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Pakistan Development Update



*Poverty Reduction and Economic
Management, South Asia Region*

The World Bank

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List of Acronyms

3G	Third Generation
ADB	Asian Development Bank
ATM	Average Time to Maturity
ATR	Average Time to Re-fixing
BISP	Benazir Income Support Programme
BOI	Board of Investment
BOP	Balance of Payments
CAR	Capital Adequacy Ratio
CASA	Central Asia South Asia
CY	Calendar Year
CCI	Council of Common Interest
CCOP	Cabinet Committee on Privatization
CCOR	Cabinet Committee on Restructuring
CCTs	Conditional Cash Transfers
CEOs	Chief Executive Officers
CGT	Capital Gains Tax
CNG	Compressed Natural Gas
CSF	Coalition Support Fund
DPC	Development Policy Credit
ECC	Economic Coordination Committee
EFF	Extended Fund Facility
EMBI	Emerging Market Bond Index
EOBI	Employees Old Age Benefits Institution
EU	European Union
FATA	Federally Administered Tribal Areas
FBR	Federal Board of Revenue
FDI	Foreign Direct Investment
FPI	Foreign Portfolio Investment
FY	Fiscal Year
GDP	Gross Domestic Product
GSP	Generalized System of Preferences
GST	General Sales Tax
H1	First Half (of the fiscal year)
IMF	International Monetary Fund
KESC	Karachi Electricity Supply Corporation
KIBOR	Karachi Interbank Offered Rate
KSE	Karachi Stock Exchange
LOI	Letter of Intent
LSM	Large-scale Manufacturing
M2	Broad Money
MDTF-KP	Multi Donor Trust Fund – Khyber Pakhtunkhwa
MFN	Most Favored Nation

MOUs	Memorandums of Understanding
MRTBs	Market Related Treasury Bills
MTBs	Market Treasury Bills
NDA	Net Domestic Asset
NFA	Net Foreign Asset
NFNE	Non-food, non-energy
NISP	National Income Support Programme
NPLs	Non-performing Loans
NSS	National Saving Schemes
PASSCO	Pakistan Agricultural Storage and Supplies Corporation
PBS	Pakistan Bureau of Statistics
PEPCO	Pakistan Electric Power Company
PIA	Pakistan International Airlines
PK	Pakistan
PML (N)	Pakistan Muslim League (Nawaz)
POL	Petroleum, Oils and Lubricants
PSBs	Private Sector Businesses
PTCL	Pakistan Telecommunications Company Limited
Q1	First Quarter (of the fiscal year)
RM	Reserve Money
ROA	Return on Asset
ROE	Return on Equity
Rs	Pakistani Rupee
SAFTA	South Asian Free Trade Agreement
SBP	State Bank of Pakistan
SECP	Securities and Exchange Commission of Pakistan
SEZs	Special Economic Zones
SMEs	Small and Medium Enterprises
SOEs	State Owned Enterprises
SROs	Statutory Regulatory Orders
US	United States
US\$	United States Dollar
USC	Utility Stores Corporation
WAPDA	Water and Power Development Authority
YoY	Year-on-Year

Summary

- **Pakistan's economy is weak but at a turning point.** Growth recovery is underway, with the projected GDP growth approaching 3.6-4.0 percent, driven by dynamic manufacturing and service sectors, better energy availability, and early revival of investor confidence. Inflation is steady at 7.9 percent (y-o-y). The fiscal deficit is contained at around 6 percent of GDP due to improved tax collection and restricted current and development expenditure. The current account deficit remains modest, at around 1 percent of GDP, supported by strong remittances and export dynamism, and the external position is slowly improving since monetary and exchange rate policies switched gear toward rebuilding reserves last November. Performance under the IMF program remains satisfactory, with the 2nd Review concluded on March 24. Domestic and external risks, however, remain high, but are declining.
- **Economic activity is gradually improving.** Preliminary data for FY14 show growth picking up, driven mainly by services and manufacturing. Growth improved in wholesale and retail trade, finance, and insurance. Acceleration in growth of large-scale manufacturing came from strong performance of agro-based industries, iron and steel, construction, and external demand-driven cotton yarn- and fabrics-based textiles. Agriculture appears slightly below target owing to unfavorable weather conditions. On the demand side, growth continues to be driven by private consumption. Credit to the private sector has started to rebound and had posted nominal growth of 4.6 percent, y-o-y, as of mid-March 2014. However, private investment recovery is mild; and much of this is inherited from the crowding out of private-sector credit by government borrowing, which grew at close to nil in FY13.
- **A significant correction of a loose fiscal stance is taking place to ensure sustainability.** Pakistan is on track to meet a fiscal deficit target of 5.8 percent of GDP in FY14. FBR collection is slightly below target. On the expenditure side, energy-related subsidies have been reduced with tariff adjustments. However, while the government dealt with the stock of the circular debt, which has resulted in reduced load-shedding in the first months of the year, the circular debt is re-emerging. Public investment –constrained by lack of fiscal space and any commitment to reduce the fiscal deficit – remains contained. Public debt remains above the 60 percent of GDP allowed by the Fiscal Responsibility Law, and justified by security reasons. As large fiscal deficits have been financed increasingly through domestic borrowing, rollover risk has increased. External financing available to the government is scarce, but expected to improve in the last two quarters.
- **The external position is fragile but strengthening.** The current account deficit was small, at around 1 percent of GDP by end-FY13 and remains so. In contrast, net official foreign exchange reserves declined to the equivalent of 1.3 months of imports at the end of June 2013 (bottoming down to 0.6 month of imports by the end of November 2013). But they had risen to above 1.1 month of imports as of March 26, 2014. This is due in part to the fact that since the second quarter of FY14, the SBP increased its policy rate and has started to purchase dollars on the spot market, turning decisively toward rebuilding the external position.
- **Three sources of risk appear worrisome.** Pakistan imports more than it exports, the latter being constrained by low productivity and competitiveness, limited access to reliable energy, and cumbersome business regulations. Political events keep FDI flows and private investment low, which also affects foreign reserves. Uncertain political environment undermines investor confidence and depresses economic activity. The troubled domestic energy sector continues to endure a long-due complex inheritance on its circular debt which, contrary to the government's plans, might affect the magnitude of fiscal adjustment. However, Pakistan's Emerging Markets Bonds Index Plus (EMBI+) risk spread keeps declining from the high levels shown at the start of the new administration. Market

confidence in the government's program is bearing fruit, as the EMBI has almost halved from 1,011 basis points in March 2013 to around 468 basis points as of March 26, 2014. The government intends to benefit from it and return to the international markets with the placement of a US\$500 million – US\$1 billion Eurobond in the fourth quarter of the current fiscal year.

Recent Economic Developments

Economic growth is picking up, driven by industry and services sectors

Real GDP growth, at 3.6 percent in FY13, was average but might improve this year. The modest growth reached last year was explained in part by a marked fall in private investment (8.7 percent of GDP), the lowest level in two decades. For FY14, GDP growth is recovering and projected to grow by 3.6-4.0 percent (Table 1) against an official target of 4.4 percent.

Table 1: Estimates of Economic Growth (%)

	FY13	Q1-FY13 ^P	Q1-FY14 ^E
Real GDP	3.6	2.9	5.0
Agriculture	3.3	2.7	2.5
Industry	3.5	3.1	5.2
Services	3.7	2.9	5.7

^E Estimates

Source: Pakistan Bureau of Statistics

Thus far, the impulse to growth is coming from industry and services, as agriculture is estimated to miss its annual target.¹

An improved industrial sector performance can be attributed to better energy availability and post-election investor confidence.

Even with this uptick in local industry, better performance by the telecom sector, and the rise in international trade volumes that directly impact wholesale and retail trade, the services sector appears to have grown faster.

Agricultural output growth appears lower than last year

Agricultural growth in FY14 is likely to remain below the previous year. Initial estimates suggest a decline in cotton, which more than offset the increase in sugarcane and rice production (Table 2). The Cotton Crop Assessment Committee has estimated the size of the FY14 crop to be 12.3 million bales, which is about 13 percent below the target for the year, and less than the FY13 crop.² This decline can be traced to a fall in the area under cultivation, particularly in Punjab, as water remained short at sowing time. Also, the previous year's low cotton price encouraged farmers this year to substitute cotton with maize, sugarcane, and rice.

Table 2: Production Estimates of Kharif Crops
(million tons, cotton in million bales)

	FY13		FY14	
	Target	Actual	Target	Estimates
Rice	6.9	5.5	6.2	6.4
Sugarcane	59.0	62.7	65.0	63.0
Cotton	14.5	13.1	14.1	12.3

Source: Planning Commission, and Ministry of Food Security & Research

Rice³ production of 6.4 million tons during FY14, however, exceeded its target of 6.2 million tons.

Estimates show that basmati rice, which is the main exporting variety, recorded about 16 percent increase over FY13. Similarly, sugarcane continued to benefit from heavier rains, and the crop is expected to record an increase for the fifth consecutive year. Similar to FY13, the crop benefited from a larger area under cultivation, as well as higher yields. Furthermore, due to more rains, farmers in some areas preferred sugarcane over cotton, which also enhanced the crop size. Latest information on area under cultivation reveals that wheat, the largest crop in terms of value addition, is expected to achieve its output target of 25 million tons in FY14.⁴

¹ In the absence of detailed quarterly GDP accounts, it is difficult to make a detailed assessment about GDP growth mid-year. Nevertheless, this fiscal year, for the first time the Pakistan Bureau of Statistics (PBS) made available first quarter GDP growth rates, without making public the actual GDP volumes and composition, as well as details of their methodology (Table 1).

² Cotton commands a share of about 30 percent in important crops segment value addition.

³ Rice for Pakistan is a major crop. It is one of the staples and one of the largest agriculture commodity exported. During FY13 Pakistan exported about US\$1.9 billion worth of rice.

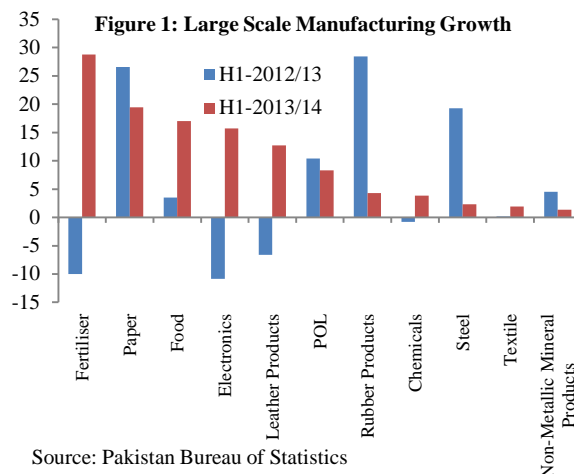
⁴ Wheat is a major *rabi* crop and the main staple of Pakistan. Wheat output arrives in April-May.

Manufacturing sector continues to perform better than initially expected

Large Scale Manufacturing (LSM) recorded an increase of 6.7 percent in the first half of FY14, compared to only 2.2 percent in the corresponding period of FY13. Several factors explain this improved performance: (i) strong performance of the sugar segment due to better sugarcane production, (ii) increasing demand and higher international prices of exports including textiles, food, petroleum and leather products, etc., (iii) improved power supply to industry (iv) improved gas supply to the fertilizer sector, and (v) increased investor confidence in the new government's policies.

After a poor performance in the previous year, the fertilizer sector (with 4.4 percent weight in LSM) rebounded during H1-FY14 as gas supplies to manufacturing plants improved (Figure 1).⁵ The food group, with a 13.7 percent weight in LSM, also grew by 17 percent in H1-FY14 compared to 3.5 percent during H1- FY13. Within this group, growth in sugar, soft drinks, and juices are the main drivers. Sugar production – with 3.54 percent weight in LSM – grew by 78 percent and is highly seasonal and influences the LSM growth significantly. In addition, major contributions came from the leather, electronics, chemicals, and textile sub-sectors.

Steady consumer spending in the US and Europe supported exports in these industries.



Services sector is driving the growth recovery

Q1-FY14 estimates shows a strong YoY recovery in the services sector – increasing from 2.9 percent in Q1-FY13 to 5.9 percent in Q1-FY14. Some leading indicators are showing a mixed performance during H1-FY14. While transport and finance sub sectors are likely to exhibit lower growth during FY14 compared to the preceding year, communication, and wholesale & retail trade sub-sectors are expected to post a recovery. The wholesale & retail trade sector has clearly gotten some support from the broad-based recovery in manufacturing along with a recovery in import volumes during H1-FY14.

In contrast to FY13, the finance and insurance sub-sector appears to have weakened during H1-FY14, mainly due to lower interest rates and higher provisioning for bad loans. The aggregate after-tax profits of banks stood at Rs 111 billion in CY13 compared to Rs 178 billion in CY12 – a fall of about 38 percent. The communication sector is likely to recover in FY14 as the Pakistan Telecommunication Company (PTCL) earned Rs 4.6 billion profit before tax in Q1- FY14. Most of the improvement has come from its international business and broadband services; the voice segment of PTCL's business could not perform well due to stiff competition from cellular companies. A sharp rise of 54 percent in the import of telecoms machinery during H1-FY14 also reflects a recovery in this sector.

⁵ This additional gas is made available due to the closure of one large thermal power plant for maintenance. Therefore, this additional gas is just a temporary arrangement, and as soon as the power plant resumes operation, supplies to fertilizer plants are likely to revert to the previous level.

Fiscal consolidation is allowing recovery in credit to private sector

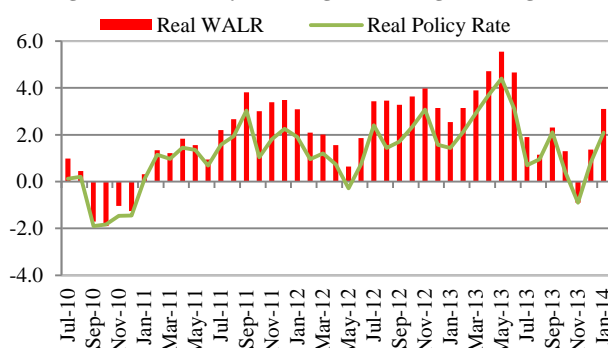
Monetary tightening has begun since end-2013. The SBP increased the policy rate by 50 basis points (bps) successively in September and November 2013 (Figure 2) to deal with two concerns: a continued deterioration in the balance of payments position, and a worsening of inflation outlook during Q1-FY14. Real weighted average lending rates remain only marginally positive in recent months. KIBOR⁶, which is used as a nominal benchmark for loans to the corporate sector, has increased by 95 bps on average up to mid-January 2014.

Growth in both reserve money (RM) and broad money (M2) are largely influenced by fiscal borrowings for budgetary support and changes in the external position. The monetary expansion, YoY, had decelerated to 13 percent by end-January 2014 from 18 percent at end-January 2013, which is explained by a substantial contraction in Net Foreign Assets (NFA) of the SBP due to depletion of foreign exchange reserves to support the rupee. Specifically, the NFA of SBP contracted by Rs 256 billion at end-January 2014 (Table 3).

On the other hand, this contraction in NFA is offset by an increase in Net Domestic Assets (NDA) of the banking system, by Rs 640 billion (7.5 percent for July-January FY14. Unlike the previous year, where NDA growth was almost exclusively driven by government borrowings, during FY14 so far the private sector also contributed to this expansion (Table 3). Still, by end-January 2014, government borrowing from the central bank stood at Rs 431 billion compared to a retirement of Rs 134 billion in the comparable period of FY13. The magnitude of central bank borrowings touched Rs 842 billion by end-November 2013, as the government shifted from its previous practice of raising debt mainly from scheduled banks (Figure 3). It is only since the policy rate hikes in September and, especially November of 2013 that scheduled banks' investment in government papers increased, thereby allowing government to retire some of the SBP borrowing.

A positive development is the mild revival of growth in private sector credit. The private sector borrowed Rs 299 billion during July-January FY14. By end-December, Private Sector Businesses (PSBs) availed Rs 272 billion during H1-FY14 compared to only Rs 147 billion in H1-FY13. This stemmed from credit uptake by businesses (textiles, energy, commerce and trade) as well as consumers. Private credit recovery is attributable to better performance in industry and services due to improved supplies of electricity after settlement of the energy sector's circular debt by the government; while more buoyant business sentiment after the May 2013 elections, in turn, led to a better performance of industry and services sectors. While

Figure 2: Real Policy and Weighted Average Lending Rates



Real rates calculated using YoY inflation

Table 3: Monetary Aggregates (Flow since end-June)

Rs billion	Flow till end-January		
	Stock	FY13	FY14
NFA	269	-28	-248
of which: SBP	133	-84	-256
NDA	8589	605	640
Government borrowing:	5737	618	384
Of which:			
Budgetary borrowing	5246	686	485
from SBP	2213	-134	431
from Scheduled banks	3033	820	54
Commodity operations	468	-67	-101
Non-govt sector borrowing:	3664	140	365
Of which:			
Private sector	3357	109	299
Public Sector Enterprises	288	32	66
M2	8858	577	393
Growth (YoY)		18	13
RM	2535	250	209
Growth (YoY)		16	13

Source: State Bank of Pakistan

⁶ Karachi Interbank Offered Rate.

cement and textiles are modernizing and expanding their production capacity due to higher expected demand (both domestically and internationally, in light of the EU granting GSP-Plus trading status to Pakistan), sugar sector is investing heavily in bagasse-based power generation projects.

Inflationary concerns resurfaced

The average headline inflation appears to have firmed up in the single digits. Average headline inflation during first eight months of FY14 stood at 8.6 percent compared to 8.2 percent during the same period last year, and 7.4 percent for the full FY13. The last fiscal year ended with over 60 percent of items registering single-digit inflation and around 20 percent of items exhibiting deflationary tendencies (Figure 4). Some favorable supply and demand factors explain this decline: good weather helped improve the food supply chain and a sharp reduction in administered prices (mainly energy and CNG charges) in the months preceding the general elections.

A temporary rise in inflation rates was predictable in early FY14. The fiscal year started with the government revising the GST rate upward from 16 percent to 17 percent. Furthermore, by October, the government levied an additional 2 percent VAT on selected manufacturing items. More significant were the several rounds of upward adjustments in the prices of energy items.^{7,8} All of these have been instrumental in raising inflationary expectations⁹ and eventually leading to a broad-based increase in the headline rate. For instance, following the upward revisions of administered prices in August and October 2013, the number of non-food items registering double-digit inflation increased from 28 percent to 36 percent by December 2013 (Figure 5). This is evident also in significant increases in energy and housing-related inflation during the first seven months of FY14, compared to a negligible impact during the latter part of FY13 (Figure 5). Subdued global economic trends, a restrained outlook for global commodity prices, and the international price of oil¹⁰ have helped contain the imported content of inflation. As mentioned earlier, the SBP increased the policy interest rate by 100 bps during this period to manage expectations and rein in inflation. Overall, the average

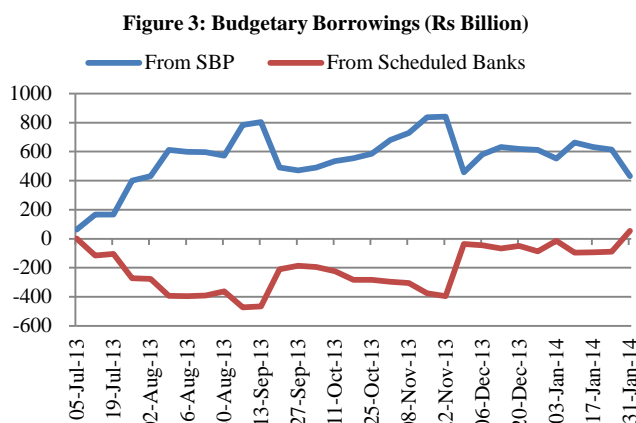
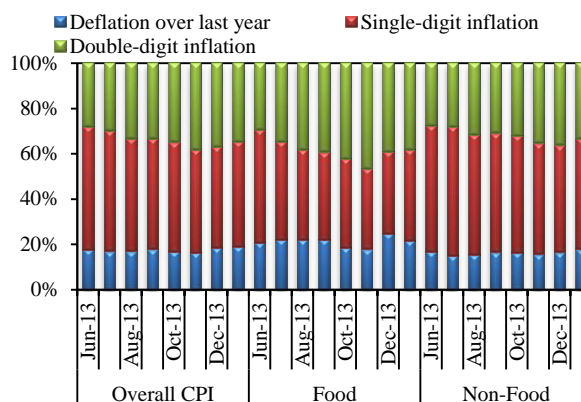
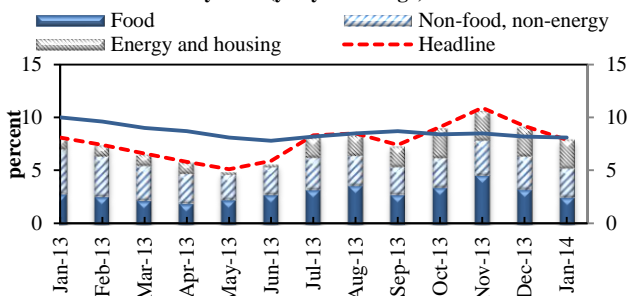


Figure 4: Percentage of items as per YoY inflation outcome



Source: State Bank of Pakistan

Figure 5: Contribution to CPI: January 2013 – January 2014 (y-o-y % change)



Source: State Bank of Pakistan

⁷ Electricity tariffs for commercial, bulk residential, and industrial users were increased by almost 24 percent on August 2013. A second adjustment for domestic consumers took place in October 2013, when tariffs were increased on average by 16 percent.

⁸ Energy-related items have an almost 30 percent share in the CPI basket.

⁹ Upward revision in the VAT rate was only announced at the time of the budget. Moreover, upward revisions in energy and gas prices are expected but the increase in scale is unclear.

¹⁰ Agricultural commodity indices declined from 161.6 in Q3-2013 to 160.3 in January 2014. Similarly, non-fuel commodities and energy indices during this period declined from 166.0 and 195.7 to 164.9 and 188.8 respectively (Source: IMF Commodities Database).

headline rate for FY14 is expected to be below 10 percent, somewhat higher than the target of 8 percent set by the government – as a result of the delayed cost of fiscal adjustment.¹¹

Non-food, non-energy (NFNE) core inflation has significantly declined. During the same period (July-February) NFNE core inflation averaged 8.3 percent, or 190 bps lower than the same period last year. This indicates that the risk of demand-driven inflation remains low.

Fiscal consolidation is taking place

Fiscal balance appears to be improving. After six of years of running a high fiscal deficit, Pakistan's fiscal indicators seems to be improving. Two factors explain this apparent departure from the past. First, the newly-elected government appears to be more committed to fiscal discipline. The FY14 budget presented a strong revenue effort to bring down the fiscal deficit from 8 percent of GDP in FY13 to 6.4 percent in FY14. Second, the government prepared an economic reform program with fiscal consolidation as its cornerstone. The program is supported by the IMF under the Extended Fund Facility (EFF), and commits the government to take actions to lower the fiscal deficit to 5.8 percent of GDP. This over-2 percent reduction in fiscal deficit is to be achieved through a 1 percentage point increase in the tax-to-GDP ratio and expenditure compression, mainly by reducing untargeted power subsidies, for the remaining 1 percentage point of GDP.

The government has initiated bold and far-reaching reforms of the tax system. In order to address some of the deep-seated structural problems with the revenue system, the government has moved simultaneously on many fronts. Not only has it increased the tariff rates (especially of GST) and cut down some fiscal concessions, it is also trying to expand the tax base to untaxed or lightly-taxed sectors. The Federal Board of Revenue (FBR) has prepared a new tax strategy to establish a coherent basis for its tax efforts (see Box 1 for details). It has committed to remove most of the tax exemptions (supported or not by SROs) over the next three-year period. At the same time, it has started issuing notices to potential, but unregistered, taxpayers. To date, about 70,000 notices have been issued, resulting in registration of 6,500 new taxpayers, while assessment orders have been issued to another 5,300 individuals. This process will continue for the next two years, with a plan to issue at least 100,000 notices each year. Similarly, the FBR is aggressively pursuing a scheme of auditing of tax returns to ensure appropriate tax compliance. A total of 41,700 cases have been selected for tax audits and to date 10,400 audits have been completed. As a first step towards enhancing transparency of the tax system, the FBR recently published a Tax Directory of Parliamentarians (see Box 2).

¹¹ Due to revision in tax rates and ongoing upward revisions in the administered prices of energy items, as discussed earlier.

Table 4. Pakistan: Fiscal Accounts, 2009/10–FY14*(In percent of GDP; unless otherwise indicated)*

	2009/10	2010/11	FY12	FY13		FY14		
	Actual	Actual	Actual	Jul-Dec	P. Actual	Budget	Jul-Dec	Proj.
Revenue and grants	14.1	12.4	13.0	6.2	13.3	14.5	6.6	14.3
Total Revenue	13.8	12.1	12.6	6.2	13.0	14.2	6.5	14.1
Tax revenue	10.0	9.3	10.1	4.3	9.6	10.8	4.5	10.3
<i>Of which: Federal Board of Revenue</i>	8.9	8.5	9.4	3.7	8.5	9.6	4.0	9.0
Nontax revenue	3.9	2.9	2.5	1.9	3.4	3.4	2.0	3.8
Grants	0.3	0.3	0.4	0.0	0.3	0.3	0.1	0.2
Expenditure	20.2	19.0	21.4	8.8	21.0	20.6	8.6	19.9
Current expenditure	16.8	16.5	17.7	7.6	16.0	15.6	7.3	15.8
Interest	4.3	3.8	4.4	2.3	4.3	4.5	2.3	4.7
Subsidies	1.5	2.7	2.8	3.3	1.3	0.9	3.3	1.3
Other federal	2.2	1.9	1.9	3.4	1.9	5.2	2.9	1.5
Provincial	4.2	4.3	4.8	2.0	4.8	5.0	2.1	4.8
Development expenditure & net								
lending/1	3.4	2.6	3.7	1.2	5.0	5.0	1.3	4.1
Overall balance								
Excluding grants	-6.4	-6.9	-8.8	-2.6	-8.0	-6.4	-2.1	-5.8
Including grants	-6.1	-6.6	-8.4	-2.6	-7.7	-6.1	-2.0	-5.6
Financing	6.1	6.6	8.4	2.6	7.7	6.1	2.0	5.6
External	0.9	0.3	0.3	0.3	0.0	0.5	-0.2	0.3
Domestic	5.2	6.3	8.1	2.4	7.7	5.6	2.2	5.3
Memorandum items:								
Nominal GDP (billions of Pakistani rupees)	14,967	18,285	20,091	23,655	22,909	25,887	26,001	26,139

Sources: Pakistani authorities for historical data; and World Bank staff estimates and projections.

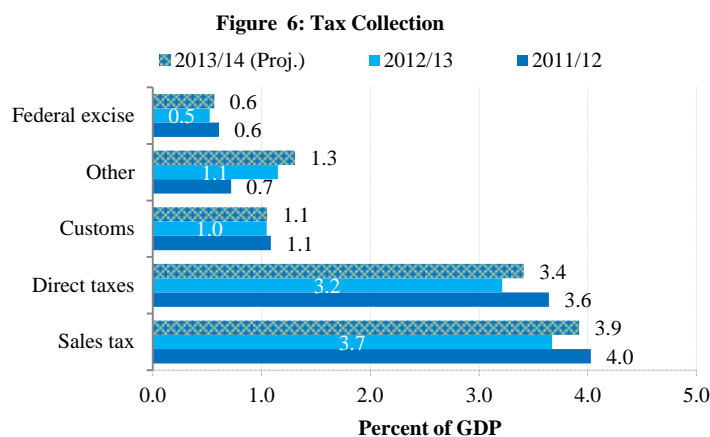
1/ Includes impact of repayment of circular debt and expenditure on BISP/NISP.

H1-FY14 performance raises hopes of achieving fiscal targets

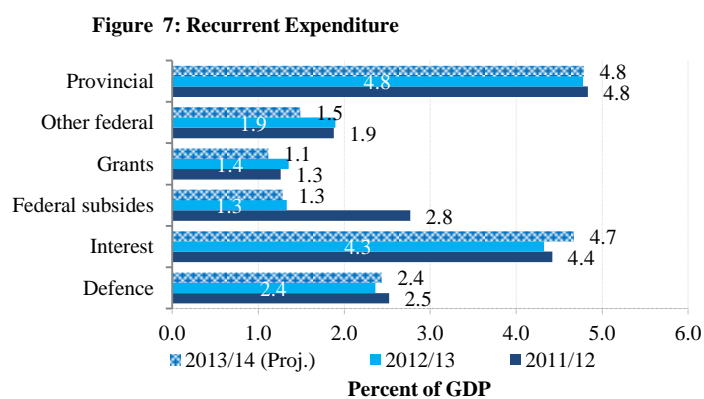
The fiscal consolidation effort appears to be paying off. During the first six months of the fiscal year, the fiscal deficit (2.1 percent of GDP) was significantly below (by 0.5 percent of GDP) the level achieved during the same period of last year (Table 4). While the government could not lower the power sector subsidy to the desired level, despite substantial increases in power tariffs for large consumers, yet the recurrent expenditure of the government was below the level of first half of last fiscal year. This was mainly because the government made strong efforts to scale back its non-salary, non-interest recurrent expenditure by controlling the release of budgetary funds for these activities. Other recurrent expenditure of the federal government was 0.5 percent below the level of H1-FY13. Development expenditure was slightly higher than registered during the first half of FY13 but is projected to be below its allocation. Revenue collection also showed improvement as both tax and non-tax revenues were higher than collections for the same period of last year.

Outlook for fiscal targets vis-à-vis budgeted targets remains positive

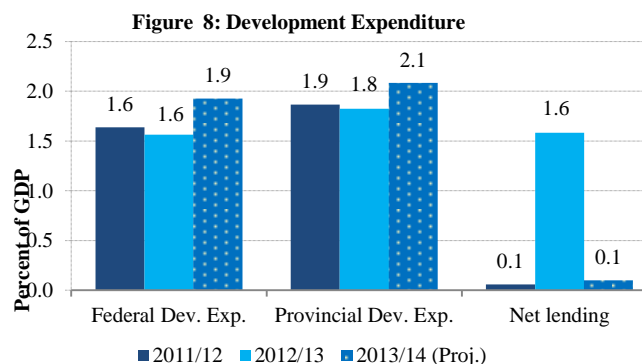
Revenue collection is expected to be close to the revised target of Rs 2,345. On the basis of performance during the first half of the year, the seasonality in fiscal transactions and the expected impact of government's policy actions, it is projected that FBR tax collection would not only recover from the exceptionally poor performance of FY13, but its tax-to-GDP ratio would much exceed the level achieved in FY12 and be quite close to its annual revised target (10.3 percent of GDP). Collection of all federal taxes is projected to be significantly higher than last year while owing to positive trend in collection of provincial tax, especially services GST, some increase is expected to come from collection of provincial revenue (Figure 6).



Recurrent expenditure is expected to remain below the level achieved last year. On the expenditure side, current expenditure of the federal government is projected to decline. The government's austerity measures are responsible for a significant reduction in federal government "other" recurrent spending, while better financial health of SOEs would imply smaller demand on federal grants to support these enterprises. Interest payments would be higher due to higher accumulated debt, increase in interest rate by SBP and depreciation of rupee (Figure 7)¹².



Development spending of the government (inclusive of net lending to the public corporate sector) is projected to decline from 5 percent of GDP in FY13 to 4.1 percent in FY14 but only because of a sharp fall in net lending. The apparent fall in overall development expenditure is an outcome of accounting protocols which include all lending (net of repayments) of the federal government to SOEs as development expenditure. In FY13, the sharp increase in development spending was due solely to very high levels (equivalent of 1.4 percent of GDP)¹³ of federal government's lending to power sector enterprises to discharge their payments arrears to other energy sector corporations. Without this exceptional net lending, the development expenditure in FY13 would have been at about the same level as in FY12 (3.4 percent of GDP) and on the basis of higher development spending



¹² A sizeable portion of government's domestic debt is in 3-month or 6-month T-Bills. As such, a within-year increase in interest rate (especially if it is during the first half of the fiscal year) does impact interest payments of the government during the same year.

¹³ In addition, there was additional federal lending of 0.2 percent of GDP to finance other expenditures of SOEs.

during the first of the FY14 and that many development projects have been only recently started, development spending could reach about 4 percent of GDP, with some increase in federal and provincial governments' development expenditures (Figure 8).

Overall, the fiscal deficit is expected to fall from 8 percent of GDP in FY13 to 5.8 percent in FY14. Expected budget support from multilateral donor agencies (i.e., the World Bank and ADB), should also improve external financing for the budget, but repayments, especially to the IMF, will also be higher. In net terms, the external financing position in FY14 is expected to be substantially better than in FY13. The lower deficit along with higher external financing implies that the need for domestic financing would be much lower than in the last three years. This could help not only in containing inflationary pressures but also freeing additional banks' resources for private credit.

Public debt continues to be a source of concern

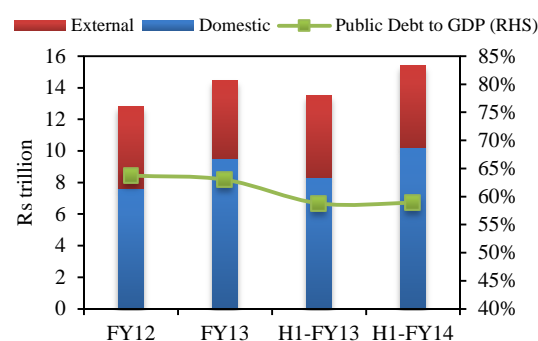
Public debt continues to exceed the cap of 60 percent of GDP set by the Fiscal Responsibility and Debt Limitation Act, justified for security reasons. Over the last two years, the public debt to GDP remained well above the threshold of 60 percent limit specified by the act passed in 2005 (Figure 9). Large fiscal deficits and their monetary financing coupled with negligible foreign debt-creating flows fuelled this trend as well as the increasing share of domestic debt over the years.

During the first half of FY14, the public debt-to-GDP ratio stood at about 58.9 percent. This is almost the same level as of December 2012. In line with the expectations of accelerating though moderate growth, near-double-digit inflation, and a lower but still large fiscal deficit for the ongoing fiscal year, the public debt-to-GDP ratio looks likely to be breached again in FY14.

Domestic debt creation has become increasingly skewed towards short-term instruments, primarily MRTBs. Domestic debt increased by almost Rs 1.9 trillion, from Rs 9.5 trillion at end-December 2012 to Rs 10.2 trillion by end-December 2013. Floating debt¹⁴ constituted more than two-third of this addition (Figure 10). Within this category, central bank borrowing gained prominence despite the SBP Amendment Act 2012¹⁵ being in place. A high Rs 1.3 trillion (or 89 percent of the floating debt) on aggregate has been borrowed from the SBP via MRTBs during this period to finance the budgetary deficit. This clearly implies that the government is utilizing fortnightly auctions to roll over the existing stock of treasury bills.¹⁶

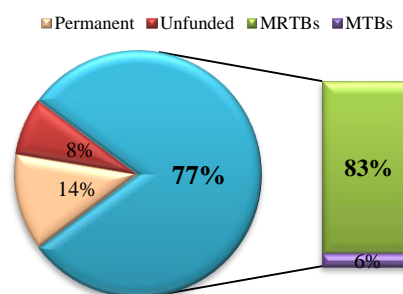
Refinancing risk remains heightened especially for domestic debt. The redemption profile on domestic debt is frontloaded with more than Rs 6 trillion of domestic debt maturing in FY14, representing 64.2 percent

Figure 9: Trends in Public Debt



Source: State Bank of Pakistan and staff calculations

Figure 10: Domestic Debt Dynamics, December 2013



¹⁴ Short-term domestic debt that includes Market Treasury Bills (MTBs) and Market-Related Treasury Bills (MRTBs).

¹⁵ Section 9c of the Act stipulates that net borrowing from the SBP has to be brought to nil on a quarterly basis.

¹⁶ The auction targets remained very close to the maturities falling in the respective quarters during January-December 2013. This ratio averaged to 1.05 times. The acceptance to targets ratio also approximated to 1.03 times.

of the domestic debt portfolio.¹⁷ The refinancing risk on domestic debt is further aggravated by the put option embedded NSS instruments giving investors the right of early redemption.^{18, 19} This redemption profile translates in an average time to maturity (ATM) of 1.8 years (Table 5). In contrast, the redemption profile on external debt is significantly smoother and exhibits an ATM of 10.1 years, indicating limited exposure to refinancing risk.

Risk Indicators		External debt	Domestic debt	Total debt
Cost of debt	Weighted Average Interest Rate (%)	1.9	10.7	7.8
Refinancing risk	ATM (years)	10.1	1.8	4.5
	Debt maturing in 1yr (% of total)	8.9	64.2	46.0
Interest rate risk	ATR (years)	9.2	1.8	4.2
	Debt re-fixing in 1yr (% of total)	22.2	67.2	52.4
	Fixed rate debt (% of total)	83.4	39.6	54.0

Source: Pakistani authorities and World Bank staff calculations

Exposure to interest rate changes is a substantial risk given the short-term nature of the domestic securities. Around 67 percent of total domestic debt is exposed to interest rate refixing within one year.²⁰ For external loans, the share of debt exposed to refixing within one year stands at 22 percent, illustrating that a relatively large share of external debt has been contracted in variable rates. Average time to refixing (ATR) for domestic debt is very low, at 1.8 years, comparable to the ATM for domestic debt, while the ATR on external debt is significantly longer, at 9.2 years. Under these conditions, a 1 percent increase in domestic interest rates would increase interest payments by Rs 63 billion whereas a 1 percent increase in interest rates on external debt would increase interest payments by Rs 8.4 billion.

DSA results point towards a declining public debt trajectory in future. Results of a Debt Sustainability Analysis²¹ (DSA) 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 past IMF-Stand By Agreement is fully repaid and total interest payments average around 29 percent of total revenues (including grants) over the projection horizon.

Marginal growth of financial flows continues to make external sector vulnerable

During the first seven months of FY14, the fundamental weaknesses in the balance of payments position persisted. The current account posted a deficit of US\$ 2.0 billion, equivalent to 0.9 percent of GDP, compared to a deficit of 0.2 percent of GDP during the same period last year. Strong inflows of remittance continued to keep the current account deficit in check. However, for the third consecutive year, paucity of financial inflows remained the main source of BOP stress (Figure 11).

¹⁷ This number is driven mainly by T-Bills and borrowing from the SBP, accounting for Rs 5.2 trillion.

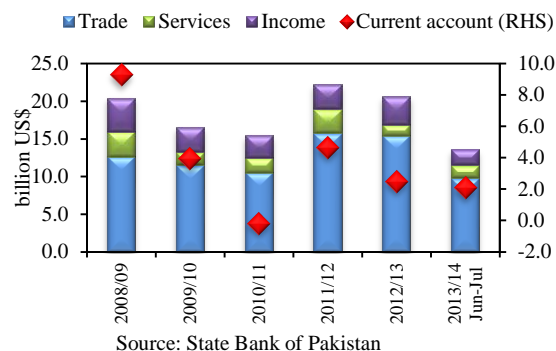
¹⁸ If investors opted to redeem all NSS instruments in 2013/14 the total domestic debt maturing in 2013/14 would increase to about Rs 8 trillion.

¹⁹ A constant redemption profile for NSS instruments is assumed. However, rising interest rates may lead investors to redeem their investments in NSS instruments earlier, hence increasing required roll-over.

²⁰ Comprising all MTBs and borrowing from the SBP, as well as longer term domestic debt that matures in 2013/14.

²¹ World Bank Debt Sustainability Analysis, 2013/14.

Figure 11: Composition of Current Account Deficit



Source: State Bank of Pakistan

The trade deficit contributed most to the widening of current account deficit. Trade deficit increased to almost US\$10 billion (Table 6). As a result of improved domestic economic activity, imports increased by 4.2 percent during the first seven months of FY14, compared to a virtual stagnation last year. This increase reflects rising demand for petroleum, to fill the demand-supply gap created by gas shortages in the country. Exports growth, however, remained modest at 3.3 percent and this increase can be attributed to a quantum increase (two thirds) and price impact (one third).²² This growth is driven predominantly by the strong performance of textile products (cotton yarn,²³ knitwear, readymade garments, bed-wear, and towels (Figures 12a and 12b), and rice and petroleum product (solid fuel, naphtha) exports. Export growth during the second half of FY14 is expected to pick up further as a result of the GSP-Plus status of Pakistani exports to the European Union²⁴ and increased demand from United States. Mildness of export dynamism remains a fundamental challenge for sustainable improvement in the external balance. Pakistan's exports remain highly concentrated in terms of commodities,²⁵ expanding the country spread and market diversification remains the binding challenge for enhancing competitiveness.

Table 6: Summary of Balance of Payments

Billion US\$	FY13	Jul-Jan	
		FY13	FY14
I. Current account balance (A+B+C+D)	-2.5	-0.4	-2.1
A. Trade balance	-15.4	-9.3	-9.8
(i) Export	24.8	14.2	14.7
(ii) Imports	40.2	23.5	24.5
B. Services	-1.5	-0.2	-1.7
<i>of which: CSF</i>	1.8	1.8	0.3
C. Income	-3.7	-1.9	-2.1
D. Current transfers	18.1	11.0	11.5
<i>of which: Worker remittance</i>	13.9	8.2	9.0
II. Capital account	0.3	0.1	0.2
III. Financial account	0.5	-0.4	0.3
(i) Net foreign investment	1.3	0.6	0.5
FDI	1.3	0.5	0.4
Portfolio	0.0	0.1	0.1
(ii) Other investment (net)	-0.7	-0.9	-0.3
IV. Errors and omissions	-0.3	-0.1	-0.5
V. Overall balance (I+II+III+IV)	-2.0	-0.8	-2.1

Source: State Bank of Pakistan

²² First seven months of FY14.

²³ Higher demand for cotton yarn and fabric is coming from China. Pakistan has benefited substantially from rising labor wages in China which have increased production cost in China and shifted some of the demand to Pakistan.

²⁴ Pakistan is expected to gain US\$350 to US\$500 million from duty free access to exports of 75 categories items of EU. According to the SBP, Pakistan has a price advantage over its competitors (mainly India and Bangladesh) in 19 categories.

²⁵ According to customs data, about 3 percent of total items account for 75 percent of total exports. Main items include textiles, rice, and petroleum (Source: SBP).

Figure 12a: Exports – Quantum Impact

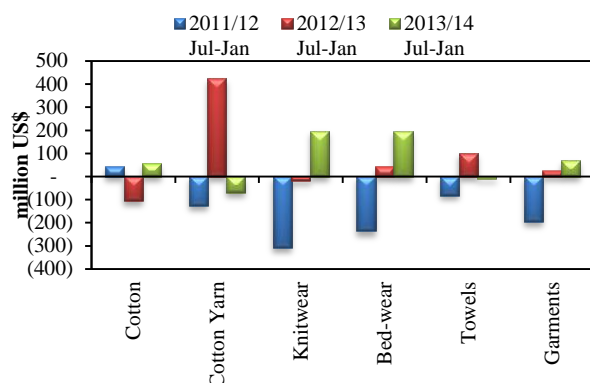
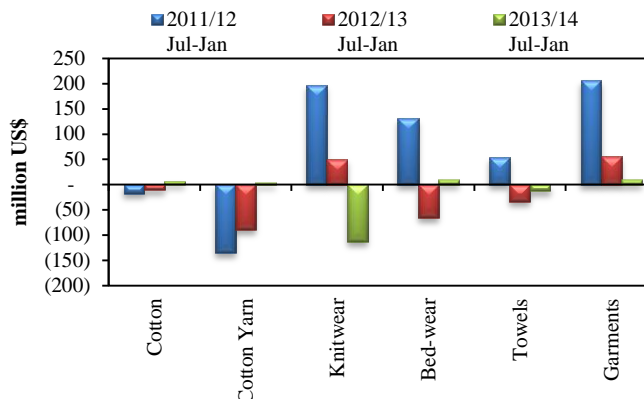


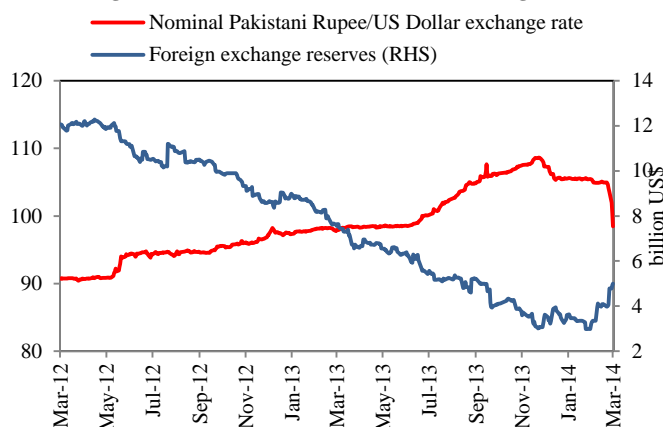
Figure 12b: Exports – Price Impact



The recovery of financial inflows remains a considerable challenge.

During the first seven months of FY14, the capital and financial account registered a marginal surplus of US\$400 million. Pakistan’s EMBI+ spreads have improved significantly, declining from 1,011 basis points in March 2013 to 482 basis points in March 12, 2014. But FDI and FPI are at extremely low levels; investor concerns over governance issues, energy and the prevailing security situation remain some of the key impediments. Higher debt service repayments (over disbursement inflows), coupled with net repayments to the IMF²⁶ during the first seven months of FY14 put considerable pressure on the financial accounts and foreign exchange reserves (Figure 13). Consequently, gross reserves declined from US\$6.0 billion at end-June 2013 to US\$4.0 billion at end-February 2014. However, by March 12, reserves had risen by US\$ 1.0 billion as a result of unexpected inflows received from bilateral sources under the Pakistan Development Fund, amounting to US\$1.5 billion.²⁷ This has helped ease pressure on reserves and the exchange rate. During the remainder of the fiscal year, the reserve position is expected to improve considerably as a result of flows of CSF monies, license fees for issuance of 3G and 4G licenses, and flotation of a Eurobond in the international market,²⁸ as well as upticks in multilateral and bilateral program flows.

Figure 13: Gross Official Reserves and Exchange Rate



The nominal exchange rate has been extremely volatile, as it appreciated by 7 percent against the US dollar during July to February, only to appreciate by 6 percent in March 2014. The exchange rate came under substantial pressure during the first five months of the fiscal year, depreciating by 8.7 percent²⁹ as a

²⁶ During the first seven months, IMF disbursements to Pakistan stood at US\$1.1 billion while repayments to the fund stood at US\$1.65 billion, implying net repayment of US\$544 million.

²⁷ A first tranche of inflows under the Pakistan Development Forum rubric, amounting to US\$750 million, was received on February 19 and a second tranche of equal amount was received on March 7. According to media reports, an additional US\$1.5 billion in inflows are expected during the remainder of the fiscal year.

²⁸ Pakistan is expected to receive US\$1 billion in CSF monies in FY14, of which US\$322 million and US\$352 million were received in October 2013 and February 2014. Eurobond issuance equivalent to US\$500 million – US\$ 1 billion is expected in Q4. Moreover, US\$1.2-US\$ 1.6 billion are expected from issuance of 3G and 4G license fee during the fourth quarter of the current fiscal year.

²⁹ As a result of large net repayments to the IMF, gross official reserves of the SBP declined from US\$6 billion at end-June 2013 to US\$4.2 billion by end-October (i.e., to about 1.0 months of imports).

result of net repayments to IMF, weak official inflows, and heavy debt repayments³⁰. Since November, however, the SBP has started to purchase dollars on the spot market, turning decisively toward rebuilding the external position and reserves.³¹ Moreover, in January, a considerable portion of oil import payments was moved out of the interbank market to FE-25,³² easing further pressure on the exchange rate. However, recent inflows of what appear to be Saudi funds have improved the reserve position and helped the rupee undershoot its value back to around Rs 98/1 US\$. This nominal appreciation will certainly hurt both exports and customs-related tax revenues.

Financial Sector Developments

The concentration of the financial sector's balance sheet remained tilted towards the public sector, its operating performance remained steady, while the solvency indicators of banks remained robust

Banking sector profitability was steady, declining only slightly in calendar year 2013. The benchmark interest rate (6-month KIBOR) increased from 9.4 percent in December 2012 to 10.2 percent in December 2013. Return on assets (ROA) and return on equity (ROE) during the last quarter of 2013 was at 1.7 percent and 18.4 percent, compared to 2 percent and 21.4 percent during the same period last year. The sector's liquidity and solvency positions remain strong backed by sluggish growth in advances and sizeable concentration of the asset portfolio in government securities which carry low risk weightages. Capital adequacy ratio (CAR) stood at 14.9 percent in December 2013, a slight decrease over the same period last year (Table 7).

Non-Performing Loans (NPLs) showed a slight decline. NPLs decreased slightly, from 14.5 percent in December 2012 to 13.0 percent in December 2013. Adequate provisioning also kept net NPLs ratio in check at 3.1 percent in December 2013. NPLs in small and medium enterprises (SMEs) remain high, representing 32.3 percent of loans, followed by the agricultural sector (14 percent) and consumer sector (13.6 percent). The largest share of the portfolio is the corporate sector (66.8 percent of loans) where the NPL ratio is 13.4 percent.

Microfinance continues to expand. The formal microfinance banks continue to explore new approaches to expand its outreach, including branchless banking. The sector registered a 20.0 percent increase in active borrowers, 36 percent

Table 7: Selected Key Indicators of the Banking Sector

	Dec 2012	Dec 2013
Profit Before Tax (Rs bn)	179	165
ROA Before Tax (%)	2.0	1.7
ROE Before Tax (%)	21.4	18.4
Advances to Deposits Ratio (%)	52.2	48.6
Liquid Assets/Total Deposits (%)	64.5	60
Capital Adequacy Ratio (%)	15.6	14.9
Gross NPLs to Loans (%)	14.5	13.0
Net NPLs to Loans (%)	4.6	3.1
6 month KIBOR (%)	9.38	10.15

Source: Quarterly Compendium of the Banking System, December 2013

Table 8: Microfinance Sector in Pakistan

	Dec 2012	Dec 2013
Active Borrowers	2,355,943	2,832,715
Gross Loan Portfolio (Rs mn)	38,238	52,092
Average Loan Size (Rs)	24,131	26,838
Number of Savers	4,682,422	5,977,426
Value of Savings (Rs mn)	24,974	34,784
Portfolio At Risk >30 days	1.4%	1.2%

Source: Micro WATCH Issue 26 and 30: Pakistan Microfinance Network

³⁰ After substantial purchases of foreign exchange in August in the run-up to the IMF board meeting, the SBP returned to net dollar sales in September and October to counter the exchange rate pressures and maintain market liquidity (IMF Country Report no. 14/1), January 2014.

³¹ As agreed under the IMF program.

³² Almost 40 percent of total oil import payments have been moved from interbank market to FE-25. This implies that these payments will be financed by creating loans against dollar deposits in commercial banks.

growth in gross loan portfolio, 27 percent increase in savers and 40 percent in value of savings over the calendar year (Table 8). Portfolio at risk declined slightly to 1.2 percent due to adequate write-offs of bad loans.

The equity market stays on the bullish trajectory begun in the past calendar year. The KSE-100 index crossed the 20,000 point threshold for the first time in 2013 and increased its market capitalization to Rs 6 billion, signifying an increase of 42 percent over calendar year 2013. In terms of returns, the KSE-100 index increased 49.4 percent in 2013, making it one of the best-performing stock markets in the world for a third consecutive year. The upward trend in turnover volumes and the KSE-100 index has been driven by the monetary easing cycle, foreign portfolio investment, resilient corporate profitability, a smooth political transition to a business-friendly democratic government, and a number of capital market reforms including revamping of a capital gains tax (CGT) regime, introduction of revised code of corporate governance, etc. The growth has also been led by increased investor confidence in the policies of the incumbent government. Among those policies is the revival of the privatization program (see below and Box 3: SOE Reforms).

Progress with Structural Reforms

The government is pursuing a comprehensive program of economic and social reforms, with a main purpose of reinvigorating a broad-based private sector-led economic growth. As a first step in this direction, the government is striving to re-establish macroeconomic stability through fiscal consolidation, with a main target of achieving a fiscal deficit of 4 percent of GDP or less³³. In addition, it has applied stringent measures to control non-development and discretionary expenditure. In parallel, it has implemented core structural reforms that include:

- **Energy sector reforms.** The main emphasis is on: (i) managing power sector tariffs and subsidies, with the Economic Coordination Committee (ECC) approving the Tariff and Subsidy Policy Guidelines which include a subsidy policy for low-income residential customers; (ii) improving power sector performance and opening the market to private participation by instructing poorly performing distribution companies to outsource their high loss-making feeders to the private sector; (iii) enhancing sector accountability and transparency by requiring each distribution company to itemize the amount of subsidy in each customer's bill, as well as publishing on their websites monthly billing and collection data aggregated by consumer category.
- **Privatization.** As a main step in this direction, the government aims to revive and revitalize Pakistan's privatization program that had been more or less stalled for over eight years. The Cabinet Committee on Privatization (CCOP) has approved a list of 31 state-owned enterprises (SOEs) to be privatized in a phased approach. The privatization of three SOEs is in an advanced stage. Two SOEs are expected to be put up for sale in the next six months, while the government is divesting its shares in three SOEs through domestic and international stock markets.
- **Financial sector development.** To eliminate the financial markets of some of its inherent distortions, the government is in the process of enacting a Credit Bureau law, which will institutionalize access to finance and credit information and strengthen creditors' rights, which could be critical for investment recovery. Similarly, the government has notified rules for micro insurance in order to enhance transparency of the sector and help to increase the density and affordability of insurance, especially of the low-income population. The government is also in the process of enhancing the supervisory role of the Securities and Exchange Commission of Pakistan (SECP) over the corporatization of postal life insurance.
- **Facilitating doing business:** Private-sector investment is inhibited by Pakistan's cumbersome business procedures. During the last two years, the SECP had developed and rolled out an electronic platform for the business registration system, which had led to a significant reduction in the time taken to register a

³³ By FY17.

business. Yet 21 days and 10 procedures are still needed to register a business in Pakistan. To further facilitate business registration, the government has been working to develop a “one-stop-shop” for business registration, creating a shared platform for registration between the SECP, the Federal Board of Revenue (FBR), and the Employees’ Old Age Benefit Institution (EOBI), to reduce the time and cost to businesses in the registration process. In the same way, creation of Special Economic Zones (SEZs) will help foster foreign investment. For this the government has recently approved a SEZ bill in order to provide a coherent framework for SEZs and one SEZ is approved for establishment by Board of Investment (BOI).

- **Trade and tariff reforms.** The government is undertaking trade policy reforms which could stimulate growth and competition and increase consumer welfare. Simplifying tariff rates, and eliminating the statutory regulatory orders (SROs) that establish special tariff rates and improving trade relations with Pakistan’s commercial partners, especially those of SAFTA, are among the government’s main policy goals to provide a level playing field and a much-needed boost to growth and investment. The government is committed to achieve a simple statutory (Most Favored Nation) rates regime of four slabs by end-2016/17.
- **Strengthening social safety nets.** Protecting the most vulnerable from the ill-effects of its structural adjustment reforms measures, the government has not only enhanced the monthly stipend provided to the beneficiaries of the Benazir Income Support Program (BISP) by 20 percent, it has also expanded the coverage of BISP to over 5.5 million families. Meanwhile, the BISP has signed MOUs with the provincial education authorities to initiate Conditional Cash Transfers (CCTs) in 20 districts of the country. This will provide the families monthly cash transfers from the BISP on the condition that they send their school-aged children to primary schools.

Medium-Term Outlook

Given modest global recovery, the medium-term outlook presents moderate downside risks. The external environment is expected to starting improving gradually, with global growth from 3.2 percent in 2014 to 3.5 in 2016.³⁴

Pakistan's real GDP growth is projected to regain momentum gradually, following a critical first year of FY14, from 3.6-4.0 percent to 4.4 percent by FY16 (Table 9). Recent activity indicators have all shown increases. At the sector level, the initial economic expansion will be supported by less load-shedding and resilient remittances complemented, on the supply side, by manufacturing exports (which are showing good

external demand growth prospects) and by dynamic services (which are projected to expand steadily as domestic aggregate demand picks up in tandem with better provision of power supply owing to improved management, later supported by initial investments in power generation). Official figures place inflation in single digits by

	Actual			Proj.	
	2011/12	2012/13	2013/14	2014/15	2015/16
	<i>Annual percentage change</i>				
Real GDP growth (at factor cost)	4.4	3.6	3.6-4.0	4.0	4.4
Consumer prices (period average)	11.0	7.4	9-10	9.2	8.4
	<i>In percent of GDP</i>				
Fiscal balance (excl. grants)	-8.8	-8.0	-5.8	-5.4	-4.5
Total public debt	63.7	63.0	64.2	63.5	62.1
Current account balance	-2.1	-1.0	-1.0	-0.8	-1.0

Source: Pakistani authorities and World Bank Staff Estimates

end-2013, but some pressures related to hikes in administered prices for provisions such as oil, electricity, and gas, might put pressure by end-fiscal year toward a 9-10 percent rate. As fiscal consolidation and monetary tightening proceed, average inflation should approach its medium-term target 8.0 percent over medium-term.

Over the medium term, the fiscal deficit (excluding grants) is projected to decline from 5.8 percent of GDP in FY14 to 4.5 percent of GDP in FY16. The fiscal deficit (excluding grants) is projected to reach 5.8 percent of GDP in FY14. About half of the effort is expected to come from revenue increases and the other half from the reduction of untargeted power subsidies and recurrent spending. Provinces are also expected to generate small fiscal surpluses. Taking into account the additional fiscal space, along with increased development spending, the fiscal deficit is expected to reach 4.5 percent of GDP in FY16. Indeed, partial elimination of power and fuel subsidies would lead current expenditures to decline from 16.0 percent of GDP in FY13 to 14.4 percent in FY16. Part of such fiscal space generated would allow development spending to increase slightly to around 5.4 percent of GDP by FY16 – significantly higher than the 3.7 percent average of the last three years. For its part, public debt-to-GDP ratios are expected to temporarily increase to 64.2 percent of GDP in FY14, but to gradually decrease to 62.1 percent of GDP by end-FY16, as fiscal consolidation requires lower financing of the fiscal deficit.

The cornerstone of this outlook is a significant increase in total revenues and grants which are projected to rise by 2.0 percentage points of GDP to 15.3 percent of GDP by FY16. The baseline assumes a marked improvement in FBR performance, allowing tax revenues to rise from 9.6 percent of GDP in FY13 to at least 12 percent by FY15. Increased revenue mobilization will be aided by a revival of economic growth, a pickup in imports as well as the authorities' own efforts to revamp and reform tax policy and tax administration, and some expected increase in provincial revenue. The scenario also assumes an increase by nontax revenues, which over the forecast period are projected to average around 3.4 percent of GDP (or slightly above the 2.9 percent average over the last three years). This increase is, however, mainly driven by Coalition Support Fund receipts, which are expected to slowly phase down by end period.

³⁴ Source: DECPG.

The current account deficit is projected to approach a modest 1 percent of GDP by end-FY14, and remain modest during the projection period supported by some export recovery, strong dynamism of remittances and imports favored by low international oil prices. Higher financial inflows are expected to be attracted by lower country risk, privatizations, new trade relations with neighbors and the opening of special economic zones and multilateral flows. Official foreign exchange reserves are expected to build from US\$6.0 billion by the end of FY13 to about US\$16 billion by the end-FY16 (equivalent to three months of imports). The main projected sources of financing are the Coalition Support Fund, Pakistan Telecommunication Company Ltd. privatization, and sales of G3 and G4 telecoms licenses. IMF and donor financing should help rebuild this critical buffer.

Box 1: FBR Tax Strategy

The Federal Board of revenue (FBR) has prepared a tax reform strategy aimed at increasing tax collection from 9.7 percent to 14 percent of GDP by FY17. The main goal of the strategy is to raise tax-to-GDP ratio from 9.5 percent in FY13 to 15 percent in FY18. This is consistent with government's commitment to achieve a sustainable fiscal deficit of around 4 percent of GDP by FY17.

The FBR tax strategy has four focus areas:

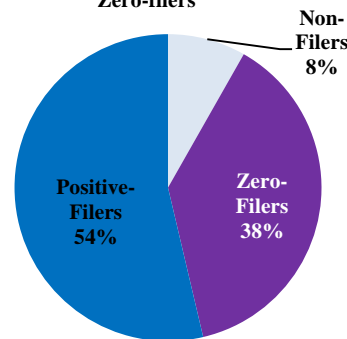
- (i) *Rationalization of concessionary regime:* The main focus is to achieve a sizeable revenue gain by eliminating all Statutory Regulatory Orders (SROs) which provide ad hoc tax exemptions or concessions over a period of three years. The critical SROs are to be made part of tax law through an action of the parliament, while the remainder would be phased out. The FBR plans to start eliminating the first batch of SROs identified in the FY15 budget, which, along with other budgetary measures, will yield up to 0.75 percent of GDP in revenue. In addition, the existing tax laws will be amended to prohibit a resort to such ad-hoc policy measures in the future.
 - (ii) *Reducing the tax gap:* The FBR intends to take a number of actions to strengthen its tax enforcement capabilities. The key initiatives include: initiating sector studies to estimate the tax potential of each sector; facilitating access to information on bank accounts of potential tax evaders and tax avoiders; enhancing FBR capacity for undertaking and expanding the coverage of tax audits; and institutionalizing a risk-based system of sales tax registration, which would not only expand the tax base but also be capable of detecting and forestalling the abuse of the tax refund process. These measures will be supplemented by a computerized risk-based evaluation of sales tax returns and an automated system of sales tax refunds; establishing an electronic monitoring system to assess accurate volumes of industrial production; and developing an anti-smuggling strategy.
 - (iii) *Broadening of the tax base:* To bring more of the large percentage of unregistered taxpayers, both individuals and businesses, into the tax net, the FBR has started using third-party information on financial activities, such as the acquisition of real estate, purchase of motor vehicles, foreign travel expenses, etc. On the basis of this information, the FBR has started issuing tax notices to these potential taxpayers to register and begin paying their tax dues. Over the next two years, the FBR intends to issue at least 100,000 notices to such individuals and businesses. In addition, the FBR has made it a mandatory requirement for all exporters and importers to register with FBR; government departments have been instructed to purchase goods and services only from registered taxpayers; registered taxpayers are discouraged to make any sale to unregistered taxpayers by levy of an additional 1 percent tax on those sales. Similarly, any purchase of goods and services from unregistered individuals and firms is subjected to a 1 percent withholding tax, and supplies of electricity and gas to unregistered businesses are subject to a 5 percent surcharge.
 - (iv) *Management improvement and behavioral change:* To strengthen its internal controls to combat corruption within the system, the FBR has devised a plan for integrity management and performance appraisal. For this purpose, an Integrity Management Unit will be established which will provide input on integrity-related matters, process corruption-related complaints, prepare profiles of officers, and coordinate with other anti-corruption agencies.
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Box 2: The Tax Directory of Parliamentarians

For the first time in the country’s history, the federal tax authorities in Pakistan have published a tax directory providing tax details of amounts paid by each member of the national senate and national and provincial assemblies, beginning in tax year 2013. Pakistan tax collection is adversely impacted by a culture of weak tax compliance, tax avoidance, and tax evasion. One reason for this non-supportive tax culture is the perception within the public that the country’s tax system supports and abets the affluent and powerful segments of the population in not paying their due share in taxes, and that therefore a disproportionately higher burden is imposed on people who are already in the tax net. The tax directory is an attempt to enhance the transparency of the tax system and dispel the impression that parliamentarians do not carry out their tax obligations.

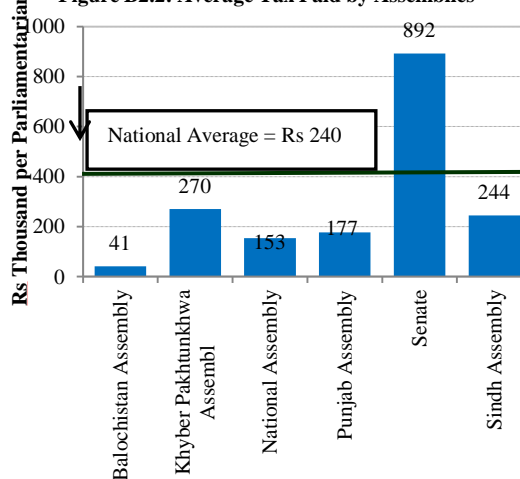
The directory reveals that of the 1,168 members presently in the senate and the national and provincial assemblies, 8 percent did not file tax returns, and another 38 percent declared no taxable income (Figure B2.1). The remaining 627 parliamentarians paid a total tax of Rs 257 million (US\$2.4 million). This appears to be very low considering that total direct taxes collected by the federal government amounted to Rs 736 billion. Also it is not fully consistent with the lifestyle of most of the parliamentarians. One reason for this apparent distorted tax behavior is that many of the parliamentarians derive income from agriculture, and taxation of agricultural income is a provincial responsibility.

Figure B2.1: Non-filers, Positive filers, and Zero-filers



The average tax paid by per parliamentarian was only Rs 240,000 (US\$ 2,250). This average would have been even lower had it not been the tax payment by the members of the national senate, each member of which paid Rs 892,000 on average (Figure B2.2). Members of national and provincial assemblies on average paid only meager amounts in tax; the average paid by members of the Balochistan assembly, for instance, was only Rs 41,000 (US\$380).

Figure B2.2: Average Tax Paid by Assemblies



The tax payments by government ministers brought even more public astonishment: 88 members of the federal and provincial cabinets paid a total tax of Rs 35 million, of which Rs 28 million came from the federal cabinet members (with Rs 22 million of this coming from just four members of the national senate). This indicates that 57 members of the provincial cabinets contributed less than Rs 7 million. What is more edifying is that on average, cabinet ministers of Balochistan, KPK, and Sindh paid just 15 percent, 23 percent, and 39 percent of the average tax paid by members of these assemblies.

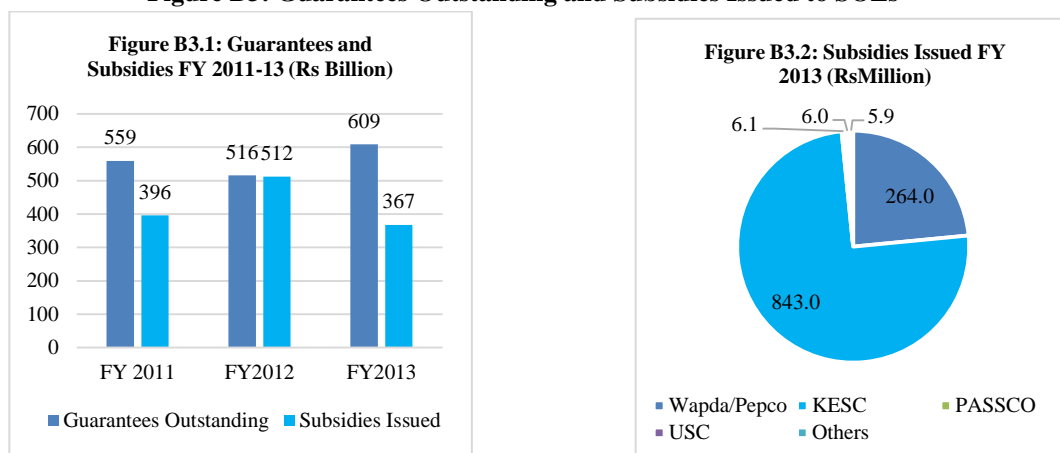
Despite the somewhat “skewed” tax behavior of the parliamentarians, publication of the tax directory has enhanced transparency of the tax system. However, this transparency was somewhat eroded by the peculiarities of Pakistani tax system, which fragments taxation of income on the basis of its sources at the federal and provincial levels. The Tax Directory addresses the perception that the political elite do not pay their dues in tax.

Box 3: Reform of State-Owned Enterprises (SOEs)

State-owned enterprises (SOEs) are a sizable element in Pakistan's economic landscape. More than 150 of them operate in a wide range of economic sectors, including infrastructure (power, transport, and logistics), energy (oil and gas, mining), financial services (banks, insurance), and manufacturing. SOEs contribute around 10 percent to GDP while representing about one-third of stock market capitalization.

Many SOEs are marred by weak corporate governance, cost-ineffective service delivery, poor service provision and considerable financial losses. Figure B3 illustrates the fiscal burden of SOEs in the form of contingent liabilities through guarantees and direct outlays through subsidies. In FY12, Rs 512 billion (2.5 percent of GDP) was spent on subsidies, of which Rs 464 billion (2.2 percent of GDP) went to the power sector. Apart from direct subsidies, guarantees outstanding to SOEs amounted to another Rs 517 billion (2.5 percent of GDP).

Figure B3: Guarantees Outstanding and Subsidies Issued to SOEs



While reforming and privatizing SOEs has been on the agenda of a succession of political establishments over the last two decades, the lack of professional and transparent board appointments, inadequate performance monitoring, and limited accountability frameworks have repeatedly hindered the government's ability to introduce sustainable reforms within SOEs. Key policy issues include: (i) the absence of a legal and regulatory framework for state-owned enterprises; (ii) a lack of clearly defined roles for government as owner, policy maker, coordinator, subsidy deliverer, and regulator; and (iii) weak corporate governance standards, particularly with respect to board nominations, appointment of CEOs, and performance measurement.

SOE reform was a key agenda in the manifesto of the PML (N), the leading political party in the country. After getting elected, the Prime Minister publically reaffirmed his party's commitment to privatization. The key objective of privatization is to improve Pakistan's fiscal position by reducing subsidies and eliminating direct and contingent fiscal losses to the government, caused by the ill-managed SOEs. In line with this commitment, the Cabinet Committee on Privatization (CCOP), on October 3, 2013, approved a priority list of 31 SOEs – out of the Council of Common Interest (CCI)'s approved list of 65 SOEs – to be taken up for privatization. Besides Pakistan International Airlines (PIA), the list includes power generation and distribution companies, energy (exploration and distribution) companies, banks, etc. The preamble to the list states that the restructuring in preparation for privatization of PIA, Pakistan Steel Mills, and Pakistan Railways will proceed under the supervision of the Cabinet Committee on Restructuring (CCOR). As for other SOEs, especially the blue chip companies, the government plans for block sales, secondary public offerings for institutional investors and the general public, or international listings.

In line with the commitment of the current government, the Securities and Exchange Commission of Pakistan has also organized a number of workshops and conferences on corporate governance in SOEs. These workshops have focused on training managers of local SOEs on international best practices. The government has also initiated the process for reconstituting the boards of selective SOEs

Annex 1: World Bank Support to Pakistan

Table A1: FY2014 Pipeline (updated February 25, 2014)

Project Name	Total Commitment (US\$ m)	Status of Preparation	
Federal			
1	Dasu Hydropower Stage 1 Project	700	Going to the Board on May 29, 2014
2	Power Sector Reform DPC	500	Going to the Board on May 1, 2014
3	PK Growth, Investment &	500	Going to the Board on May 1, 2014
4	CASA 1000	40	Going to the Board on March 27, 2014
Federal Total		1740	
Punjab			
5	Punjab Public Management Reform	50	Signed and Effective
Punjab Total		50	
IDA Total		1790	
KP/FATA			
6	MDTF-KP Emergency Roads	9.1	Signed and Effective
7	MDTF-KP Emergency Roads	7.8	Going to the Board on March 31, 2014
KP/FATA Total (MTDF)		16.9	
Total FY14		1,806.9	

Annex 2: Pakistan Data Sheet

Selected Economic Indicators									
Key Summary Indicators	/1	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14*
Real GDP growth		5.5	5.0	0.4	2.6	3.7	4.4	3.6	3.6
Fiscal Balance as percent of GDP (excluding grants)		-4.1	-7.3	-5.2	-6.2	-6.5	-6.8*	-8.0	-5.8
Current Account Balance as percent of GDP		-4.5	-8.2	-5.5	-2.2	0.1	-2.1	-1.0	-1.0
Inflation (Year Average)		7.8	12.0	17.0	10.1	13.7	11.0	7.4	10.0
Foreign Reserves, Exchange Rate, and Spreads		30-Jun-13	12-Feb-14	19-Feb-14	26-Feb-14	5-Mar-14	12-Mar-14	19-Mar-14	26-Mar-14
Official Foreign Exchange Reserves (FER) in US\$ million	/2	6,047	3,293	3,959	4,086	3,995	4,999	4,525	4,961
Official Reserve's import coverage in months of imports	/3/4	1.3	0.7	0.9	0.9	0.9	1.1	1.0	1.1
Nominal Rupee-Dollar exchange rate (Interbank average)		99.1	105.4	104.9	105.0	104.6	98.4	98.3	98.1
Appreciation(+)/depreciation(-) since 30-June-2013			-5.9	-5.5	-5.6	-5.3	0.7	0.8	1.1
6-month forward spread on Exchange Rate (basis points)		310	318	326	311	330	294	283	286
6-month KIBOR rate (% p.a.)	/5	9.09	10.16	10.16	10.13	10.15	10.1	10.1	10.14
Karachi Stock Exchange-100 Index		21,006	26,677	25,687	25,501	26,522	27,115	27,259	26,822
Balance of Payment (US\$ million)		Jul-Jun	Jul-Jun	Jul-Feb	Jul-Feb	Jul-Feb	Jul-Feb	Jul-Feb	Jul-Feb
		2011/12	2012/13	2011/12	2012/13	2013/14	2011/12	2012/13	2013/14
a. Current Account		-4,658	-2,496	-3,235	-831	-2,020			
Current account balance (% of GDP)		-2.1	-1.1	-1.4	-0.4	-0.9			
Trade Balance		-15,765	-15,431	-10,981	-10,434	-10,907	49.4	-5.0	4.5
Exports		24,696	24,795	16,195	16,162	16,762	5.1	-0.2	3.7
Imports		40,461	40,226	27,176	26,596	27,669	19.4	-2.1	4.0
Workers' remittances		13,186	13,922	8,593	9,235	10,246	23.4	7.5	10.9
b. Capital & Financial Account		1,463	813	704	54	1,293	-55.4	-92.3	2294.4
of which Net Foreign direct investment		744	1,258	503	452	513	-50.3	-10.1	13.5
Overall balance		-3,275	-1,992	-2,627	-1,078	-1,078			
External Debt Amortization (US\$ million)		Jun-13	Aug-13	Sep-13	Oct-13	Nov-13	Dec-13	Jan-14	Feb-14
		441	821	445	294	1,012	642	156	449
Sovereign Bond Interest Rate Spreads (bps over US T-Bills)		Jun-13	Sep-13	Oct-13	Nov-13	Dec-13	Jan-14	Feb-14	Mar-14
Pakistan		694	667	613	604	618	578	546	468
Sri Lanka		441	496	429	463	456	442	404	350
Argentina		1,204	1,069	926	819	804	927	970	892
Monetary and Credit Aggregates (Cumulative flow in Rs billion)		2012/13	From July 1, 2013						
			31-Jan-14	7-Feb-14	14-Feb-14	21-Feb-14	28-Feb-14	7-Mar-14	14-Mar-14
Broad money (M2)		1217.1	392.5	382.0	444.1	433.2	455.9	502.9	519.0
(Year-on-Year growth)		15.9	12.6	12.0	12.7	13.1	13.1	12.9	13.1
Reserve money		347.4	209.4	265.9	224.3	286.2	213.5	247.4	236.2
Net government borrowing from SBP		506.8	431.3	597.8	565.9	717.2	185.7	502.5	523.2
Net government borrowing from scheduled banks		939.6	53.6	-29.2	6.1	-184.9	306.5	36.6	38.7
Credit to private sector		-19.0	299.0	273.0	286.1	280.7	298.5	285.7	292.9
(Year-on-Year growth)		-0.6	4.9	4.1	4.3	4.4	4.8	4.5	4.6
Credit to public sector enterprises		30.9	66.0	54.6	58.3	58.1	68.3	65.1	71.2
Treasury Bill Auction		30-Jun-13	24-Dec-13	8-Jan-14	22-Jan-14	6-Feb-14	19-Feb-14	5-Mar-14	19-Mar-14
6-month T-bill weighted avg. yield (percent/p.a.)		8.92	9.98	9.95	9.98	9.98	9.98	9.98	9.98
Inflation and Large Scale Manufacturing		Jun-13	Aug-13	Sep-13	Oct-13	Nov-13	Dec-13	Jan-14	Feb-14
CPI inflation (Year-on-Year)		5.9	8.5	7.4	9.1	10.9	9.2	7.9	7.9
CPI inflation, 12-month moving average		7.4	7.2	7.1	7.2	7.6	7.7	7.7	7.7
CPI Inflation, monthly		0.7	1.2	-0.3	2.0	1.3	-1.3	0.5	-0.3
Quantum Index of Large Scale Manufacturing (YoY growth)		6.1	4.5	11.1	4.6	2.5	13.2	2.6	n/a
Fiscal Data (Rs billion)		Budget 2013/14	Upto Q4-2011/12	Q1-2012/13	Upto Q2-2012/13	Upto Q3-2012/13	Upto Q4-2012/13	Q1-2013/14	Upto Q2-2013/14
Fiscal Deficit (excluding grants)		1,650	1,370	284	625	1,046	1,834	287	540
Fiscal Deficit as % of GDP		6.3	6.8*	1.2	2.6	4.4	8.0	1.1	2.1
Total Revenue		3,675	2,567	692	1,462	2,125	2,982	830	1,685
Tax Revenues		2,826	2,053	451	1,013	1,528	2,199	537	1,172
FBR		2,475	1,946	400	883	1,335	1,936	469	1,031
Non-tax revenue		849	514	241	449	597	783	293	513
Total Expenditures		5,325	3,936	976	2,087	3,171	4,816	1,117	2,225
Current expenditure		3,948	3,123	812	1,722	2,642	3,660	868	1,888
of which Interest payments		1,154	889	313	553	772	991	301	598
Development Expenditure		1,377	744	75	278	446	1,140	170	326
Debt and Non-Performing Loans (stock)		2010/11	Upto Q4-2011/12	Q1-2012/13	Upto Q2-2012/13	Upto Q3-2012/13	Upto Q4-2012/13	Q1-2013/14	Upto Q2-2013/14
Gross Public Debt as Percent of GDP	/6	59.4	63.7	58.2	58.8	60.1	63.0	59.1	58.9
Domestic Debt as Percent of GDP		32.9	38.0	35.4	36.4	38.4	41.6	38.8	39.1
Foreign Currency Public Debt as Percent of GDP		26.5	25.7	22.8	22.4	21.7	21.4	20.2	19.8
Foreign Currency Public Debt Service as percent of exports		13.1	15.1	16.4	22.0	22.2	23.2	26.0	28.8
Domestic Debt Rs. Billion		6,012	7,638	8,120	8,329	8,801	9,521	10,155	10,228
Domestic Debt Service as percent of revenues		28.0	32.0	43.3	34.7	34.1	30.9	34.5	33.2
Non-Performing Loans as percent of Total Loans (All Banks)		15.3	15.9	15.5	14.5	14.7	14.8	14.3	13.0
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 lending.									
6/ Gross Public debt ratio for 2010/11 reported in CPS Progress Report was 59.7 percent of GDP and did not include Central Bank Deposits.									
* Excludes one off payment of Rs391 billion (1.95% of GDP) for settlement of circular debt and commodity finance in November 2011.		P: Projections							