading across borders, and getting credit.
- 5) Finally, a fifth critical reform is the strengthening of the Benazir Income Support Program (BISP) as part of the support of the poor and vulnerable and, through its conditional cash transfer program, increase enrolment in primary school. As part of the Growth DPC, the government approved an increase in BISP allocation for Rs. 97.15 billion, which allowed an increase in individual family allocations to Rs1500 per month, a 25 percent increase, well above inflation. However, BISP has yet to start activities to expand CCTs in the additional 27 districts, and needs to formalize provincial Governments' commitment to cost-sharing arrangements on CCTs with the federal Government. BISP also needs to strengthen its internal governance, as perceived weaknesses are affecting its performance. The BISP Board — half of its members from private sector—is incomplete and not meeting, and there is frequent overlap on management affairs between the Chairperson, the Secretary and the rest of the administration in decision-making, which results in delayed or ineffective key decisions. A definite solution requires systemic not just managerial measures with strong government-wide backing. An option is to address the existing ambiguity in the BISP Act 2010 with respect to the respective powers and functions of the Board, the Chairperson and the Secretary by issuing subsidiary rules and regulations.

The preliminary outlook for FY2014/15 remains cautiously sanguine

33. The macroeconomic framework for FY2014/15 projects sustained growth recovery-cum-low inflation, supported by fiscal consolidation and rebuilding of the external position. This projected outcome assumes improvements in power load-shedding, cumbersome business environment, low access to finance and stable commodity prices (see Table 10).

34. **Growth and inflation:** GDP growth is expected to be between 4.3 percent and 4.6 percent in the current fiscal year. Relatively stable or declining international commodity prices and stable exchange rate in real terms are expected to help contain imported inflationary pressures. On the supply side, growth is expected to continue to be driven by the services and large-scale manufacturing sectors, which would benefit from decreased power load-shedding, improved business climate, and better availability of credit ensuing from fiscal consolidation. On the demand side, growth will be supported by substantial remittances inflow, with strengthened private investment, and renewed export dynamism, and to an increase in public investment. Inflation, which is already below double digits since the last two fiscal years, is expected to reach between 7.5 percent and 8.0 percent due to continued fiscal prudence and monetary tightening.

35. **Public Finance:** Fiscal consolidation is expected to continue on the basis of the effort to raise tax revenue, curtail federal government grants and subsidies, and increase in development spending for key public infrastructure and human resource development. Revenues and grants are projected to increase from 15.1 percent of GDP in FY2013/14 to 15.0 percent in FY2014/15 as a result of a sound tax reform strategy adopted by the government. On the expenditure side, the government's privatization program and actions to improve governance and efficiency of the SOEs will result in significant reduction in demand for government grants for SOEs, whereas adjustments in electricity tariffs and reduction in power sector losses through administrative and technological measures will lead to substantial reduction in power subsidies. This will lead to containment of consolidated recurrent expenditure to 16.0 percent in FY2014/15. The overall fiscal deficit will therefore decline from 5.5 percent of GDP in FY2013/14 to 5.1 percent of GDP in FY2014/15.

Table 10: Medium term Framework

Percent of GDP unless mentioned otherwise	FY2012/13	FY2013/14	FY2014/15 Projections
Real GDP Growth at factor cost	3.7	4.1	4.3-4.6
Consumer Prices Inflation (period average)	7.4	8.7	7.5-8.0
Current Account Balance	(1.1)	(1.2)	(1.4)
Exports of goods & services	13.6	12.3	11.8
Imports of goods & services	20.9	20.0	19.4
Remittances Growth	6.0	6.4	6.1
Gross official reserves (in months of imports of G&S) 1/	1.5	2.1	2.9
Revenues and Grants	13.3	15.1	15.0
Expenditures	21.5	19.8	19.7
of which: Current	16.7	16.7	16.0
Overall Fiscal Balance 2/	(8.3)	(5.5)	(5.1)
Memorandum:			
GDP at Market price (in billion Pakistan Rupees)	22,489	25,402	29,057

Notes:

1/ Excluding gold and foreign currency deposits of commercial banks held with the State Bank of Pakistan.

2/ Excluding grants

Source: The World Bank staff

36. **External Sector:** The current account deficit, which was at 1.2 percent of GDP in FY2013/14, is expected to increase initially to 1.4 percent in FY2014/15,³⁰ on the basis of an economic recovery requiring higher imports (including oil) of raw materials, and gradually declining thereafter. Export recovery and strong dynamism of remittances is expected to support current account in medium term. Nevertheless, higher investment inflows attracted by lower country risk, privatizations, setting up of special economic zones especially attractive to China and Japanese investors; and multilateral flows will support the financial account.

³⁰ We are expecting the investment rate to rise faster than the national savings rate.

Gross official foreign exchange reserves are expected to build from 2.1 months of imports by the end of FY2013/14 to about three months of imports by the end of FY2014/15.

But the overall impact of August political events on the economy is yet uncertain

37. *The August political turmoil has negatively affected the macroeconomic stance and might affect the pace and depth of structural reforms.* Despite the satisfactory outcomes achieved during the first year of Government, there are early short-term signs of deterioration in key macro indicators that might lead to medium term external or domestic imbalances.³¹

38. *Whether the domestic shock is just a temporary or a permanent shock and the sustainability of its final outcome will determine the magnitude of its long lasting impact on the economy.* In the meantime, there are perceived signs of deterioration in August that might have long lasting effects over the entire fiscal year.

- *Growth may have slowed in the first quarter.* The virtual paralysis of the government machinery may have led to a first quarter slowdown of the economy (particularly affecting trade, construction and services). Exports decreased by 7.6 percent (year-on-year) in August. Public investment, especially infrastructure projects, have been put on hold, precisely when they were gathering some pace in the last quarter of last fiscal year. High-level official visits—China and Sri Lanka presidents were postponed. In response to an Overseas Investors Chamber of Commerce and Industry (OICCI) Survey, firms from 35 countries reported that: half postponed business trips and 40 percent expected declines in their sales and profits in Pakistan linked to the crisis.
- *The international reserve position has suffered small losses.* Accelerated rupee depreciation triggered by political impasse forced SBP's intervention by about US\$375 million since August 15, 2014.
- *The fiscal balance has not been affected significantly.* The government's estimate of the cost of additional security was Rs.357.6 million until the end of August (small amount equivalent to 0.1 percent of GDP). But, paradoxically, and contrary to expectations, tax collection growth was a robust 25 percent (year-on-year) and remittances were also a dynamic 7 percent (year-on-year), last August.

39. *A remaining question is how much the pro-business investor-friendly image that Pakistan was rebuilding has been shattered by the demonstrators' sit-ins and how much this will affect prospects for attracting foreign and private investors.* Many investment decisions have been postponed. Investors want to play safe until a quick and sustained settlement to the crisis. This could delay investment decisions, including those affecting its privatization process. The international credit ratings that were just recently upgraded might also get re-evaluated.

40. *Similarly, it remains to be determined how much the reform momentum gathered during past fiscal years will be affected by political unrest.* A politically weaker government may water-down certain structural reforms that are badly needed for growth acceleration and poverty reduction. In an early sign of the ongoing difficulties, and unlike the past three favorable and timely reviews of the IMF program, the fourth review initially scheduled for Board presentation by the end of September is currently at a standstill and its completion is likely to be affected by the recent political unrest. At least three areas of reform may actually get delayed or modified: (i) approval of power tariffs, (ii) the privatization agenda, and (iii) reforms requiring legislative approval. Alternatively, the recent events may also influence the government to consider strengthening some areas of the program with less than incremental but rather more decisive actions, such as power, inclusion, and governance. Strengthening media communication efforts on the benefits of reforms may also contribute to regain momentum.

³¹ By early September, the government of Pakistan's estimated overall losses on the economy at Rs547 billion (about 2.1 percent of GDP).

Box 1: Government's Tax Reform Strategy

The government is fully cognizant that creating additional fiscal space through revenue mobilization is critical to accelerate the pace of economic and social development. For this, it has designed a tax reform strategy to increase tax revenue by rationalizing tax exemptions, increasing the number of registered taxpayers, expanding the base to taxes; and ensuring adequate tax compliance through a system of effective audits and strengthened tax enforcement. Overall, expected minimum annual revenue yields from tax reform from FY14/15 onwards are 0.75, 0.32 and 0.45 percent of GDP.

Rationalizing tax exemptions: Pakistan's tax bases are badly perforated due to ad-hoc, discretionary, and generally distortionary tax exemptions and concessions. By one estimate, these tax exemptions and concessions resulted in a revenue loss of over Rs 400 billion (or 2 percent of GDP) in FY2010/11. A large number of these exemptions are granted through Regulatory Statutory Orders (SROs) issued by the Federal Board of revenue (FBR) rather than through tax laws. The government has categorized these exemptions into: Category A comprising exemptions that would be retained by transferring them to the tax laws; Category B, consisting of those exemptions which would be eliminated but with reduced (than normal) rates; and Category C, containing those exemptions which would be eliminated by imposing the normal rates. The government has also prepared a plan to eliminate the exemptions in categories B and C over a period of three years (FY2014/15 – FY2016/17).

Taxpayer registration drive: Among the estimated 52 million income earners, less than 1.5 million are registered income taxpayers. To increase the number of registered income taxpayers, the government is committed to sending tax notices to 100,000 every year between FY2013/14 and FY2015/16 to salaried individuals with non-salaried income. These potential taxpayers are identified on the basis of third-party data on acquisition of property, purchase of vehicles, foreign travel and children's tuition fee. After 60 days of the issuance of the tax notice, non-compliant individuals are being served with a second tax notice and after 60 days of second notice, the non-compliant individuals are being served with provisional assessment orders. In FY2013/14, FBR issued 120,000 tax notices; almost 38,500 second notices and about 28,700 assessment orders. About 17,000 of these individuals have registered themselves as taxpayers and are creating a tax demand of Rs. 17 billion.

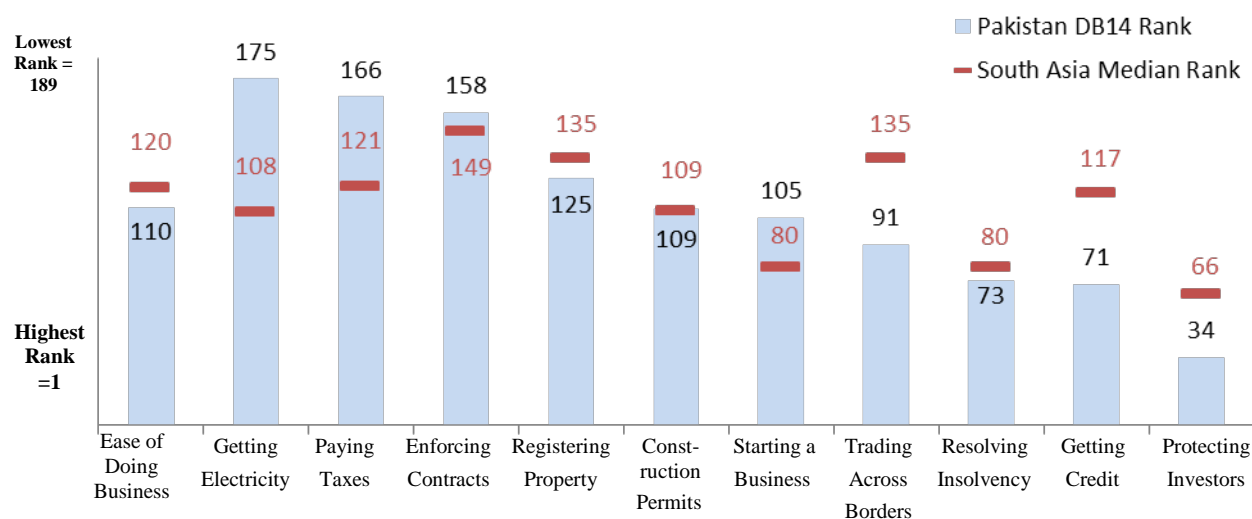
Expanding the base of federal sales tax: In Pakistan, bases of all taxes, especially of sales tax, are very narrow. The retail sector in particular has managed to stay outside the sales tax net. Through negotiations with the trading community, the government has designed a new scheme to impose a General Sales Tax (GST) on the retail sector. Retail traders are divided into two categories. Those traders whose electricity bill is over Rs 600,000 per year would be asked to register for sales tax and would pay GST at 5 percent of their turnover. While smaller traders, whose electricity bills are less than Rs 600,000 per year, GST will be charged at 5 percent and collected with the electricity. This measure is expected to yield Rs 35 billion in FY2014/15.

Effective tax audits: Pakistan has a system of self-assessment for most of the federal taxes. However, until FY2012/13, tax audits were not undertaken for variety of reasons. In FY2013/14, the government selected 5 percent of filed tax returns through computerized random balloting, for tax audits. A total of 37,576 tax audits were started and by the end of June 2014, 78 percent of these were completed, creating a tax demand of Rs 14.5 billion. For FY2014/15, the government intends to increase the number of tax audits to 10 percent (or higher) of filed tax returns, with expected minimum tax demand of Rs 40 billion.

Box 2: Doing Business Indicators

The private sector in Pakistan continues to face a tough investment climate, manifested by consistent deterioration in the country's Doing Business ranking. In 2014, Pakistan's ranking was 110 out of 189 economies, down from 76 out of 181 countries in 2008. Pakistan performs well in certain indicators, but lags other South Asian countries considerably in areas such as getting electricity connections, paying taxes, and enforcing contracts (see Figure A). Additionally, the performance on doing business indicators varies across cities throughout the country. Challenging business environment is particularly impeding SME start-ups, operations and exit. SMEs account for 99 percent of business establishments in Pakistan, employing between one and 20 workers and 70 percent of the non-agricultural labor force, contributing around 30 percent to GDP and 25 percent to exports.

Figure A: Pakistan Doing Business Rankings 2014



Source: Doing Business 2014. The World Bank.

The government of Pakistan is aiming to improve the quality of the business environment to unlock the potential for private sector growth, employment, and competitiveness. The Board of Investment has been tasked to mobilize relevant federal and provincial authorities for developing a shared reform action plan and successful implementation. But this needs to be institutionalized since presently there is no single agency at the national or provincial levels with a mandate to identify, implement, and enforce investment climate reforms on an on-going basis.

Efforts needed to improve the quality of business environment will have to take into account three critical dimensions for delivering sustainable improvements in the national and sub-national investment climate including: (i) the respective roles of federal and provincial authorities, (ii) the extent to which a suitable and structured public-private dialogue for understanding the significance of reforms exists, and (iii) the mechanism for monitoring and evaluation of indicator based targeted reform actions. Ultimately, high quality conditions for doing business depend on the role of government not just as an effective "regulator" but also as a "facilitator" of the private sector.

Annex 1: World Bank Support to Pakistan

FY2014/15 Pipeline (updated September 10, 2014)

	Project Name	Total Commitment (US\$ m)	Status of Preparation
Federal			
1	Immunization Support Project	50	Going to the Board on October 30, 2014
2	Power Sector Reform DPC II	200	Going to the Board on May 28, 2015
3	PK Growth, Investment & Competitiveness DPC II	300	Going to the Board on May 24, 2015
	Federal Total	550	
Punjab			
4	Punjab Skills Development Project	50	Going to the Board on March 25, 2015
5	Punjab Inclusive Value Chain and Agribusiness	100	Going to the Board on March 31, 2015
	Punjab Total	150	
Sindh			
6	Sindh Agricultural Growth	76.4	Signed and Effective
7	Sindh Irrigated Agriculture Productivity	200	Going to the Board on October 2, 2014
8	Sindh Water Sector Improvement AF	138	Going to the Board on Nov 26, 2014
9	Enhanced Nutrition for Mothers and Children	36.2	Going to the Board on Aug 29, 2014
10	Sindh Public Sector Management Reform	50	Going to the Board on Dec 5, 2014
11	Sindh Barrages Improvement Project	160	Going to the Board on Feb 17, 2014
	Sindh Total	660.6	
	IDA Total	1360.6	
KP/FATA/Baluchista			
12	Governance Support Project AF	4.1	
13	Rural Livelihoods Community Infrastructure AF	2.6	
14	FATA Urban Centers AF	1	
	KP/FATA Total	7.7	
	Total FY2014/15	1368.3	

Annex 2: Pakistan Data Sheet

Selected Economic Indicators									
Key Summary Indicators	/1	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15 ^P
Real GDP growth		5.0	0.4	2.6	3.6	3.8	3.7	4.1	4.4
Fiscal Balance as percent of GDP (excluding grants)		-7.3	-5.2	-6.2	-6.9	-8.8	-8.2	-5.5	-5.1
Current Account Balance as percent of GDP		-8.2	-5.5	-2.2	0.1	-2.1	-1.1	-1.2	-1.4
Inflation (Year Average)		12.0	17.0	10.1	13.7	11.0	7.4	8.6	8.0
Foreign Reserves, Exchange Rate, and Spreads		30-Jun-14	6-Aug-14	20-Aug-14	27-Aug-14	3-Sep-14	10-Sep-14	17-Sep-14	24-Sep-14
Official Foreign Exchange Reserves (FER) in US\$ million	/2	9,198	9,295	8,651	8,548	8,735	8,875	8,530	8,745
Official Reserve's import coverage in months of imports	/3 /4	2.1	2.1	1.9	1.9	2.0	2.0	1.9	2.0
Nominal Rupee-Dollar exchange rate (Interbank average)		98.8	98.8	100.8	101.3	102.6	102.1	102.7	102.8
Appreciation(+)/depreciation(-) since 30-June-2014			0.0	-2.0	-2.5	-3.7	-3.2	-3.8	-3.9
6-month forward spread on Exchange Rate (basis points)		276	267	224	210	218	222	195	183
6-month KIBOR rate (% p.a.)	/5	10.17	10.17	10.17	10.19	10.16	10.18	10.22	10.19
Karachi Stock Exchange-100 Index		29,653	29,383	28,665	27,811	29,596	29,691	30,137	30,096
Balance of Payment (US\$ million)		Jul-Jun	July	July	July	July	YoY % change		
		2012/13	2013/14	2011/12	2012/13	2013/14	2011/12	2012/13	2013/14
a. Current Account		-2,496	-2,971	-454	-125	-454			
Current account balance (% of GDP)		-1.1	-1.2	-0.2	-0.1	-0.2			
Trade balance		-15,431	-16,635	-1,442	-1,251	-1,901	-0.6	-13.2	52.0
Exports		24,795	25,151	2,019	2,196	1,906	-5.6	8.8	-13.2
Imports		40,226	41,786	3,461	3,447	3,807	8.9	-0.4	10.4
Workers' remittances		13,922	15,832	1,205	1,404	1,649	9.8	16.5	17.5
b. Capital & Financial Account		813	7,068	28	-411	185			
of which Net foreign direct investment		1,258	1,483	47	119	24	-40.5	153.2	-79.8
Overall balance		-1,992	3,843	-613	-820	-348			
External Debt Amortization (US\$ million)		Jun-13	Jan-14	Feb-14	Mar-14	Apr-14	May-14	Jun-14	Jul-14
		441	153	442	473	210	531	432	191
Sovereign Bond Interest Rate Spreads (bps over US T-Bills)		Jun-13	Mar-14	Apr-14	May-14	Jun-14	Jul-14	Aug-14	Sep-14
Pakistan		694	466	495	461	501	450	517	490
Sri Lanka		441	348	354	339	320	298	306	277
Argentina		1,204	880	778	782	724	649	808	706
Monetary and Credit Aggregates (Cumulative flow in Rs billion)		Jul-Jun	Jul-Jun	Jul-Jun	Jul-Jun	Jul-Jun	Jul-Jun	Jul-Jun	Jul-Jun
		2012/13	2013/14	8-Aug-14	15-Aug-14	22-Aug-14	29-Aug-14	5-Sep-14	12-Sep-14
Broad money (M2)		1216.0	1110.2	-153.5	-203.8	-184.5	-131.9	-118.5	-157.6
(Year-on-Year growth)		15.9	12.5	11.6	10.6	11.5	11.3	11.3	10.6
Reserve money		346.4	326.0	133.0	56.0	30.1	1.7	64.7	48.0
Net government borrowing from SBP		506.9	196.9	121.0	30.9	118.0	110.6	168.2	-37.2
Net government borrowing from scheduled banks		939.6	106.1	39.2	97.4	34.1	29.0	55.1	140.9
Credit to private sector		-19.0	384.0	-86.8	-78.9	-68.7	-56.6	-69.4	-74.4
(Year-on-Year growth)		-0.6	11.4	11.1	11.6	11.8	11.6	11.3	11.2
Credit to public sector enterprises		31.1	54.0	5.5	15.7	16.2	10.7	14.3	17.7
Treasury Bill Auction		30-Jun-13	25-Jun-14	9-Jul-14	23-Jul-14	6-Aug-14	20-Aug-14	3-Sep-14	17-Sep-14
6-month T-bill weighted avg. yield (percent/p.a.)		8.92	9.97	9.98	9.98	9.97	9.98	9.98	9.98
Inflation and Large Scale Manufacturing		Jun-13	Feb-14	Mar-14	Apr-14	May-14	Jun-14	Jul-14	Aug-14
CPI inflation (Year-on-Year)		5.9	7.9	8.5	9.2	8.3	8.2	7.9	7.0
CPI inflation, 12-month moving average		7.4	7.7	7.9	8.2	8.4	8.6	8.6	8.4
CPI Inflation, monthly		0.7	-0.3	1.0	1.7	-0.3	0.6	1.7	0.3
Quantum Index of Large Scale Manufacturing (YoY growth)		6.8	2.0	-1.1	3.5	2.3	0.3	1.1	n/a
Fiscal Data (Rs billion)		Budget 2013/14	Upto Q2-2012/13	Upto Q3-2012/13	Upto Q4-2012/13	Q1-2013/14	Upto Q2-2013/14	Upto Q3-2013/14	Upto Q4-2013/14
Fiscal Deficit (excluding grants)		1,650	625	1,046	1,834	287	540	812	1,389
Fiscal Deficit as % of GDP		6.3	2.6	4.4	8.0	1.1	2.1	3.2	5.5
Total Revenue		3,675	1,462	2,125	2,982	830	1,685	2,477	3,637
Tax Revenues		2,826	1,013	1,528	2,199	537	1,172	1,786	2,565
FBR		2,475	883	1,335	1,936	469	1,031	1,575	2,266
Non-tax revenue		849	449	597	783	293	513	691	1,073
Total Expenditures		5,325	2,087	3,171	4,816	1,117	2,225	3,289	5,026
Current expenditure		3,948	1,722	2,642	3,660	868	1,888	2,905	4,005
of which Interest payments		1,154	553	772	991	301	598	909	1,148
Development Expenditure		1,377	278	446	1,140	170	326	556	1,237
Debt and Non-Performing Loans (stock)		2011/12	Upto Q2-2012/13	Upto Q3-2012/13	Upto Q4-2012/13	Q1-2013/14	Upto Q2-2013/14	Upto Q3-2013/14	Upto Q4-2013/14
Gross Public Debt as Percent of GDP	/6	64.1	60.1	61.4	64.4	61.0	60.8	62.0	63.7
Domestic Debt as Percent of GDP		38.1	37.0	39.1	42.3	40.0	40.3	42.6	42.9
Foreign Currency Public Debt as Percent of GDP		26.0	23.0	22.3	22.0	21.0	20.6	19.4	20.8
Foreign Currency Public Debt Service as percent of exports		16.1	23.6	23.7	24.2	27.3	30.5	26.4	25.3
Domestic Debt Rs. Billion		7,638	8,329	8,801	9,521	10,155	10,228	10,820	10,897
Domestic Debt Service as percent of revenues	/7	32.0	34.7	34.1	30.9	34.5	33.2	34.5	29.5
Non-Performing Loans as percent of Total Loans (All Banks)		15.9	14.6	14.7	14.8	14.3	13.3	13.4	12.8
1/ Fiscal year runs from July - June. 2/ SBP reserves (liquid reserves plus foreign currency cash holdings less CRR). 3/ Based on next 12 months' projected imports of goods & services. 4/ Import coverage ratio may change with the change in import projections. 5/ KIBOR: Karachi Interbank Offer Rate - Bench mark for commercial 6/ The definition of public debt has been revised following IMF's revision of the concept. 7/ Both the variables for Q4 2013/14 are revised estimates (of authorities) to be updated in the light of provisional data.									