ECONOMIC ANALYSIS (SUMMARY)[1]

1. Economic Structure

1. Pakistan is located in southern Asia, and borders Afghanistan, the People's Republic of China, India and Iran, with about 1,000 kilometers of coastline along the Gulf of Oman and the Arabian Sea. It has substantial natural resources (e.g. natural gas, coal, hydropower, and minerals); fertile land in a variety of climatic zones; rich biodiversity; and a young population, with the potential for rapid and sustained development.

2. An economic transformation from agriculture to higher-productivity industry and services has not occurred.[2] Between 1990 and 2014, the share of both agriculture and industry in output declined by about 5 percentage points each, with a corresponding increase in services.[3] In fiscal year (FY) 2014, agriculture accounted for 21.2% of gross domestic product (GDP) and 44% of employment;[4] livestock accounts for over half of agricultural production. In FY2014, manufacturing accounted for 13.4% of GDP and 14% of employment, comprising mainly textiles, as well as agro-processing, cement, and chemicals. The services sector accounts for 58.4% of GDP, led by wholesale and retail trade, transport, storage and communications. The informal economy is large.[5]

3. Exports are concentrated in textiles (accounting for 54% of export receipts in FY2014) and primary agricultural products (17%).[6] The country is a major exporter of rice and cotton. It has significant potential to produce and export other agricultural products (such as fruit, vegetables, and livestock); minerals (including copper, gold, lead, zinc, coal, industrial stones and quality gemstones); manufactured goods (including agro-processing, higher-value textiles, sporting goods, and surgical instruments); and services (such as information technology). The country is heavily dependent on hydrocarbon imports—oil accounts for over one third of total imports—exposing the country to periodic oil price spikes. Workers' remittances rose to $15.8 billion (6.5% of GDP) in FY2014, double the level in FY2009, and are a key source of foreign exchange earnings.

2. Economic Performance

4. The economy has stabilized following macroeconomic imbalances during FY2010–FY2013, which were marked by large fiscal deficits, higher average inflation, and declining foreign exchange reserves. The Pakistan Muslim League-Nawaz government that took office in June 2013 signaled that restoring macroeconomic stability and growth was a high priority for the

[1] This summary is based on various reports cited below, as well as the Pakistan chapter of ADB. 2015. *Asian Development Outlook 2015*. Manila. http://www.adb.org.

[2] ADB. 2013. *Key Indicators: Asia's Economic Transformation: Where to, How, and How Fast?* Manila, and R. Amjad. 2013. *Economic Management under Musharraf and Coalition Rule: Key Lessons for Sustainable Growth*, in R. Amjad and S. Burki, eds. 2013. *Pakistan: Moving the Economy Forward*. Lahore: Lahore School of Economics.

[3] In FY2014, the composition of industry was manufacturing (13.4% of GDP), mining (2.9%), electricity and gas (1.7%), and construction (2.4%).

[4] Ministry of Finance. 2014. *Pakistan Economic Survey 2013-14*. Islamabad.

[5] Estimates of the size of the informal economy in Pakistan range from 35% to 90% of the formal economy in the 2000s. M. Arby, M. Malik, and M. Hanif. 2010. *The Size of the Informal Economy in Pakistan*. Karachi: State Bank of Pakistan Working Paper; and M. Kemal and A. Qasim. Undated. *Precise Estimates of the Informal Economy*. Islamabad: Pakistan Institute of Development Economics.

[6] The country's share of world exports fell from 0.16% in 1990 to 0.13% in 2014; in comparison, during the same period, India's share more than tripled and Bangladesh's quadrupled. World Trade Organization database. http://stat.wto.org/CountryProfile/WSDBCountryPFHome.aspx (accessed 21 April 2015); H. Ahmed et al. 2013. Exports: Lessons from the Past and the Way Forward in R. Amjad and S. Burki, eds. (footnote 2, above); and Planning Commission. 2011. *Pakistan: Framework for Economic Growth*. Islamabad.

next 5 years. The government entered into a $6.7 billion 3-year International Monetary Fund Extended Fund Facility arrangement in September 2013.

5. **Economic growth.** Growth has been volatile, falling from a recent peak of 9% in FY2005 to a low of 0.4% in FY2009, when it was affected by the global financial crisis, before recovering gradually to 4.0% in FY2014.[7] During FY2010–FY2014, the average annual growth rate was 3.5% compared with 5.1% in FY2005–FY2009 and 6.3% in FY2005–FY2008.[8] The lower average rate of growth in FY2010–FY2014 reflected more intense energy shortages, declining external inflows, higher food and oil prices in FY2011, floods in 2010 and 2011, the residual impact of the 2008 global financial crisis, and domestic security challenges.

6. Growth is largely consumption-driven. The gross national saving rate was 13.7% of GDP in FY2014, due in part to the increase in workers' remittances. The gross domestic saving rate is low relative to the country's regional peers.[9] Gross fixed investment declined from 14.2% in FY2010 to 13.4% in FY2014, reducing economic capacity and the prospects for faster growth.[10] Private fixed investment fell from 10.5% of GDP in FY2010 to 10.0% in FY2014, reflecting weaker investment in manufacturing as a result of intensifying power shortages and weakening confidence in the country's economic prospects. Lack of investment contributed to weakening competitiveness: Pakistan ranked 129 out of 144 countries in the Global Competitiveness Index 2014–2015, compared with 101 out of 134 countries in 2008–2009. This is lower than Bangladesh (109), India (79), and Nepal (102).[11]

7. **Inflation.** The rise in international commodity prices in FY2008 was largely responsible for a sharp increase in inflation to 20.8% in FY2009. Inflation declined to an average 8.6% in FY2014, following some volatility owing in part to increased government borrowing from the banking system, including the central bank, the State Bank of Pakistan (SBP). Average inflation decelerated sharply to 4.5% in FY2015 reflecting a significant slowing in the increase in food prices (38% of the consumer price index basket) and a decline in oil prices. The prospects of moderate inflation prompted the SBP to reduce the policy rate by a cumulative 300 basis points to 7.0% during November 2014–May 2015.

8. **Fiscal deficit.** The consolidated government budget deficit was 5.5% of GDP in FY2014, down from an average 7.4% over FY2010–FY2013.[12] The improvement resulted mainly from higher nontax revenues and lower-than-targeted development spending. Fiscal spending increased in FY2010–FY2013 with the persistent need to finance rising energy sector subsidies, losses incurred by public sector enterprises (PSEs), reconstruction after the 2010 floods, and high expenditures for security.[13] Subsidies, mainly for the power sector, averaged 2.1% of GDP in FY2010–FY2013 before falling to 1.3% of GDP in FY2014. With higher borrowing, interest payments reached 4.5% of GDP in FY2014. During FY2010–2014, development spending, including net lending, for provinces and the federal government averaged only 4.2% of GDP, implying that the escalating deficits were to a large extent driven by current expenditures. Federal tax revenues during FY2010–FY2014 were 9%–10% of GDP, partly because of exemptions and concessions granted on an ad hoc basis under statutory

[7] Provisional data suggest that growth increased further to 4.2% in FY2015, the fastest rate since FY2009.
[8] Country and Portfolio Indicators (accessible from the list of linked documents in Appendix 2).
[9] The gross domestic saving rate was 8% of GDP in FY2013, compared with more than 20% in Bangladesh, India, and Sri Lanka. ADB. 2014. *Key Indicators for Asia and the Pacific 2014*. Manila.
[10] Gross domestic investment, which includes changes in inventories, is higher by 1.6% of GDP over FY2010–FY2014.
[11] World Economic Forum. *The Global Competitiveness Report*. Geneva. Pakistan's competitiveness score fell from 3.65 in 2008–2009 to 3.42 in 2014–2015.
[12] The fiscal deficit is officially estimated to have fallen further to 5% of GDP in FY2015.
[13] PSEs are present in infrastructure services, oil, gas, mining, financial services, and manufacturing.

regulatory orders, and partly because of noncompliance with tax legislation. Less than 800,000 people pay income tax, out of a population of 188 million.[14]

9. Fiscal deficits during FY2010–FY2013 were financed mostly from domestic sources as external inflows slowed. Inflows—from bilateral and multilateral creditors, privatization receipts, issuance of Eurobonds, and sales of 3G and 4G licenses—increased in FY2014 as a result of the economic reform program. Net government budgetary borrowing from the SBP was 25% of total domestic credit in FY2014, largely unchanged from 24% in FY2009. However, net borrowing from commercial banks during the same period rose from 11% to 33%, with a corresponding decline in the private sector's share of domestic credit from 63% (22% of GDP) in FY2009 to 40% (15% of GDP) in FY2014. In FY2014 total public debt (two-thirds of which was domestic debt) was 64% of GDP, above the 60% limit set in Pakistan's Fiscal Responsibility and Debt Limitation Act, 2005.

10. Public sector dissaving contributed to a low domestic saving rate. However, as a result of workers' remittances and weak investment, the external current account deficit averaged a modest 1.3% of GDP during FY2010–FY2014, lower than the 4.7% of GDP in the previous 5 years. Export receipts, which temporarily rose 28.9% in nominal US dollar terms boosted by the doubling of cotton prices in FY2011, declined by an average 0.3% in FY2012–FY2014, due in part to the impact of energy outages on key export sectors, anti-export bias in trade policy, and a stronger real effective exchange rate, which strengthened by 14% between the end of FY2009 and the end of FY2014.[15]

11. The overall balance of payments deteriorated, partly reflecting the fall in net foreign direct investment flows from a high of $5.4 billion in FY2008 to an average of $1.5 billion in FY2010–FY2014, and repayments to the International Monetary Fund for the FY2009 standby arrangement. As the authorities attempted to stem the consequent depreciation of the rupee, official foreign exchange reserves fell to $6.0 billion at the end of FY2013, equal to about 1.5 months of imports. Subsequent improvement in external inflows contributed to a recovery in foreign exchange reserves to $9.1 billion by the end of FY2014 (2.2 months of imports) and $13.1 billion by end-June 2015.

12. **Population.** Pakistan's population is growing at around 2% annually. It is young, with a median age of 22. The working-age population has been rising by about 3.5% a year, from 52.6% of the population in 1990 to 61.7% in 2013.[16] The youth workforce is growing by 4.3% annually, compared to an average of 2.7% in South Asia. The economy has not been able to create sufficient jobs for the labor force in recent years, as reflected in the stagnant employment–population ratio of around 50% during FY2006-FY2013, and a rise in the unemployment rate from 5% in FY2008 to 6% in FY2013.[17] Youth (aged 15–24 years) employment declined from a high of 42% in FY2006 to 39% in FY2013. Women's share of employment is rising, but accounted for just 22% in FY2013. About 60% of the total workforce employed consists of own-account workers or contributing family workers, reflecting a high degree of informality in the economy and thus vulnerability to unemployment and poverty.

[14] Sustainable Development Policy Institute. 2013. *Reforming Tax System in Pakistan*. Draft.

[15] The trade regime was significantly liberalized during 1997–2003 with simplification of and steep cuts in import tariffs. These policies were reversed in 2008 as the external current account worsened during the global financial crisis. Maximum tariff rates were raised, the number of tariff slabs was increased from four to nine, and ad hoc exemptions were provided through statutory regulatory orders, thereby increasing the dispersion and complexity of import tariffs, accentuating the anti-export bias, distorting incentives, providing opportunities for rent seeking, and likely deterring trade. Planning Commission 2011. *Framework for Economic Growth*. Islamabad.

[16] World Bank. World Development Indicators Online (accessed 22 December 2014); World Bank. 2014. Pakistan: Country Development Landscape. Working paper.

[17] Pakistan Bureau of Statistics. 2013. *Pakistan Employment Trends 2013*. Islamabad. "Vulnerable employment" is defined as "own-account workers" and "contributing family workers".

3. Inclusive Economic Growth

13. Growth has historically been pro-poor in Pakistan.[18] Poverty rates declined (i) by 12.1 percentage points to 22.3% during FY2001–FY2006, when GDP grew 5.1% on average annually; and (ii) by 9.9 percentage points to 12.4% during FY2006–FY2011, when average growth was 3.8%. The significant decline in poverty in the latter period also reflects a faster rise in workers' remittances, higher support prices for key agricultural commodities, and the initiation (in FY2009) of the Benazir Income Support Program, a nationwide targeted cash transfer program.[19] Although poverty has declined across the regions, poverty incidence in rural areas is twice that in urban areas, and in Balochistan it is higher than in Khyber Pakhtunkhwa, Sindh and Punjab.

14. Estimates of overall inequality vary little over time, suggesting that growth has been inclusive. The Gini coefficient was a relatively low 0.30 in FY2011, down from 0.33 in FY1991. The ratios of shares of consumption expenditures by the richest 20% to those of the poorest 20% declined from 4.8 to 4.5 from FY2008 to FY2014. The generally favorable trend in poverty and inequality, however, masks underlying weaknesses. About half of the population lives on $2 per day (based on 2005 purchasing power parity), as also suggested by the high share of vulnerable workers in total employment.

15. Non-income poverty and inequality have also declined, although the progress is slow and many of the Millennium Development Goals are unlikely to be met by 2015.[20] Literacy rates rose from 47% in FY2000 to 58% in FY2014, but rates for females are substantially less than those for males. Education spending reached a high of 2.8% of GDP in FY2008 and subsequently fell to 2.1% of GDP in FY2012, lower than the level in early 1990s and compared with 3% of GDP in countries such as India and Indonesia; this likely reflects the fiscal pressures that have constrained public investment generally.[21] Total spending on health was 2.5% of GDP in FY2011, of which 0.7% of GDP was public expenditures.[22]

16. Pakistan's infrastructure services have deteriorated.[23] In the 1990s, per capita electricity consumption was ahead of that in South Asia, but it has fallen significantly behind since 2007, with frequent power outages. As of 2011, an estimated 68.6% of the population had access to electricity, with access in urban areas substantially higher (90%) than in rural areas (55%).[24] The supply of electricity has not kept pace with demand, leading to a shortage of 4000–5000 megawatts during peak periods. Load shedding reaches 8–12 hours per day in urban areas, and more in rural areas, disrupting production.[25] Pakistan is ahead of the South Asian average in the share of paved roads, but the share has been stagnant since 2009. Lack of funds for operation and maintenance of roads has led to premature deterioration of the road network, with only 56% of national highways in good or fair condition. In cities, development of mass transit,

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[18] According to one estimate, the growth elasticity of poverty in Pakistan during 1987–2008 was –2.2, compared with a mean elasticity in sample countries of –0.7. This suggests that a 1% increase in GDP per capita reduces poverty by 2.2%. J. Newman. 2013. *Recovering Strong Positive Trends in Poverty and Opportunity*, in R. Benmessaoud, et.al. 2013. *Pakistan: The Transformative Path*. Washington D.C.: The World Bank.
[19] Poverty Analysis (accessible from the list of linked documents in Appendix 2).
[20] *Country and Portfolio Indicators* (accessible from the list of linked documents in Appendix 2).
[21] World Bank. *World Development Indicators Online*. Accessed 22 December 2014.
[22] In comparison, the total spending was 3.9% of GDP in India and 2.7% in Indonesia.
[23] Sector Assessment Summaries for Agriculture, Natural Resources and Rural Development; Energy; Transport; Water and Other Urban Infrastructure Services (accessible from the list of linked documents in Appendix 2 of the CPS main text).
[24] ADB. 2014. *Framework of Inclusive Growth Indicators*. Manila.
[25] Load shedding is estimated to cut GDP growth by 2 percentage points annually. Institute of Public Policy. 2013. *State of the Economy 2013: From Survival to Revival*. Lahore: Government of Pakistan Ministry of Finance. *Economic Survey 2012-13*. Islamabad. Government of Pakistan Planning Commission. 2013. *Annual Plan 2013-14*. Islamabad.

on which the poorer segments of the society rely, is at a nascent stage. An estimated 30% of agricultural output is wasted due to inefficient farm-to-market channels, lack of cold storage facilities and an obsolete trucking fleet.[26]

17. Inadequate investment in irrigation and poor management of water resources have contributed to low productivity in agriculture, which accounts for 75% of female employment. Irrigation efficiency is low (40%); this impedes agricultural productivity and output, and limits opportunities for, and increases the vulnerability of, some of the poorest people who rely on farming in *barani* (rain-fed) areas. Overall access to an “improved” water supply appears high, but water supply quality remains poor, with intermittent provision, inadequate quality of drinking water, and limited wastewater treatment that contributes to outbreaks of waterborne diseases. Access to sanitation is low.

18. The number of commercial bank depositors has increased gradually, but remains low, suggesting weak penetration of financial services. Just over 10% of the adult population in Pakistan, and only 3% of women, has an account at a formal financial institution.[27] The financial system is shallow and intermediation to facilitate the access to, and efficient use, of domestic capital is weak. Pakistan has the lowest private sector credit to GDP ratio and the lowest share of broad money (M2) in GDP among major emerging economies (footnote 26). Credit to small and medium-sized enterprises (SMEs) comprised just over 6% of total loans at the end of 2013.[28]

4. Main Constraints to Inclusive Economic Growth

19. The main challenge to poverty reduction is attaining a high, sustained rate of economic growth to provide productive jobs for the labor force, which is growing by about 3.5% annually. Although past economic growth has been pro-poor, a sustainable reduction in poverty will depend on equitable access to infrastructure and social services to ensure that the relatively disadvantaged groups have the opportunity to participate in growth. Half the population is either in, or vulnerable to, poverty and the country is exposed to economic shocks (e.g. through natural hazard-related disasters), making an adequate safety net important for vulnerable people in the event of such shocks.

20. With an employment elasticity of GDP growth estimated to be around 0.5, economic growth of at least 7% is required to provide sufficient jobs (footnote 26). Major constraints to achieving such growth include macroeconomic instability, lagging infrastructure and connectivity, inadequate skills of the labor force and poor health services, deficient governance and institutions, limited access to finance, and domestic security challenges.[29] These constraints manifest themselves in a poor business climate; low rates of domestic saving and investment; suppressed competitiveness; inadequate diversification of the economy; lackluster performance of exports, which are concentrated in few products; poor public service delivery; and increased vulnerability of the population to poverty and deprivation.

21. Factors undermining macroeconomic stability include large fiscal deficits. With indirect taxes comprising 65% of total tax revenues in FY2014, the tax system is regressive. Tax exemptions contribute to high deficits, distort incentives and increase opportunities for rent

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[26] Planning Commission. 2011. *Pakistan: Framework for Economic Growth*. Islamabad.
[27] Sector Assessment Summary (Finance) (accessible from the list of linked documents in Appendix 2 of the CPS main text).
[28] State Bank of Pakistan. 2013. *Quarterly Compendium: Statistics of the Banking System.* http://www.sbp.org.pk/ecodata/fsi/qc/2013/Dec.pdf.
[29] Footnotes 2 and 26 (above); World Bank. 2013. *Country Economic Memorandum: Pakistan -- Finding the Path to Job-Enhancing Growth.* Washington DC.

seeking. Large fiscal deficits have led to increased borrowing from the SBP, and commercial banks, contributing to the risk of inflation, potential crowding out of the private sector, a low domestic saving rate, larger public debt, and a higher country risk premium.

22. Pakistan's relatively slow progress in human development retards the acquisition and use of knowledge and skills, and its ability to compete in global markets and transition to products with greater value. Poor human development indicators reflect insufficient funding and inadequate governance. Constrained domestic public resources and governance challenges also mean that infrastructure services fall short of demand—most obviously energy, but this is true of other infrastructure sectors as well—thus increasing operational costs for businesses and reducing access by the general public to key services.[30] Poor public provision of infrastructure and social services is likely to affect the relatively poorer segments of society disproportionately, as they have fewer alternatives.

23. The lack of depth in the financial system reflects (i) the dominance of banks, (ii) large public sector borrowing requirements, (iii) the preference of banks to hold relatively risk-free government securities, and (iv) risk perceptions of lending to SMEs. Development of conventional bond and *Sukuk*[31] markets to provide long-term finance for infrastructure projects and increased access to finance by SMEs will be necessary in order to mobilize savings and investment.

24. Governance challenges cut across all sectors and are key impediments to private sector development and effective public service delivery. For example, the operational losses in some major PSEs and guarantees provided to them contribute to fiscal weakness by diverting resources from spending that is more socially productive. Preferential access to credit and inputs by PSEs disadvantages private firms where these coexist. Inefficiencies in PSE production of key inputs used in downstream industries raises costs in these industries.

25. Fiscal decentralization under the 18th amendment of the constitution in 2010 raised the prospect of better public service delivery, but also brought challenges in terms of (i) coordination among federal and provincial entities, (ii) inadequate capacity at local levels, and (iii) the need to match devolution of functions with revenues. Unpredictable trade and investment policies, bureaucratic delays, and inconsistent implementation in the context of decentralization also serves to mute private sector development, especially that of SMEs, because smaller firms have fewer resources to mitigate their effects, and are encouraged to move from the formal to the informal economy.[32]

5. Economic prospects

26. In the short-term, economic growth will likely remain in the 4%–5% range as the government continues fiscal consolidation and seeks to increase foreign exchange reserves. Net oil imports account for 5% of GDP, and the fall in global oil prices that began in mid-2014 should provide significant benefits in the form of improved terms of trade, lower imports, contained inflation, and greater policy flexibility (e.g., on electricity tariffs and subsidies). Over the medium to longer term, achieving 7% growth will require substantial progress on reforms to

[30] One study estimates that Pakistan requires $116 billion to $165 billion (in 2010 prices) in infrastructure investment during 2010–2020, or 6.6%–9.4% of 2010 GDP per year. L. Andres, D. Biller, and M. Dappe. 2013. *Reducing Poverty by Closing South Asia's Infrastructure Gap*. The World Bank. Washington D.C. (Tables 5 and 6).

[31] *Sukuk* is an Islamic financial certificate or instrument, similar to a conventional bond, which complies with Islamic religious law.

[32] Pakistan ranked 110 out of 189 economies in World Bank. 2013. *Doing Business 2014*. Washington D.C., compared with a rank of 121 for South Asia. It compares well in the overall ease of doing business, but fares worse in key components such as starting a business, registering property, getting electricity, paying taxes, and enforcing contracts.

raise tax revenues; strengthen the energy sector and PSEs; rationalize import tariffs; improve the business climate; and increase the quality and quantity of much-needed investment in education, health, and infrastructure. Risks include the failure to implement reforms, domestic security concerns, political uncertainty, and the effects of natural hazard-related disasters.

27. Economic reforms and an improving security environment should further boost business confidence and foster private investment. The government is moving toward market-based pricing of energy and improved governance of the energy sector. It has begun selling shares of some listed PSEs in capital markets and is prioritizing others for restructuring and possible privatization. It has also started to remove statutory concessions and exemptions, reduce maximum import tariff rates, and institute a simpler tariff system with fewer slabs.

28. Improved irrigation and water supply should boost agricultural productivity. Further progress to reduce energy shortages, reform the tax and tariff systems, and increase investment in transport and connectivity would benefit manufacturing growth. Manufacturing, and especially textiles, also benefit from the Generalized Scheme of Preferences Plus status granted by the European Union as of January 2014. Growth in transport and communication will depend partly on sector reforms, including restructuring of Pakistan Railways and privatization of Pakistan International Airlines. Improved agriculture and manufacturing performance would spur finance, retail and wholesale trade activity.

29. On the demand side, private consumption will likely be supported by the sustained inflow of remittances and better credit availability at banks. Government spending will be contained by fiscal consolidation to reduce the budget deficit. Continuation of economic reforms and higher credit flows to the private sector would benefit private investment.

30. Headline inflation is expected to average around 5% in the near term as a result of the decline in global oil prices. There will be upward pressure on prices over the medium term as a result of the reversion of global oil prices to more normal levels, a likely increase in domestic demand, reforms to align energy prices up to market-determined levels, and initiatives to raise tax revenues. However, the government's plan to increase operational independence of the central bank and not borrow from the central bank to finance fiscal deficits should limit inflation to moderate levels.

31. The current account deficit will likely remain at 1%–3% of GDP in the near to medium term, supported by lower oil prices and workers' remittances. Easing energy shortages, trade policy reforms and more preferential access under the Generalized Scheme of Preferences Plus should support exports. Imports may rise with stronger investment. The current account deficit is expected to be financed by somewhat larger flows of private direct and portfolio investment, sustained multilateral and bilateral lending to support the government's economic reform program, and periodic government borrowing from international capital markets.