PAKISTAN DEVELOPMENT UPDATE

MANAGING RISKS FOR SUSTAINED GROWTH

November 2017

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Preface

The objective of this report is to apprise the Government of Pakistan, think-tanks and researchers, the public and The World Bank's senior management of the state of Pakistan's economy, outlook, structural reforms and development challenges. The report begins with a chapter on economic developments, with sections on growth, fiscal policy, public debt, the external sector, and inflation and monetary developments. The second chapter provides a medium-term macroeconomic outlook and describes upcoming challenges, and structural reform needs. The third chapter focuses on progress against social indicators. The final chapter addresses entrepreneurship in Pakistan from the perspectives of jobs, enabling new startup businesses, women's entrepreneurship and export competitiveness.

This update was prepared by the Macroeconomic and Fiscal Management Global Practice under the guidance of Patchamuthu Illangovan (Country Director, SACPK) and Manuela Francisco (Practice Manager, GMF06). Analyses were contributed by: Mehwish Ashraf (Economist, GMF06) who authored the 'Real Sector' and 'Debt and its Dynamics' sections, and contributed to the section on 'Monetary Policy and Inflation'. Adnan Ashraf Ghumman (Economist, GMF06) authored the 'Balance of Payments', the 'Monetary Policy and Inflation', and the 'Outlook' sections. Saadia Refaqat (Senior Economist, GMF06) and Mehwish Ashraf (Economist, GMF06) co-authored the 'Fiscal Accounts' section.

The sections on 'Risks' and 'Progress and Next Steps on Structural Reforms' were written by Enrique Blanco Armas (Lead Country Economist, GMF06). The latter section benefitted from contributions by Irum Touqeer (Public Sector Specialist, GGO18), Muhammad Waheed (Senior Economist, GMF06), Nadia Patrizia Rocha Gaffurri (Senior Economist, GTCTC), Amjad Bashir (Senior Economist, GTCSA), Rafay Khan (Analyst, GTC06), Winston Percy Onipede Cole (Senior Financial Management Specialist, GGO24), and Akmal Minallah (Senior Financial Management Specialist, GGO24). The 'Human Development: Moving the Needle' chapter is a joint effort led by Ali Ansari (Economist, GED06), Ali Nadeem Qureshi (Social Protection Specialist, GSP06), and Cristina Isabel Panasco Santos (Program Leader, SACPK), with input from Uzma Quresh (Social Development Specialist, GSU06), Muhammad Ali (Consultant, GWA09), and Silvia Redaelli (Senior Economist, GPV06). The same team also provided the social indicators data reported in Annex 1. The box on 'Dynamics of Low Savings in Pakistan' was contributed by Mehwish Ashraf (Economist, GMF06), the box on 'Exchange Rate Management in Pakistan' was authored by Adnan Ashraf Ghumman (Economist, GMF06), and the box on 'Doing Business Reforms in Pakistan' was contributed by Amjad Bashir (Senior Economist, GTCSA).

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GTC06). Qursum Qasim (Young Professional, GTCIE) and Komal Mohindra (Senior Private Sector Specialist, GTCIE) wrote the special section on 'Catalyzing Women's Growth Entrepreneurship in Pakistan's Cities: Data from Karachi and Lahore'. The note on 'Entrepreneurship in Pakistan: A 360-Degree Analysis' was contributed by Kulsoom Lakhani (Consultant).

Mehreen Saeed (Communications Officer, SAREC) provided valuable communications support to the team. Maheen Pracha (Consultant) provided editorial input. Kayhan Suleman (Consultant) developed HD-related infographics and designed the report. Mohammad Aslam Malik (Program Assistant, SACPK) provided helpful administrative support. The report benefitted from comments provided by Manuela Francisco (Practice Manager, GMF06) and Enrique Blanco Armas (Lead Country Economist, GMF06). The overall effort was led by Saadia Refaqat (Senior Economist, GMF06), with assistance from Aban Haq (Consultant).

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Acronyms and Abbreviations

CPEC	China-Pakistan Economic Corridor
CPI	Consumer Price Index
CRR	Cash Reserve Requirement
CSF	Coalition Support Fund
DB	Doing Business
FBR	Federal Board of Revenue
FDI	Foreign Direct Investment
FED	Federal Excise Duty
FRDL	Fiscal Responsibility and Debt Limitation (Act)
FY	Fiscal Year
GBP	British Pound
GCC	Gulf Cooperation Council
GDP	Gross Domestic Product
GEM	Global Entrepreneurship Monitor
GoP	Government of Pakistan
HIES	Household Integrated Economic Survey
HSD	High-Speed Diesel
IT	Information Technology
KP	Khyber Pakhtunkhwa
LFS	Labor Force Survey
LHV	Lady Health Visitor
LNG	Liquefied Natural Gas
LSM	Large-Scale Manufacturing
M2	Broad Money
MICS	Multiple Indicator Cluster Survey
m-o-m	Month-on-Month
MRTB	Market-Related Treasury Bill
MTB	Market Treasury Bill
NDA	Net Domestic Assets
NFC	National Finance Commission
NFNE	Non-Food, Non-Energy
NSS	National Savings Schemes
OCAC	Oil Companies Advisory Council
OECD	Organization for Economic Co-operation and Development
PIA	Pakistan International Airlines
PIB	Pakistan Investment Bond
PFM	Public Financial Management
PKR	Pakistani Rupee
POL	Petroleum, Oil and Lubricants
PPG	Public and Publicly Guaranteed
PRSP	Poverty Reduction Strategy Paper
PSDP	Public Sector Development Program
PSE	Public Sector Enterprise
PSLM	Pakistan Social and Living Standards Measurement (Survey)
PSPC	Pakistan Security Printing Corporation
PTA	Pakistan Telecommunication Authority
REER	Real Effective Exchange Rate
RM	Reserve Money
Rs.	Pakistani Rupees
SBP	State Bank of Pakistan
SCRR	Special Cash Reserve Requirement
SDG	Sustainable Development Goal
SME	Small or Medium Enterprise
SOE	State-Owned Enterprise
SPR	School Participation Rate
SRO	Statutory Regulatory Order
UIS	UNESCO Institute for Statistics
UK	United Kingdom
UNCTAD	United Nations Conference on Trade and Development
UNESCO	United Nations Educational, Scientific and Cultural Organization
US	United States
US$	United States Dollar
VCF	Venture Capital Fund
WAPDA	Water and Power Development Authority
WBG	World Bank Group
WDI	World Development Indicators
WHT	Withholding Tax
WITS	World Integrated Trade Solutions
WTO	World Trade Organization
y-o-y	Year-on-Year

Executive Summary

Pakistan's growth stayed strong in FY17, but vulnerabilities started to emerge

Pakistan's economic performance remained robust during the fiscal year 2017 (FY17) as growth continued to accelerate, reaching its highest level in the last decade, while inflation stayed well below target. Growing fiscal and external imbalances, however, have eroded the hard-earned gains in restoring macroeconomic stability in the last three years and they could affect the country's growth prospects if not addressed. The fiscal deficit expanded to its highest level during the last three years as revenue mobilization weakened and expenditures rose at both the provincial and federal levels. Simultaneously, the external account deteriorated sharply due to a widening trade deficit and a fall in international remittances.

Strong domestic demand, led by recovery in agriculture and robust services sector, drove growth…

Strong private consumption, recovery in agriculture, and vibrancy in the services sector has resulted in an increase of 0.8 percentage points in gross domestic product (GDP) growth in the last year. However, investment continued to drag, reflecting the long-standing challenge of stimulating investment, especially from the private sector. This year, agricultural performance registered a remarkable turnaround, growing at 3.5 percent compared to last year's growth of 0.3 percent. However, on the supply side, services continue to be the economy's mainstay, with a broad-based growth of 6 percent during the year. See **Section A1** for further discussion of the real sector's performance.

…but fiscal and external pressures grew…

However, as growth picked up, imbalances re-emerged on the internal and external front. On the domestic side, fiscal pressures increased. After having fallen significantly till FY16, the consolidated fiscal deficit widened (excluding grants), reaching 5.8

percent of GDP, compared to 4.6 percent in FY16. A less-than-satisfactory tax collection effort by the center and the provinces, combined with an unprecedented increase in development spending, led to this slide. The provinces have posted fiscal surpluses over the past few years, but these turned into a deficit of 0.5 percentage points of GDP in FY17. On the external side, the current account deficit widened substantially. The trade deficit widened as imports surged and exports declined marginally. While structural issues have caused a long-term decline in Pakistan's export competitiveness, exchange rate flexibility remains critical to supporting competitiveness. Furthermore, international remittances, which have been resilient to previous international and domestic shocks, declined. As a result, Pakistan's official reserves fell to US$16.2 billion at the end of FY17 compared to a high of US$18.1 billion at the end of FY16 – enough to cover imports for 3.1 months. See **Section A2** for further discussion of fiscal accounts and **A4** for further discussion of the balance of payments.

…while expansion in public debt was marginal…

The public debt stock declined to 68.1 percent of GDP in FY17, compared to 68.6 percent of GDP in FY16, despite an expansion in the fiscal deficit. Favorable currency movement, growth in nominal GDP, and the drawdown of government deposits with the banking sector allowed for this decline. Commercial loans dominated the public external debt borrowing during the year. However, domestic debt composition seems to be undergoing a structural shift, with an increase in the proportion of short-term borrowing. This substitution toward short-term borrowing could pose refinancing and repricing risks. See **Section A3** for details of debt and its dynamics.

…and inflation remained well-anchored despite trending upward

Inflation remained contained, rising moderately in FY17, but staying well below the year's target of 6 percent. An improved domestic supply situation and stable exchange rate helped curtail headline inflation, which was recorded at 4.2 percent during the year. As a result, the State Bank of Pakistan (SBP) kept the policy rate unchanged at 5.75 percent throughout FY17. Encouragingly, private sector credit picked up in FY17 due to the net retirement of government borrowing to scheduled banks and low real interest rates. The credit to the private sector grew by 16.8 percent, expanding by Rs. 748 billion over FY16 levels. The improvement was broad-based in terms of financing instruments, but was concentrated in the manufacturing sector. See **Section A5** for further discussion of monetary policy and inflation.

Pakistan's growth outlook is positive, but contingent on maintaining macroeconomic stability…

Growth is expected to continue accelerating, and reach 5.8 percent in FY19. However, going forward, this momentum is contingent on managing the challenges that have emerged on the external and fiscal fronts. Growth is expected to be driven by public and private consumption, aided by a steady increase in public investment, especially due to projects under the China-Pakistan Economic Corridor (CPEC). On the supply side, growth will likely be supported by services and industry. The wide current account deficit is expected to remain a concern and pressure on international reserves is likely to persist. Similarly, further fiscal consolidation will also remain challenging. The imbalances also make Pakistan more vulnerable to domestic and external shocks, limiting the economy's ability to absorb such shocks. Export competitiveness could be eroded further if the US dollar appreciates and there is limited flexibility in the exchange rate. Thus, a competitive real effective exchange rate (REER), supporting exports and import-competing industries, will contribute to addressing imbalances on the external front. See **Sections B1** and **B2** for discussions of the outlook and risks, respectively.

…and moving forward on the structural reforms agenda to ensure sustainable growth

Short-term measures to recover macroeconomic stability need to be combined with longer-term structural reform efforts. In light of the emerging imbalances, longer-term fiscal and private sector reforms will be critical. Pakistan aims to increase tax collection to 15 percent of GDP by 2020. Reaching this target will require the next level of reforms, which aim to broaden the tax base, increase tax compliance, and reduce administrative and taxpayer compliance costs. Similarly, reforms in tariff rationalization, diversification, and integration with global value chains would need to be reflected in the government's upcoming Strategic Trade Policy Framework (2018–23), responding to the decline in the country's exports. Structural reforms complemented by supportive monetary, fiscal, and financial sector policies will be required to improve the economy's competitiveness. See **Section B3** for further discussion of the status of structural reforms.

Moving the needle on human development is key to inclusive growth

Overall, there has been some improvement in human development indicators since 2010, although inter-provincial, income, and gender disparities remain. In education, there has been progress in terms of school participation at all levels of schooling. However, youth enrollment in higher education and skills training remains very low. In health, indicators such as skilled birth attendance and child immunization rates have improved. However, stunting is chronically high among children under five years of age, with 44 percent in this age group being either severely or moderately stunted. Public financing for the human development sectors (as a percentage of GDP) remains low, especially so in health. In terms of poverty, Pakistan has made substantial progress, reducing its poverty rate from 64.3 percent in 2001 to 29.5 percent in 2013. However, shared prosperity has declined in more recent years, suggesting an uptick in inequality. Water and sanitation infrastructure has also improved since 2010, but a large proportion of the population does not yet have access to piped water at home or toilets linked to a sewage system, which are considered essential factors contributing to the high incidence of stunting. Similarly, in terms of gender, gradual improvements in maternal mortality ratios and adolescent fertility rates are encouraging, but a concerted effort is required to accelerate the pace of these gains. See **Section C** for further discussion of human development indicators.

Growth-oriented entrepreneurship could stimulate job creation for a rapidly growing young population…

Pakistan's working-age population is expected to continue to grow at 2.1 percent per year over the next decade. The country faces the triple challenge of creating enough jobs for this growing population, improving the quality and productivity of jobs, and enhancing access to jobs and economic opportunities for women. Entrepreneurship can play a key role in meeting these job challenges, especially in the small-and-medium enterprise sector. More than a third of those participating in the labor force are self-employed. However, the share of growth-oriented businesses among these is low, as most people opt for self-employment out of 'necessity' rather than 'opportunity'. Most businesses remain small and do not contribute to job creation. Data from the formal private sector in Pakistan suggests that there are significant barriers to growth-oriented entrepreneurship – the kind that could provide more and better employment opportunities to a growing workforce. The investment climate is weak, as reflected in the country's Doing Business (DB) rankings, and most businesses identify corruption, electricity, and tax rates as the top three constraints they face. See **Section D1** for further discussion of jobs and entrepreneurship in Pakistan.

…which requires building a healthy ecosystem for startups in general and women-led businesses in particular

A key driver of growth entrepreneurship is the health of a country's startup ecosystem. 'Startups' or nascent businesses have the potential to introduce innovative ideas into the marketplace, create jobs, and contribute to economic growth. However, the ability of these new firms to grow and survive is contingent on, among other things, the quality of the ecosystem in which they operate. This includes the type of 'support' services available, access to 'finance' and the 'policy' and regulatory environment. Pakistan's startup ecosystem has evolved rapidly in recent years, with substantial growth in the level of support services available to entrepreneurs through business incubators and accelerators, and access to finance through venture capitalists and angel investors. However, these developments are limited to major cities, and several policy bottlenecks remain, making it expensive and difficult for young entrepreneurs to grow their businesses. For women, the challenges of starting and growing a business are especially acute in Pakistan, leading to a very low percentage of women in business. Even women who do run their own businesses tend to be 'necessity entrepreneurs' operating in low-productivity sectors. Converting entrepreneurial potential into jobs and economic growth in the country will thus require policy interventions that support startups in general and women-led businesses in particular. See **Sections D2** and **D3**, respectively, for further discussion of the startup ecosystem and women's entrepreneurship in Pakistan.

Proactive and urgent action is required if exports are to catalyze growth

The loss of export competitiveness has also discouraged entrepreneurship and innovation in outward-oriented sectors in Pakistan. Only 5.5 percent of firms classified as small (5–19 employees) directly export their output, compared to a global average of 8 percent. Similarly, only 12.3 percent of small firms in Pakistan use material/inputs or supplies of foreign origin in their production processes as opposed to a global average of 55 percent, indicating the existence of barriers and informational asymmetries, which prevent small firms from accessing quality inputs at globally competitive prices. While peer countries have managed to diversify their export base, Pakistan's export basket remains concentrated, with the same three exports (cotton manufactures, leather, and rice) making up over 70 percent of total exports for over a decade. Similarly, five markets have historically accounted for over 60 percent of Pakistan's exports. Even in textiles, the country has not managed to break into high-value-added sectors, while production remains cotton-based contrary to the global shift toward synthetic materials. Holistic reforms in trade policy, trade facilitation, logistics, and infrastructure, as well as overarching investment climate reforms are required if the loss of global competitiveness is to be reversed. See **Section D4** for more detail.

A. Economic Update

1. The Real Sector

South Asia is no longer the fastest-growing region in the world

The world economy continues to recover, with global growth accelerating for the fifth consecutive quarter. Despite concerns about a globalization backlash, world trade remains robust and is expected to grow by 2.4 percent this year. Oil prices are slowly rebalancing and – despite prospects of continued monetary policy normalization in the US and the Euro Area – global financing conditions remain benign. The global environment is thus favorable and South Asia is well positioned to take advantage of it. However, it is no longer the fastest-growing region in the world.[1] This is a consequence of the deceleration in India, the region's powerhouse.[2] While growth has accelerated slightly elsewhere in the region, concerns remain. Bangladesh has seen an increase in financial sector risks while, in Pakistan, macroeconomic discipline has weakened. Overall, South Asia has done well on the internal front, with inflation rates declining and staying below target in most countries. Its performance has been less impressive, however, on the external front, with trade and current account deficits increasing in most of the region. From a policy perspective, a major concern across South Asia is the widening of fiscal deficits, which now exceed 5 percent of GDP in most countries in the region.[3]

[1] South Asia has been ranked the fastest-growing region since the second quarter of 2014 (World Bank, South Asia Economic Focus, Fall 2017).
[2] Short-term disruptions related to the introduction of the landmark Goods and Services Tax may explain the steep decline observed in the last quarter, but the deceleration has continued for over a year. Over this period, imports increased sharply while private investment declined.
[3] World Bank, *South Asia Economic Focus*, Fall 2017.

While Pakistan's economy continues to grow, vulnerabilities are emerging

Pakistan's economic growth continued to accelerate amid a supportive domestic and external environment. Key growth drivers included strong consumption, a robust services sector and recovery in agriculture, growth in private sector credit, low interest rates, and relatively stable security. Moreover, foreign direct investment (FDI) increased during FY17 as a result of CPEC projects and other large investments. On the flip side, the current account deficit widened to unprecedented levels, the fiscal deficit widened to 5.8 percent, and remittances declined in contrast to the growth exhibited over the last decade.

FY17 witnessed the highest GDP growth of the decade

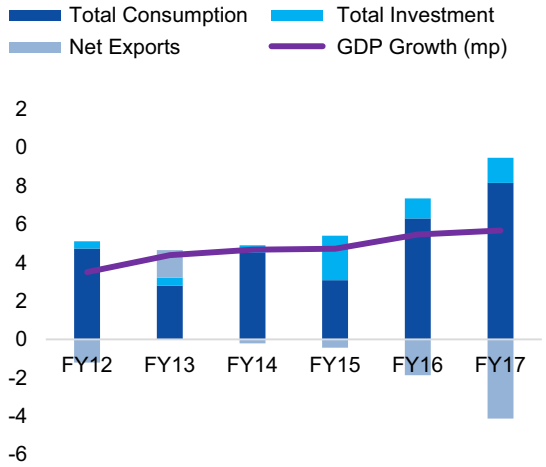
Supported by the factors mentioned above, the GDP growth rate (at factor cost) has increased by 0.8 percentage points over the previous year to reach 5.3 percent in FY17[4]– the highest growth rate in the last decade. Strong growth performance and improved prospects were among the key drivers that led Standard & Poor's to revise Pakistan's rating from *'B–'* to *'B'*[5] and Moody[6] and Fitch[7] to raise the country's economic outlook from *'negative'* to *'stable'*. Its growth performance, however, fell short of the government's target of 5.7 percent for FY17.

On the demand side, growth is driven mostly by consumption

Total consumption expenditure made up almost 92 percent of GDP and contributed nearly eight percentage points toward GDP growth (market prices) (**Figure 1**). Private consumption dominated this category, supported by rising income levels, higher domestic demand, strong growth in the services sector, steady growth in small-scale manufacturing, and recovery in agriculture.

Figure 1: Point contribution to GDP growth – aggregate demand

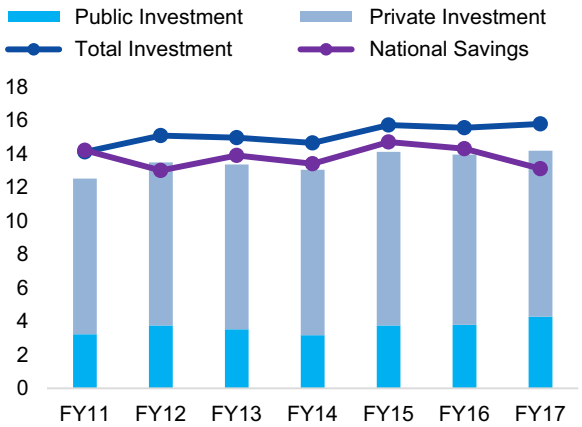
Percent



Note: mp = market prices.
Source: Pakistan Bureau of Statistics.

Figure 2: Savings and investment

Percent of GDP



Note: Total investment does not equal public plus private investment in this figure as the 'change in inventories' is not included. This variable equals 1.6 percent of GDP throughout the period under review.
Source: Pakistan Bureau of Statistics.

Investment continues to drag…

Investment-to-GDP ratio grew marginally from 15.6 percent in FY16 to 15.8 percent in FY17 (**Figure 2**). This was mostly from public investment-to-GDP, which rose from 3.8 percent in FY16 to 4.3 percent in FY17. Nevertheless, overall investment remains sluggish, averaging around 15 percent in the past eight years. Several factors have, historically, been responsible for this and continue to be so, including: (i)

[4] This was slightly higher than the 5.2 percent GDP growth rate projected by the World Bank for FY17.
[5] In October 2016.
[6] In May 2017.
[7] In February 2017.

the volatile security situation in Pakistan, which has only recently started to improve; (ii) a deteriorating business climate; and (iii) energy shortages that prevent full capacity utilization.

…unaided by national savings

The low investment situation was exacerbated by a sustained decline in national savings[8] from 14.2 percent of GDP in FY11 to 13.1 percent in FY17. In the last year alone, savings plummeted by 1.2 percent of GDP. Lower profits on National Savings Schemes (NSS)[9] and the continued imposition of withholding tax (WHT) on financial transactions may have led to this decline. The government needs to encourage savings in the economy to be able to accumulate sustainable levels of fixed capital over the long term (see **Box 1** on the dynamics of savings in Pakistan).

Recovery in agriculture supported supply-side growth

Agriculture (20 percent of GDP) grew by 0.3 percent in FY16 as the cotton crop production fell by almost 30 percent.[10] This year, agriculture turned around, meeting the 3.5 percent target as plantings switched to sugarcane and, combined with sugar reserves and high support prices, translated into positive sugar export prospects[11] (**Figure 3**). Cotton also grew by 7.6 percent despite the falling area under cotton[12], accompanied by a bumper wheat crop of 25.8 million tons.[13] Overall, *important crops*[14] grew at a higher rate than expected – by 4.1 percent compared to a decline of 5.5 percent in FY16. This revival received impetus from enabling key policy measures such as fertilizer subsidy, tax relief measures[15] and better access to credit.[16] *Livestock* grew at the same rate of 3.4 percent as last year, *cotton ginning* at 5.6 percent (–22 percent in FY16), and *forestry* at 14.5 percent (14.3 percent in FY16), while *fishing* fell by 2 percentage points to 1.2 percent in FY17.

Industry continues to grow, though the momentum has slowed down

The industry sector (20 percent of GDP) grew by 5 percent, at a lower rate than the 7.7 percent target and 5.8 percent growth rate in FY16. *Mining and quarrying* growth fell to 1.3 percent (7 percent in FY16), while *construction* normalized to 9 percent (15 percent in FY16). *Electricity and gas generation and distribution* grew by only 3 percent (8 percent in FY16), mainly because generation declined. Manufacturing, the largest component of industry, grew by 5.3 percent (3.7 percent in FY16), with 5 percent growth in large-scale manufacturing (LSM)[17] (3 percent in FY16), given the strong growth in sugar, steel products,[18] electronics,[19] and tractors[20] (**Figure 4**). On the other hand, cigarette

[8] National savings, which represent the difference between disposable income and consumption, have replaced domestic savings – a concept used by the World Bank before 2006. The change was made to conform to SNA concepts and definitions.

[9] For instance, the profit rate on Behbood Savings Certificates – one of the many NSS instruments – fell from 10.56 percent on June 30, 2016 to 9.6 percent by end-June 2017.

[10] Following a prolonged cold spell, severe pest attacks, and depressed cotton prices, which reduced incentives to invest in good-quality pesticides and inputs.

[11] Almost 308 million metric tons of sugar were exported in FY17, indicating a 5 percent growth in the export volume compared to last year.

[12] Although this decline in FY17 was broad-based (except for maize and sugarcane), it was more pronounced for cotton, which fell from 2.9 million hectares in FY16 to 2.5 million hectares in FY17.

[13] This is more than the estimated average annual domestic consumption of 24.5 million tons. (Source: FAS-USDA). The excess production coupled with substantial wheat stocks appears to be exportable surplus. However, the widening price differential (domestic versus international) has hampered exports of this commodity.

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

[15] These include, among others, the exemption of 7 percent sales tax on pesticides and the reduction of sales tax on urea from 17 percent to 5 percent.

[16] This was the first year that microfinance institutions (such as the National Rural Support Program and Khushhali Bank) were included in agri-financing.

[17] The provisional data for the complete fiscal year points toward a higher growth rate of 5.6 percent for FY17.

[18] Owing to sustained growth in construction and restraint in the import of steel products from China, following the imposition of anti-dumping duties (6.0–40.5 percent) in February 2017.

[19] In tandem with a rise in consumer financing, particularly for consumer durables, which more than doubled in FY17.

[20] The reduction in sales tax on tractors (announced in the federal budget for FY17) from 10 percent to 5 percent, spurred the demand.

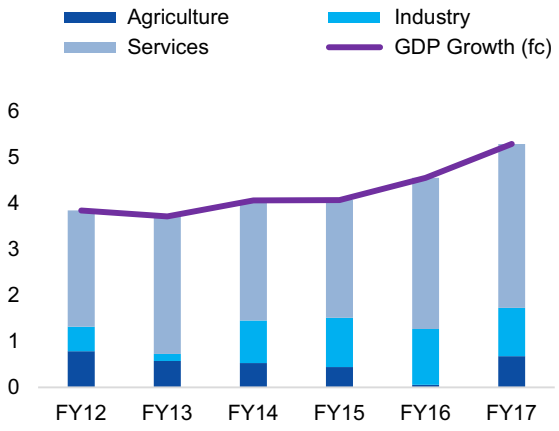
production declined due to an increase in the federal excise duty (FED) on existing tiers of cigarettes and the addition of a new tier to document and curb the illicit trade of sub-standard, low-priced cigarettes.

The services sector remains the strongest driver of growth

Services (60 percent of GDP) is the most sustainable component of growth, recording expansion at 6 percent in FY17 against a target of 5.7 percent and 5.5 percent growth last year. This growth is broad-based, reflecting vibrancy in several sub-sectors: *wholesale and retail trade* (6.8 percent compared to 4.3 percent in FY16) recovered as agriculture and manufacturing rebounded and trade activities increased; *finance and insurance* (11 percent vs. 6 percent in FY16) also picked up as private sector credit accelerated, accompanied by government debt retirement to commercial banks. *General government services* growth (7 percent vs. 10 percent in FY16) reflected rising public sector wages[21] while subdued *transportation, communication and storage* (4 percent vs. 4.8 percent last year) indicated (i) the constrained growth of Pakistan Railways and Pakistan International Airlines (PIA), (ii) a contraction in the production and sale of commercial vehicles,[22] (iii) higher Internet and mobile subscriptions, and (iv) lucrative real estate schemes.

Figure 3: Sectoral contribution to GDP growth – aggregate supply

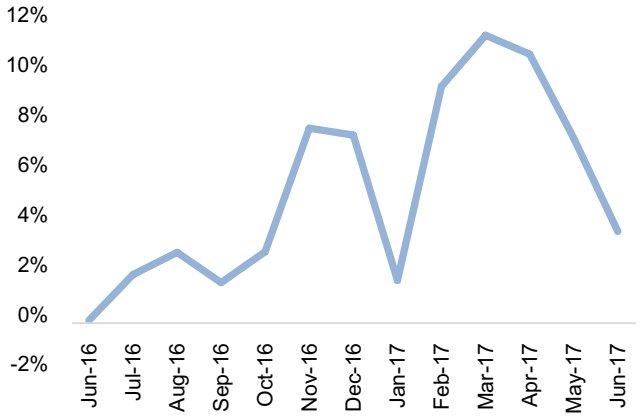
Percent



Note: fc = factor cost.
Source: Pakistan Bureau of Statistics.

Figure 4: Quantum growth in LSM (m-o-m)

Percent



Source: Pakistan Bureau of Statistics.

[21] A 10 percent increase in pay was given to all federal and provincial employees in the FY17 budget.
[22] The conclusion of the Apna Rozgar Scheme led to this decline.

Box 1: Dynamics of Low Savings in Pakistan

Pakistan seems to be stuck in a low-savings-low-investment trap, which has seriously hampered its growth potential. It is not surprising, therefore, that nearly all of Pakistan's high-growth periods have coincided with abundant inflows of *foreign savings* (in the form of external loans, grants, and remittances).[23] Accordingly, whenever such inflows dried up, economic growth slid back, as domestic savings and investment were never enough to sustain the growth momentum. While foreign savings are important in financing the savings-investment gap, the most reliable source of funds for investment in a country is its own savings. Pakistan's record in this respect is not encouraging. Its savings rate of 13.8 percent of GDP (2011–15 average) also compares unfavorably with that of neighboring countries: the savings rate in India was 33.2 percent, in Bangladesh 29.7 percent, and in Sri Lanka 24.5 percent over the same period.

The savings behavior of economic agents is a complex phenomenon and is an outcome of the interaction of many social and economic factors. The key determinants of the savings rate are (i) income level, (ii) inflation, and (iii) the rate of return on savings. While past trends in the savings rate as well as its recent fall can be explained by real GDP growth, inflation, and the real interest rate, we still need to understand the structural factors that have kept savings historically low in Pakistan. The empirical literature on the determinants of savings behavior finds that education, financial deepening, culture, religion, and demographic factors (such as the labor force participation rate and dependency ratio) affect the private sector savings rate, while political stability is a key determinant of the public savings rate.[24]

Low level of savings is one aspect of the problem. An equally important issue is the efficient allocation of savings toward investment through the financial sector. Less than 50 percent of national savings finds its way into the financial sector in Pakistan. The rest is used in real estate or other forms of capital formation via informal channels. Interestingly, financial savings (i.e., savings in the form of financial instruments)[25] declined sharply to 22 percent of the total national savings during 2000–05 – a period of real estate boom. Incidentally, interest rates were also very low during this period.

Source: Extract from SBP Staff Notes, 01/16, Saving and Investment in Pakistan, Amjad Ali, January 2016.

2. Fiscal Accounts

Pakistan's hard-won fiscal consolidation appears to be eroding away

Pakistan registered a consolidated[26] fiscal deficit (excluding grants) of 5.8 percent of GDP in FY17 (**Table 1**) – 2.0 percentage points higher than the target set at the start of the year and 1.2 percentage points higher than that of the previous year. At this level, FY17 saw a reversal of the gains in fiscal consolidation witnessed since FY13. This is particularly true for FY17 as the primary deficit (excluding grants) increased to 1.6 percent of GDP, up from 0.3 percent in FY16.

[23] Loans and grants include project aid, food aid, and non-food aid. There is no conclusive evidence in the literature on the impact of foreign aid on capital formation as there are always questions on the uses of aid. However, in the case of Pakistan, such foreign inflows together with remittances seem to have a positive relationship with growth.

[24] See, for example: S. Edwards. 1995. *Why are Savings Rates so Different across Countries? An International Comparative Analysis*, Working Paper No. 5097. Cambridge, MA: National Bureau of Economic Research; A. Kazmi. 2001. 'A Study on Saving Functions for Pakistan: The Use and Limitations of Econometric Methods', *Lahore Journal of Economics*, 6(2): 57–101.

[25] Financial savings include bank savings and fixed deposits, NSS deposits, and postal saving deposits. Demand deposits and currency in circulation are not included as they are kept by the public primarily for transaction purposes. Some households keep cash with the intention to save, but such amounts may not be very significant.

[26] This analysis refers to the consolidated fiscal accounts of the federal and provincial governments.

Table 1: Summary of Pakistan's fiscal operations

Rs. billion unless mentioned otherwise

				Percent growth	
	FY15	**FY16**	**FY17**	**FY16**	**FY17**
Total revenue	**3,931**	**4,447**	**4,937**	***13.1***	***11.0***
Tax revenue	3,018	3,660	3,969	*21.3*	*8.4*
Federal	2,812	3,377	3,647	*20.1*	*8.0*
Provincial	206	283	322	*37.6*	*13.6*
Non-tax	913	787	967	*-13.9*	*23.0*
Federal	838	693	888	*-17.3*	*28.1*
Provincial	76	93	79	*23.4*	*-14.8*
Expenditures	**5,387**	**5,796**	**6,801**	***7.6***	***17.3***
Current *of which*:	4,425	4,694	5,198	*6.1*	*10.7*
Interest	1,304	1,263	1,348	*-3.1*	*6.1*
Defense	698	758	888	*8.6*	*17.2*
Development	1,113	1,301	1,693	*16.9*	*30.1*
Net lending	27	13	-13		
Statistical discrepancy	-178	-212	-78		
Fiscal balance	**-1,456**	**-1,349**	**-1,864**	*-7.3*	*38.1*
% of GDP	*-5.3*	*-4.6*	*-5.8*		
Memorandum items					
GDP (nominal)	27,443	29,103	31,862		

Source: Ministry of Finance.

Large increases in development spending coupled with decelerating tax revenues led to the slippage

Total revenues during FY17 recorded a lower growth of 11.0 percent despite healthy collection in federal non-tax revenues. This was due, primarily, to timid growth in federal tax collection (responsible for 90 percent of total tax revenues). On the other hand, total expenditure registered a sizeable jump of 17.3 percent. Recurrent spending played its part to some extent, but the main driver was a 30 percent increase in development expenditure. To put this in perspective, provincial development spending increased by 44 percent over the previous year – the highest increase in Pakistan's history.

Tax performance remained far from satisfactory

The total revenue of the consolidated government slowed down in FY17 due to the weak performance of the Federal Board of Revenue (FBR). FBR revenue grew by 8 percent during FY17, compared with the budgeted growth of 17 percent (**Table 2**). FBR collection amounted to Rs. 3,361 billion, equal to 93 percent of the FY17 revenue target.[27] The shortfall was broad-based[28] and equaled almost Rs. 260 billion (or 0.8 percent of GDP). The lower collection is, in part, a result of relief measures and tax incentives[29] introduced through the federal budget for FY17 to boost investment, exports, and domestic production in the economy.[30] On the other hand, the taxes collected by the provincial governments grew by 13.6 percent during FY17, although this was lower than the 37.6 percent growth seen in FY16.

[27] The target for FY17 was set at Rs. 3,621 billion.

[28] Except for customs duties, the collection of which surpassed the budget target by Rs. 83 billion.

[29] For instance, the government allowed sales tax exemptions/concessions on agricultural inputs (fertilizer and pesticides) to reduce the cost of production for farmers. Similarly, it announced incentives such as zero-rating, exemptions of sales tax on imports of new machinery and raw material for textiles, and duty drawbacks to registered exporters to revive exports. The government also offered tax incentives to firms investing in energy projects. (*The State of Pakistan's Economy, Third Quarterly Report 2016–17*, State Bank of Pakistan).

[30] Despite these incentives, investment inched up by only 0.2 percent of GDP, merchandise exports contracted further by 1.3 percent, and LSM grew by 5.6 percent (as opposed to a target of 5.9 percent) in FY17.

Table 2: FBR tax collection
Rs. billion unless mentioned otherwise

				Percent growth	
	FY15	FY16	FY17	FY16	FY17
Direct	**1,029**	**1,192**	**1,343**	***15.8***	***12.7***
Indirect	**1,565**	**1,920**	**2,018**	***22.7***	***5.1***
Customs	306	406	496	*32.7*	*22.1*
Sales tax	1,089	1,324	1,323	*21.6*	*-0.03*
Federal excises	170	191	199	*12.1*	*4.2*
Total taxes	**2,594**	**3,112**	**3,361**	***20.0***	***8.0***

Source: Federal Board of Revenue.

Most of the FBR collection continues to come from customs duties and direct taxes…

During FY17, collections from direct and indirect taxes grew by 12.7 percent and 5.1 percent, respectively. Growth in direct taxes, when compared to last year, slowed down because of a sustained reduction in corporate taxes.[31] More importantly, the bulk of direct taxes – about 70 percent on average over the last three years – is collected as withholding tax (WHT), which become a form of indirect taxes when treated as final tax and passed onto the consumer. For instance, contracts alone comprise a fourth of the collection through WHT. If only this source is classified as an indirect tax, the share of direct taxation would go down from 40 percent of total FBR collection to approximately 30 percent. This level is abysmally low compared to other developing countries, where direct taxes amount to 55 percent of total tax revenues.[32] Within indirect taxes, customs and federal excise duty (FED) grew by 22 percent and 4 percent, respectively, in FY17. The robustness of customs duties can be attributed to an increase in imports (particularly in transport, food, and machinery)[33] while FED lost its momentum primarily due to the increase in the rate on cigarettes (which comprise a third of total FED collection), eventually affecting the commodity's local production.[34]

…while sales tax collection stagnated

Sales tax performance showed significant deterioration vis-a-vis budgeted targets.[35] Interestingly, the collection in FY17 stayed at the level observed in FY16. This flat growth can be traced to the relief measures aimed at supporting export sectors and agriculture[36]announced in the federal budget for FY17 (as mentioned before). Furthermore, sales tax revenues were affected by plummeting petroleum revenues due to lower prices and changes to the tax regime.[37] The decline in cigarette production following the increase in excise duty also reduced sales tax revenues.

[31] The government has, in a bid to promote corporatization, been reducing corporate tax rates consistently by 1 percent each year, from 35 percent in FY13 to 30 percent in FY18.
[32] S. Cevik. 2016. *Unlocking Pakistan's Revenue Potential*, Working Paper No. 16/182. Washington, DC: International Monetary Fund.
[33] Merchandise imports grew by 17.6 percent in FY17 as opposed to a contraction of 0.2 percent last year. More specifically, imports of transport, food and machinery increased by 42 percent, 18 percent, and 11.5 percent respectively (y-o-y).
[34] For further discussion, see the section on 'The Real Sector'.
[35] The collection was lower by Rs.114 billion.
[36] These include the zero-rating of export-oriented sectors (textiles, leather, sports goods, surgical goods, and carpets); exemption of 7 percent sales tax on pesticides; reduction of sales tax on urea from 17 percent to 5 percent; and the doubling of the turnover threshold for cottage industries.
[37] This performance is attributable to two factors: (i) SRO 490(I)/2016 notifying ad valorem tax rates w.e.f. July 1, 2016 for this sector from a previously fixed-rate regime; and (ii) a fall in average domestic petroleum prices during FY17 (Rs. 68.3 per liter) compared to last year (Rs. 71.5 per liter).

Table 3: Non-tax revenues
Rs. billion unless mentioned otherwise

				Percent growth	
	FY15	FY16	FY17	FY16	FY17
Profits Post Office Dept. and PTA	4	34	34	*831.9*	*-2.1*
Mark-up (PSEs and others)	14	58	100	*306.9*	*72.6*
Dividends	74	89	70	*19.5*	*-21.3*
SBP profits	399	228	228	*-42.9*	*-0.05*
Defense (incl. CSF)	157	107	68	*-31.9*	*-36.7*
Passport and other fees	19	21	20	*11.2*	*-3.6*
Discount ret. on local crude price	10	9	9	*-5.9*	*-0.1*
Royalties on oil/gas	74	58	53	*-22.1*	*-8.3*
Windfall levy on crude oil	12	2	2	*-86.6*	*1.0*
Others	75	88	306	*17.7*	*245.8*
Provincial	76	93	79	*23.4*	*-14.8*
Total	**913**	**787**	**967**	***-13.9***	***23.0***

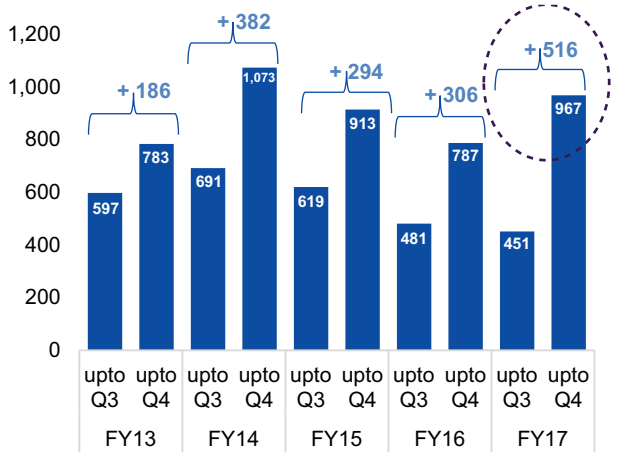
Source: Ministry of Finance.

Non-tax revenues largely made up for the slippage in tax collection

Non-tax revenues increased by 23 percent to Rs. 967 billion after a contraction of 14 percent in FY16. However, to put this strong performance in perspective, it is worth noting that non-tax collection was dwindling till Q3FY17, contracting by 6.2 percent compared to same period last year. These inflows strengthened only in the last quarter of the fiscal year and amounted to more than the cumulative collection of the previous three quarters (Rs. 516 billion in Q4 versus Rs. 451 billion till Q3) (**Figure 5**). Despite the drying up of Coalition Support Fund (CSF) receipts,[38] the recovery in Q4FY17 has largely been driven by three categories: (i) interest income in FY17 almost doubled compared to last year, (ii) the recovery of SBP profits in the last quarter,[39] and (iii) the 'others' category witnessed a significant increase, mostly in Q4,[40] amounting to Rs. 306 billion (**Table 3**). The latter was due mostly to one-off receipts. For instance, the government sold a portion of its stakes in the printing corporation[41] and Pakistan Development Fund proceeds worth Rs. 64 billion were booked as the sale proceeds of two LNG power plants. Furthermore, Rs. 20 billion was recorded under this category following an amendment to the rules governing 'dead accounts' (dormant plus lapse to the government) under the NSS.[42] On the flip side, dividends from state-owned enterprises (SOEs) have declined substantially. Moreover, royalties on gas and oil declined due to prevailing low domestic petroleum prices. During FY17, provincial non-tax revenue collection contracted by 15 percent in contrast to a healthy growth of 23 percent last year.

[38] Pakistan received CSF flows of just US$550 million in Feb–Mar FY17.
[39] The profits amounted to Rs. 228 billion during FY17, almost the same level witnessed in FY16.
[40] The government received Rs. 219 billion alone in Q4FY17.
[41] The SBP acquired the banknotes and prize bonds printing functions of the Pakistan Security Printing Corporation from the federal government. The SBP paid the government a consideration of Rs. 100.149 billion in June 2017 for transfer of ownership and control (State Bank of Pakistan, Press Release No. ERD/M&PRD/PR/01/2017-68).
[42] The original rule under the Savings Account Rules, Government Savings Bank Act 1873, stipulated marking inactive accounts as dormant. Under the amended rule, time limits have been prescribed for these dormant accounts and the scope has been expanded to include all instruments. Moreover, after a certain period, the investment in these accounts is treated as lapsed and booked as the government's non-tax revenue. However, these accounts can be revived any time subject to due diligence of the claims. This move aims to minimize the misuse of dead accounts, but the treatment of recoveries is against the principles of financial reporting. NSS flows are categorized as unfunded debt and any recoveries associated with NSS should, ideally, be adjusted in the debt accounts.

Figure 5: Trend in non-tax revenue
Rs. billion



Source: Ministry of Finance.

Consolidated government expenditure witnessed robust growth

The total expenditure of the consolidated government grew considerably during FY17 on the back of increased spending, both recurrent and development (**Table 4**). After keeping a tight rein for the last three years, the federal government increased its recurrent expenditure by 10.4 percent in FY17. More prominently, defense as well as public order and safety expenditures increased significantly as a result of augmented security-related spending. Pensions grew by 36.5 percent[43] and interest payments by a modest 6.7 percent during FY17, whereas federal grants to SOEs declined by almost Rs. 10 billion.

[43] This builds on the 20.2 percent growth observed in FY16. The growth was only 2.8 percent in FY15.

Table 4: Analysis of consolidated spending
Rs. billion unless mentioned otherwise

				Percent growth	
	FY15	FY16	FY17	FY16	FY17
Total expenditures	**5,387**	**5,796**	**6,801**	***7.6***	***17.3***
Current	**4,425**	**4,694**	**5,198**	***6.1***	***10.7***
Federal	3,038	3,144	3,472	*3.5*	*10.4*
Interest payments	1,304	1,263	1,348	*-3.1*	*6.7*
Domestic	1,208	1,151	1,220	*-4.7*	*6.0*
External	96	113	128	*17.7*	*13.9*
Pensions	185	223	304	*20.2*	*36.5*
Grants	288	362	352	*25.6*	*-2.7*
Defense	698	758	888	*8.6*	*17.2*
Public order and safety	83	96	128	*15.6*	*32.8*
Health and education	84	95	106	*12.7*	*11.5*
Others	395	348	346	*-12.0*	*-0.4*
Provincial	1,387	1,550	1,726	*11.7*	*11.3*
Development	**1,113**	**1,301**	**1,693**	***16.9***	***30.1***
PSDP	988	1,186	1,578	*20.1*	*33.1*
Federal	489	593	726	*21.4*	*22.3*
Provincial	499	592	852	*18.8*	*43.8*
Other dev. expenditures	125	116	116	*-7.8*	*0.1*
Net lending	**27**	**13**	**-13**	**-**	**-**
Statistical discrepancy	**-178**	**-212**	**-78**	**-**	**-**

Source: Ministry of Finance.

The highlight of FY17 has been historically high development spending

Both the federal and provincial governments increased their development expenditure to record levels. Spending under the Public Sector Development Program (PSDP) by both tiers of the government amounted to Rs. 1,578 billion,[44] surpassing the revised estimates[45] by Rs. 39 billion for the first time since FY14.[46] In addition, other development expenditure (of which the Benazir Income Support Program is the main component) maintained the same level of Rs. 116 billion during FY17. The federal PSDP grew by 22 percent during FY17 – almost at the same level of growth seen last year. However, the uptake was more pronounced in the last quarter. Moreover, the provincial governments increased their PSDP spending by 44 percent in FY17 compared to 19 percent last year. The provincial spending levels in Q4FY17 of about Rs. 430 billion are slightly higher than the development expenditure of Rs. 423 billion spent by the provinces in the first three quarters collectively. Acceleration of this magnitude in the last quarter raises questions regarding the quality, efficiency, and effectiveness of such spending.

Extraordinary development spending amid lower federal transfers suggests the provinces ran a sizeable deficit

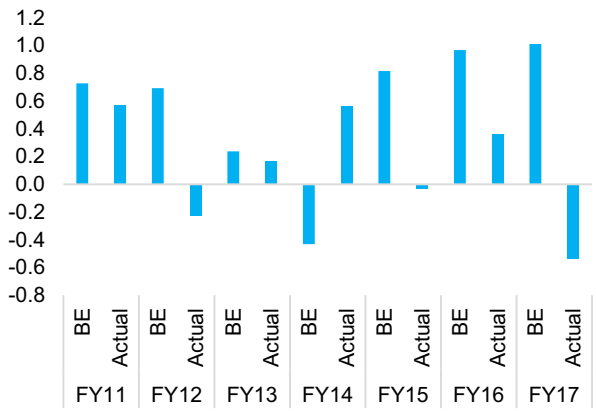
The federal government's fiscal deficit of 5.3 percent of GDP this year was not helped by the provincial governments' performance, which registered a combined deficit of 0.5 percent of GDP during FY17. Khyber Pakhtunkhwa (KP) and Sindh contributed the most by running deficits worth Rs. 76 billion and Rs. 63 billion,[47,48] respectively. This is surprising, given that the provinces face, in principle, hard budget constraints and require the explicit consent of the federal government to initiate any form of deficit

[44] With a 46/54 federal-provincial composition.
[45] Revised estimates are based on nine months' actual data and three months' projections for the reference year.
[46] When the actual spending was higher by Rs. 51 billion from the revised estimates.
[47] Against an overdraft limit of Rs. 22.5 billion for the Government of Sindh. The province's request to include the remaining Rs. 40 billion (= Rs. 63 billion – Rs. 22.5 billion) in this limit is still pending with the federal government. The case for KP would also be similar.
[48] These numbers differ from the overall balance reported for the respective provinces as per the fiscal operations data released by the Ministry of Finance. The difference arises on account of adjusting the overall balance with development grants to arrive at a provincial deficit (excluding grants) number.

financing beyond a balanced budget stance. Furthermore, the budgeted assumption of provincial surpluses (0.9 percentage of GDP for FY17) by the federal government at the start of the year did not hold. This situation has become a norm, particularly after the 7th National Finance Commission (NFC) Award period (**Figure 6**). Given this trend, the assumption of a provincial surplus beyond a certain level is overly optimistic in the federal budget without a prior agreement with the provinces. To this end, emphasis could be placed on better incentives, coordination in tax revenue mobilization, and the overall fiscal stance across all layers of government, either in the context of the NFC Award or as subject matter for the Council of Common Interests (CCI). However, achieving a broad consensus on specific improvements and modalities for strengthening the fiscal framework will require extensive dialogue to balance the provinces' concerns about preserving their autonomy on the one hand and the need for more coordination and flexibility to improve overall economic outcomes on the other. In this context, closer alignment of provincial and federal economic objectives could help deliver common strategies and coordination mechanisms over time.[49]

Figure 6: Trend in provincial balances (budgeted vs. actual)

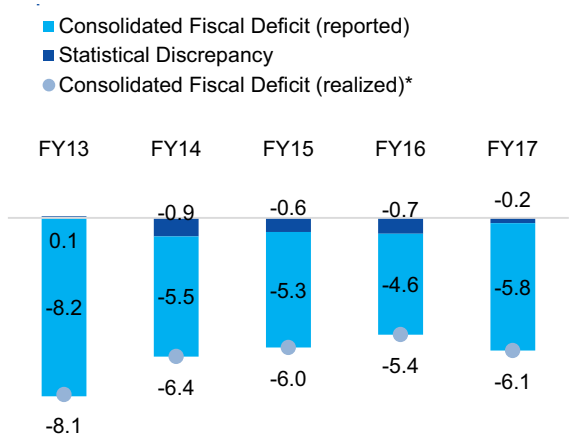
Percent of GDP



Source: Ministry of Finance.

Figure 7: Fiscal deficits and statistical discrepancies

Percent of GDP



Source: Ministry of Finance.
Note: Consolidated fiscal deficit (realized)* is the sum of the statistical discrepancy and the reported fiscal deficit. Figures may not add up due to rounding off.

However, the large reduction in the statistical discrepancy is a welcome development

A statistical discrepancy arises from errors or unrecorded transactions in measuring fiscal account transactions. The discrepancy, in general, is relatively small. However, over the last five years, Pakistan's fiscal accounts (particularly on the expenditure side) have been marred by large negative statistical discrepancies.[50] Since FY14, the magnitude of these discrepancies has hovered around 0.7 percent of GDP on average, largely clouding the realized fiscal deficit (**Figure 7**). However, in a positive development, in FY17 the statistical discrepancy fell considerably to 0.2 percent of GDP. Adjusting the expenditure for this discrepancy, it appears the realized fiscal deficit has increased by 0.7 percent of GDP in FY17 over the previous year and not 1.2 percent, as can be seen from the trend in the reported fiscal deficit. As far as fiscal transparency is concerned, this is a step in the right direction.

[49] International Monetary Fund. 2017. *Fiscal Decentralization and Macroeconomic Challenges in Pakistan*, Country Report No. 17/213. Washington, DC: International Monetary Fund.

[50] A negative discrepancy means that over-recorded (spending) transactions exist and thus improves the fiscal deficit by lowering expenditure.

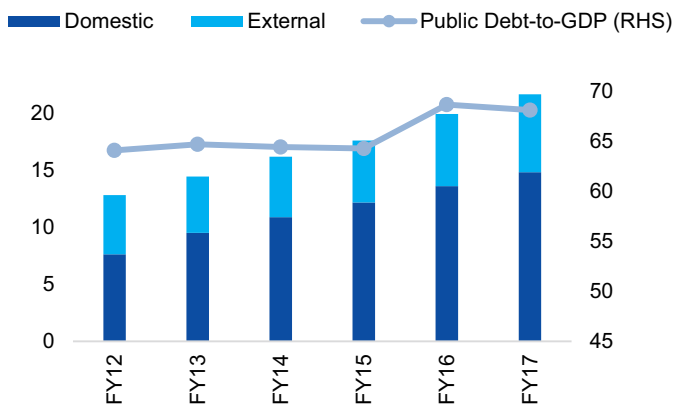
3. Debt and its Dynamics

Public debt stayed at almost the same level

As of end-June 2017, the total public debt stood at 68.1 percent of GDP – 0.5 percentage point lower than the June 30, 2016 stock of 68.6 percent [51] (**Figure 8**). This slight decline has occurred at a time when the fiscal deficit has swelled by 1.2 percent of GDP.[52] The improvement stems primarily from the fact that the growth in nominal GDP has slightly outpaced the growth in nominal public debt stock. There are two other underlying factors at play. First, in a positive development, the government drew down deposits held with the banking sector (including the SBP)[53] during FY17, primarily to retire some of the in-year borrowings from the SBP.[54] Second, favorable currency movements led to a decrease in the foreign currency public debt-to-GDP ratio (by 0.3 percentage point) despite substantial borrowings. These pertain to (i) a largely stable Pakistani rupee against the US dollar [55] and (ii) revaluation gains [56] accruing from an appreciating US dollar against the Japanese yen.[57]

Figure 8: Trends in public debt

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



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

[51] Public debt-to-GDP ratio is estimated by the World Bank as per the Government Financial Statistics Manual 2014, and is the definition used in this report. This results in the inclusion of external debt of public enterprises not included in the debt stock as defined by the Government of Pakistan. The Government of Pakistan official statistics show public debt-to-GDP ratio of 67.2 percent as of June 30, 2017, compared to 67.6 percent of GDP in FY16.

[52] This is the opposite of the previous year (FY16) when public debt increased by 4.4 percent despite the decline in the fiscal deficit by 0.7 percent of GDP.

[53] Government deposits contracted by Rs. 80 billion during FY17, as opposed to an accumulation of Rs. 459 billion during FY16.

[54] Owing to the slow mobilization of market funding (particularly during Q1), the government borrowed heavily from the central bank to repay the heavy maturities due in that period.

[55] During FY17, the Pakistani rupee depreciated by only 0.1 percent against the US dollar (point-to-point).

[56] A revaluation gain/loss implies the appreciation/depreciation of the US dollar against major currencies. In Pakistan, external loans are contracted in various currencies, but disbursements are effectively converted into Pakistani rupees. Since the rupee is not an internationally traded currency, other currencies are bought and sold by selling and buying US dollars. Hence, the currency exposure of foreign debt originates from two sources: US dollar/other foreign currencies and Pakistani rupee/US dollar. The former exchange rate movement is termed a revaluation gain/loss.

[57] More than 95 percent of Pakistan's outstanding public external debt is concentrated in three major currencies: the US dollar (60 percent), the euro (20 percent), and the Japanese yen (16 percent). During FY17, the US dollar appreciated by almost 8 percent against the yen (stock valuation).

Commercial loans dominated public external debt disbursements…

Pakistan received record-high gross disbursements amounting to US$10.1 billion in FY17 under public and publicly guaranteed (PPG) external debt (**Table 5**). Furthermore, disbursements during June 2017 alone touched US$2.7 billion for the first time in Pakistan. In totality, some 43 percent came from commercial banks during FY17. Chinese banks dominated this category, lending to the tune of US$2.3 billion.[58] To put this in perspective, commercial borrowing has only gathered pace since FY16 when the country received US$1.4 billion. However, the magnitude in FY17 is more than three times that in FY16. The government deems this instrument a diversification of its existing funding avenues. However, these bullet facilities of relatively short horizons[59] can create repayment issues in the future. Furthermore, in FY17 financing from China (both bilateral and commercial) became as important as flows from multilaterals. In October 2016, Pakistan successfully issued an international sukuk bond of US$1.0 billion[60] with a maturity of five years. The profit rate was 5.5 percent – the lowest ever in Pakistan's history and 125 bps lower than that on the same-maturity sukuk bond issued in November 2014.

Table 5: Gross disbursements – public external debt
US$ million unless mentioned otherwise

	FY13	FY14	FY15	FY16	FY17
Multilateral	**1,335**	**3,099**	**2,774**	**3,784**	**2,963**
Bilateral	**1,151**	**927**	**1,359**	**1,247**	**1,793**
Of which: China	843	594	1,161	1,042	1,583
Commercial	**-**	**323**	**150**	**1,381**	**4,368**
Of which: China	-	-	-	-	2,300
Eurobonds/sukuks	**-**	**2,000**	**1,000**	**500**	**1,000**
Total disbursements	**2,486**	**6,349**	**5,283**	**6,913**	**10,124**
Memo: China	*843*	*594*	*1,161*	*1,042*	*3,883*

Source: Economic Affairs Division.

…while domestic debt underwent a shift in composition

Total domestic debt stood at Rs. 14.8 trillion as of end-June 2017, registering y-o-y growth of 9 percent against a three-year average of 12.7 percent. In this context, the deceleration in FY17 is an improvement. However, the share of floating debt,[61] which had been falling since FY13, has increased considerably to 44 percent during FY17 (versus 37 percent last year). Interestingly, the share of permanent debt[62] mirrored this trend in the opposite direction, falling from 44 percent in FY16 to 37 percent in FY17. This implies that the government substituted medium-to-long-term debt with short-term debt to meet its financing needs during FY17. Such a financing strategy is not in line with the strategic guideline of lengthening the maturity profile of domestic debt,

[58] Among these are US$1 billion and US$700 million single-tranche facility agreements contracted with the China Development Bank. Moreover, two similar agreements worth US$300 million were signed and fully disbursed by the Bank of China and the Industrial and Commercial Bank of China during FY17. These are medium-term loans meant for balance-of-payments support with an in-built bullet repayment feature, a maturity of two to three years and a floating rate based on the LIBOR.

[59] However, in June 2017, two World Bank guarantees (US$630 million) helped Pakistan secure over US$1 billion in international commercial financing. In both cases, the tenor was extended to 10 years.

[60] Against initial expectations of raising US$500 million.

[61] This refers to short-term domestic debt and is composed mainly of market treasury bills and market-related treasury bills.

[62] This is the medium-to-long-term arm of domestic debt. Notable instruments include prize bonds, Pakistan Investment Bonds and Ijarah Sukuk.

as stipulated under the Pakistan Medium-Term Debt Management Strategy 2015/16–2018/19. In addition, high levels of short-term borrowing pose renewed refinancing and repricing risks'.[63,64]

Banks lent eagerly to the government, but mainly in shorter tenors

During FY17, commercial banks bid aggressively for market treasury bills (MTBs).[65] However, the government mopped up only 66 percent of these offers and, in doing so, accepted a slightly higher volume than the target set for FY17.[66] In aggregate, commercial banks exhibited the most interest in the shortest tenor throughout the year (**Figure 9**). The 12-month paper did not generate much interest, reflecting the market's short-term view,[67] specifically from Q2FY17 onwards. Similarly, banks offered more than twice the target announced for Pakistan Investment Bonds (PIBs) over FY17. Given this response, the government could tap little higher than the target[68] and accepted half the offers in all. However, it rejected all the bids in PIB auctions held during Q2FY17 (**Figure 10**) as the banks were bidding for higher rates. Nevertheless, there was a mismatch between the yearly target (Rs. 800 billion) and the maturity due in FY17 (Rs1.93 trillion) in this instrument. This prompted the government to meet the rest of its financing needs by resorting heavily to the SBP. Thus, market-related treasury bills (MRTBs) witnessed an addition of Rs. 912 billion to the stock in the first quarter. The remaining quarters, however, were marked by sizeable net retirements under MRTBs. In aggregate, MRTBs worth Rs. 451 billion were added during FY17 to the outstanding stock of June 30, 2016.

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

[64] The last available public debt risk report (of December 2016) already points toward a slight deterioration in key indicators. For instance, domestic debt re-fixing and maturing in one year increased from 52.8 percent and 51.9 percent as of end-June 2016 to 53.6 percent and 52.7 percent as of end-December 2016, respectively. (Source: *Public Debt Management Risk Report* (various issues), Debt Policy Coordination Office, Ministry of Finance).

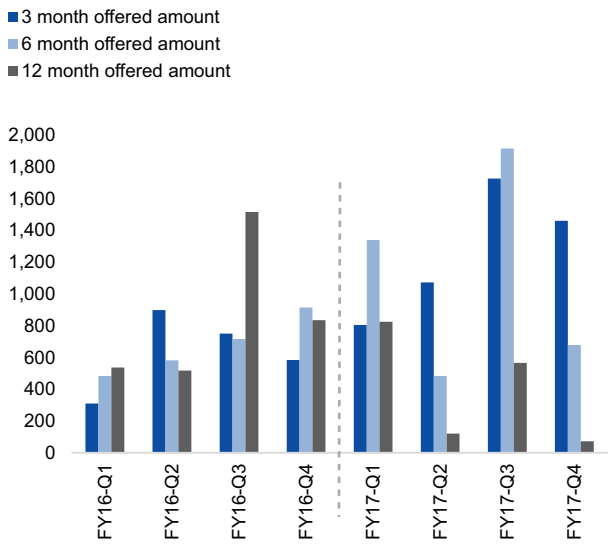
[65] The offers were 1.5 times the target set for the year.

[66] Rs. 7,275 billion accepted against the target of Rs. 7,200 billion.

[67] The market kept expecting an increase in interest rates in view of the y-o-y increase in inflation and the widening of the current account deficit Q2FY17 onward.

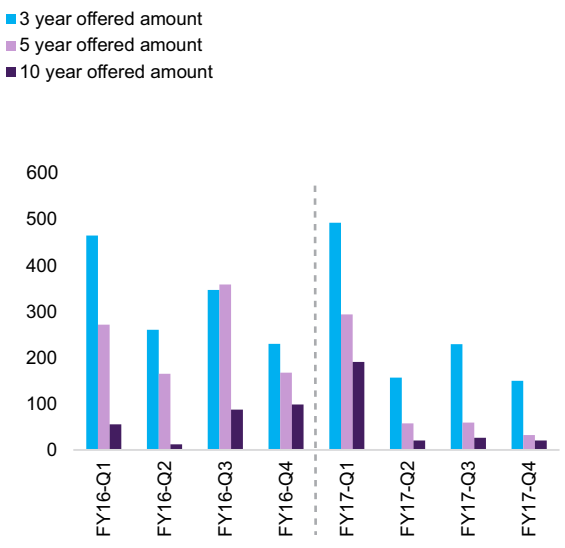
[68] Rs. 870 billion accepted against the target of Rs. 800 billion.

Figure 9: MTBs– auction profile
Rs. billion unless otherwise mentioned



Source: State Bank of Pakistan.

Figure 10: PIBs – auction profile
Rs. billion unless otherwise mentioned



Source: State Bank of Pakistan.

Despite these vulnerabilities, the public debt continues to decline…

Nonetheless, Pakistan's public debt is expected to fall to 66.4 percent by FY19 (**Table 6**). This projected declining trajectory (based on the medium-term projections for FY18–19; **see section on Outlook**) is due mainly to the nominal growth in GDP outpacing the nominal growth in public debt over the projection horizon. However, this downward trajectory assumes fiscal tightening post-election (2018) and any deviation from the expected path of fiscal consolidation may lead to an upward trend in the public debt.

Table 6: Baseline case debt projections
Percent of GDP unless mentioned otherwise

	Actual			Projected	
	FY15	**FY16**	**FY17**	**FY18**	**FY19**
Public sector debt 1/	**64.3**	**68.6**	**68.1**	***67.7***	***66.4***
o/w foreign-currency denominated 2/	19.8	21.8	21.5	*21.4*	*20.6*
Key macroeconomic and fiscal assumptions					
Real GDP growth (in percent)	4.1	4.5	5.3	*5.5*	*5.8*
Inflation rate (in percent, period average)	4.5	2.9	4.2	*6.0*	*7.0*
Primary deficit 3/	0.5	0.2	1.5	*1.5*	*1.6*

Source: World Bank staff estimates.
Notes: 1/ Public sector gross debt.
2/ This includes medium- and long-term PPG debt as well as short-term external debt. It also includes IMF debt (both budget support and balance-of-payments support), foreign currency bonds, and PSEs' non-guaranteed debt.
3/ Includes grants. '-' means a surplus.

…but the risks remain high

The public debt path can be sensitive to the materialization of contingent liabilities. These liabilities can originate from loss-making PSEs[69] and take the form of the absorption of outstanding power sector circular debt.[70] Moreover, a one-time 30 percent real depreciation of the Pakistani rupee against the US dollar[71] may lead to an increase of almost 10 percentage points in the public debt ratio over the projection horizon.[72]

Even with a positive outlook, the implementation of the amended FRDL Act remains a distant reality

FY18 is the first year of implementation for the amended Fiscal Responsibility and Debt Limitation (FRDL) Act.[73] Under one of the amendments, the government has to ensure that, within a period of two fiscal years beginning from FY17, total public debt is reduced to 60 percent of GDP. The legislation further stipulates that, within a period of five fiscal years beginning from FY19, total public debt shall be reduced by 0.5 percent every year; from FY24 and going up to FY33, a reduction of 0.75 percent is stipulated every year to reduce the total public debt to 50 percent of GDP. Thereafter, it will be maintained at 50 percent or less of GDP. The public debt ratio stood at 68.1 percent as of end-June 2017. Sustainability analysis shows a declining trajectory of public debt to GDP going forward, however, compliance with the FRDL Act limits is likely to be challenging unless an ambitious fiscal consolidation agenda is put in place, starting FY18.

4. Balance of Payments

Pakistan's international reserves are under stress because of a high and widening trade deficit

Pakistan's external account position experienced a considerable slide in FY17 due to a substantial widening of the current account deficit, which has resulted in the decline of international reserves. Despite this decline, the official exchange rate remained stable in FY17. The current account dynamics deteriorated on the back of a large trade deficit driven by a rapid increase in imports, coupled with another year of weak export performance. The increase in imports came on the back of higher fuel, food, machinery, and transport group imports driven by strong domestic demand. However, limited exchange rate flexibility may have contributed to higher imports and the widening trade deficit (see **Box 2** for a discussion of exchange rate dynamics in Pakistan). A decline in remittances for the first time in a decade also aggravated the current account deficit. The external financing gap increased in FY17 compared to FY16, which resulted in a decline in official reserves to US$16.2 billion by end-June 2017, compared to US$18.2 billion at end-June 2016.

[69] Pakistan Steel Mills, Pakistan Railways, PIA, etc.

[70] Circular debt is estimated to have crossed Rs. 400 billion (or 1.3 percent of GDP) as of end-June 2017. As per World Bank staff estimates, some Rs. 350 billion will be added to the existing stock by FY20 if the underlying causes of non-collection and high losses are not addressed.

[71] IMF staff estimate an overvaluation in the 10–18 percent range for the Pakistani rupee based on an IMF-wide external balance assessment (EBA). At the same time, the REER-based EBA-lite method, explicitly accounting for factors such as remittances and aid flows, suggests a slightly larger overvaluation of about 20 percent. The REER gap is therefore estimated to be in the 10–20 percent range (IMF Country Report No. 17/212).

[72] This is one of the standard sensitivity tests to the baseline scenario under the *Joint Bank-Fund Debt Sustainability Framework for Middle-Income Countries*. A one-time 30 percent real exchange rate depreciation shock corresponds approximately to a two-standard-deviation shock to the US$ value of the GDP deflator growth.

[73] The amendments to the FRDL Act 2005 were passed through the Finance Act 2016.

Table 7: Balance of payments summary[1]
US$ billion unless mentioned otherwise

	FY16	FY17
i. Current account (A+B+C+D)	**-4.9**	**-12.4**
A. Trade balance	**-19.3**	**-26.6**
Exports	22.0	21.9
Imports	41.3	48.5
B. Services net	**-3.4**	**-4.3**
of which, CSF	0.9	0.6
C. Balance on primary income[2]	**-5.3**	**-5.0**
D. Balance on secondary income[2]	**23.2**	**23.5**
of which, remittances	19.9	19.4
ii. Capital account	**0.3**	**0.3**
1. Balance from current and capital accounts (i+ii)[3]	**-4.6**	**-12.1**
2. Financial accounts[4]	**-6.8**	**-10.0**
of which:		
Direct investment	-2.3	-2.6
Portfolio investment	0.4	0.2
Net acquisition of financial assets	0.1	1.3
Net incurrence of financial liabilities	5.0	8.8
3. Errors and omissions	**0.5**	**0.2**
Overall balance (-1+2-3)	-2.7	1.9
SBP reserves (excl. CRR, SCRR)	**18.2**	**16.2**
Memorandum items		
Current account (percent of GDP)	*-1.7*	*-4.1*
Trade account (percent of GDP)	*-6.9*	*-8.7*
Export growth (percent)	*-8.8*	*-0.2*
Import growth (percent)	*-0.2*	*17.6*
Remittance growth (percent)	*6.4*	*-2.8*
Financial account (percent of GDP)	*2.4*	*3.3*

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

The current account deficit swelled to 4.1 percent of GDP, its highest level in nearly a decade

The current account deficit for FY17 swelled to 4.1 percent of GDP (US$12.4 billion), compared to 1.7 percent of GDP in the last year – the highest level since FY08. A large trade deficit proved to be the key driver of this imbalance, which jumped to US$26.6 billion (8.7 percent of GDP) compared to US$19.3 billion (6.9 percent of GDP) last year, on the back of declining exports and high import growth. Declining remittances and CSF inflows exacerbated the current account deficit (**Table 7**).

The fall in exports, remittances, and CSF inflows, coupled with high import growth, contributed to this outcome

Exports continued to shrink for a third consecutive year in FY17, albeit at a much lower pace of 0.2 percent (y-o-y). Imports, after slowing down in FY16, accelerated in FY17, growing by 17.6 percent (y-o-y). This resulted in a substantial widening of the trade deficit from 6.9 percent in FY16 to 8.7 percent in FY17. In addition, remittances declined by 2.8 percent (y-o-y) after an approximately decade long run of consecutive growth. The imbalance was further affected by widening of the services account deficit in FY17 compared to the previous year, due to lower CSF inflows.

Exports fell despite some uplift in the international prices of textiles and rice, along with global demand

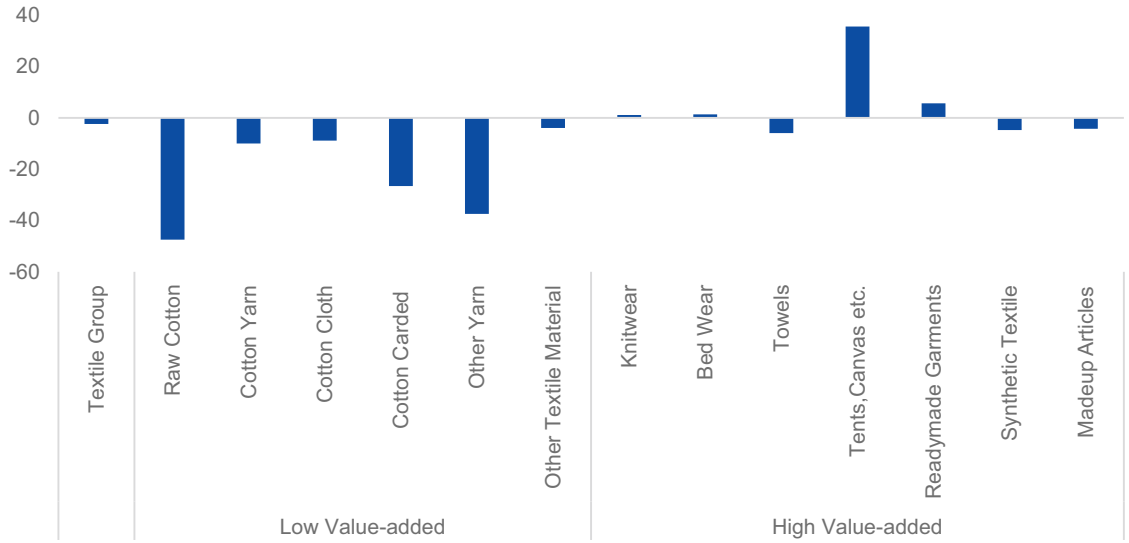
Globally, international trade is expected to grow by 2.4 percent in 2017 compared to 1.3 percent in 2016.[74] The impact of this recovery was felt in merchandise exports in South Asia, which recovered in 2017. Despite this recovery in regional exports, Pakistan's exports declined by 0.2 percent during FY17, albeit slowly, compared to the 8.8 percent decline in the previous year. While exports declined in FY16 as a result of lower prices, the quantum effect caused a marginal decline in export earnings in FY17. The decline was broad-based: its major contributors were food and textiles, which constitute about 75 percent of Pakistan's exports. Food group exports declined by 3.0 percent, whereas the textiles group declined by 2.4 percent in FY17. The latter's poor performance is a worrying sign as Pakistan's competitors, including Bangladesh and Vietnam, have benefited from the recovery in international prices and better global demand in 2017.[75]

Pakistan's exports continued to lose their market share on the back of declining competitiveness

The disaggregated data reveals that the decline in textile exports was mostly driven by the weak performance of low-value-added sectors, which include cotton yarn, cotton cloth, carded cotton, raw cotton, and others (**Figure 11**). Pakistan's export performance has been particularly lackluster in recent years as it has lost 1.5 percent of its export market share annually over the past decade[76](see **Section D4** for an in-depth discussion of export competitiveness). The country's weak export performance is an outcome of poor trade facilitation, logistics, and infrastructure; a worsening investment climate; and a protectionist and discretionary trade policy.[77]

Figure 11: Growth in value of textile exports, FY17

Percent



Source: State Bank of Pakistan.

[74] World Trade Organization projections released on April 12, 2017. These indicate that, in the absence of political uncertainty, this growth could touch 3.6 percent in 2017.
[75] Vietnam's textile exports are expected to grow by 7 percent in 2017 compared to 5 percent in 2016 *(Cotton and Products Annual Commodity Report 2017)*.
[76] World Bank, forthcoming "Pakistan: Unlocking Private Sector Growth through increased Trade and Competitiveness". Washington, DC: World Bank.
[77] Ibid.

Imports grew strongly, partly due to CPEC projects, but mainly on the back of fuel imports

Imports increased by 17.6 percent during FY17 in contrast to a decline of 0.2 percent in the previous fiscal year. This is the highest y-o-y import growth since FY08. While the capital goods imports linked with CPEC projects contributed partly to this increase (**Figure 12**), a significant contribution to this growth came from consumer goods and petroleum group imports.

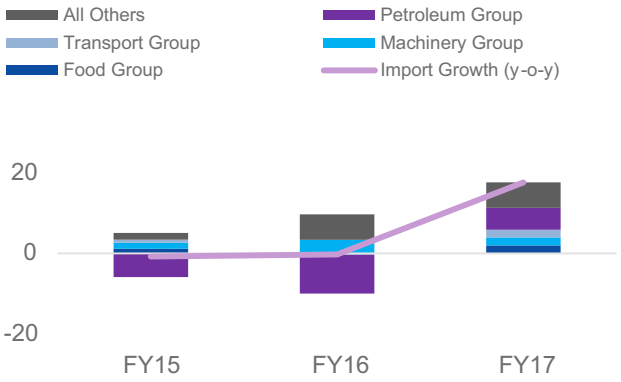
Petroleum imports jumped on the back of strong domestic demand and stable fuel prices

Petroleum group imports, which touched US$10.6 billion in FY17 compared to US$8.4 billion in FY16, were largely driven by higher imports of crude and petroleum products (**Figure 13**). Relatively stable domestic oil prices, complemented by a stable exchange rate, led to higher domestic demand for petroleum, oil and lubricants (POL). High-speed diesel (HSD) and petroleum product (excluding furnace oil) sales recorded growth rates of 26.2 percent and 14.9 percent, respectively, as per OCAC. HSD sales slowed down in H2FY17 as domestic HSD prices were hiked initially by Rs. 5.8 and then by Rs. 5.6 per liter.

Food group and capital goods imports also increased

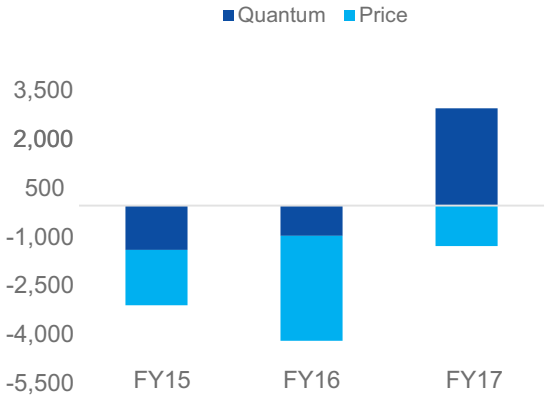
The non-POL segment also contributed to import growth, with sharp growth recorded in food items and machinery (17.8 percent and 11.5 percent y-o-y, respectively). The increase in non-oil imports came on the back of (i) the continued implementation of CPEC projects, (ii) a decline in the domestic production of pulses, and (iii) an increase in international palm oil prices.

Figure 12: Contribution in import growth
Percent



Source: State Bank of Pakistan.

Figure 13: Change (y-o-y) in oil petroleum products and crude oil
US$ million



Source: State Bank of Pakistan.

The remittances slowdown further aggravated the current account deficit

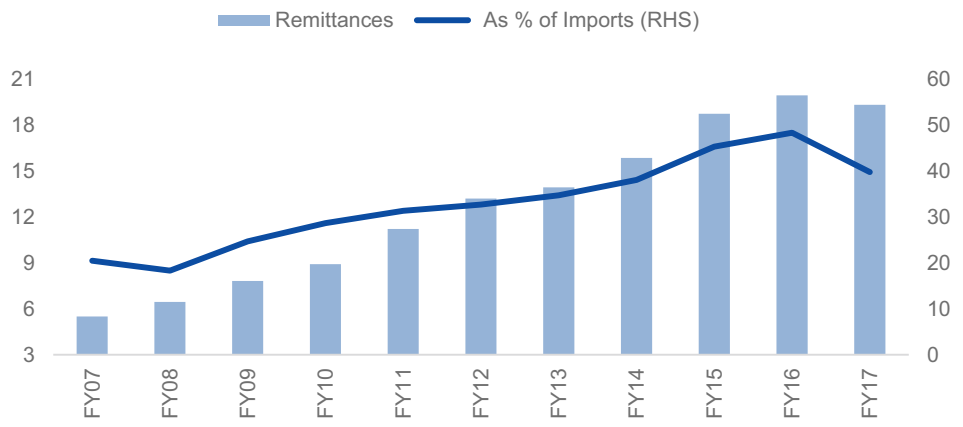
The balance of secondary income stayed at US$23.5 billion during FY17, marginally higher than FY16. Remittances, after growing for more than a decade, experienced a small contraction of 2.8 percent in FY17[78] (**Figure 14**). Remittances from the Gulf Cooperation Council (GCC) countries, which accounted for 63 percent of total remittances in FY17, have started to contract due to the decline in public investment in these economies as oil prices have only mildly recovered.[79] Remittance flows from the GCC countries decreased by 5.0 percent in FY17, compared to an increase of 6.0 percent in FY16. Remittance flows from the UK and US – which contributed 25

[78] This is the first instance since FY04 that remittances have contracted (y-o-y) in a fiscal year.

[79] Fiscal deficits in four leading sources of Pakistan's remittances, including Saudi Arabia, the United Arab Emirates, Kuwait, and Qatar, peaked in 2016. These countries recorded fiscal deficits (as a percent of GDP) of 16.9 percent, 3.9 percent, 3.6 percent, and 4.1 percent, respectively in 2016 (*World Economic Outlook*, April 2017). Nonetheless, they are taking fiscal consolidation measures to reduce these deficits.

percent to total remittances in FY16 – experienced a slowdown during FY17, falling by 9.2 percent and 2.8 percent, respectively. Remittances from the UK took a hit as the pound sterling depreciated substantially in the aftermath of Brexit, before partially recovering against the US dollar.

Figure 14: Workers' remittances – a mainstay of the current account
US$ billion



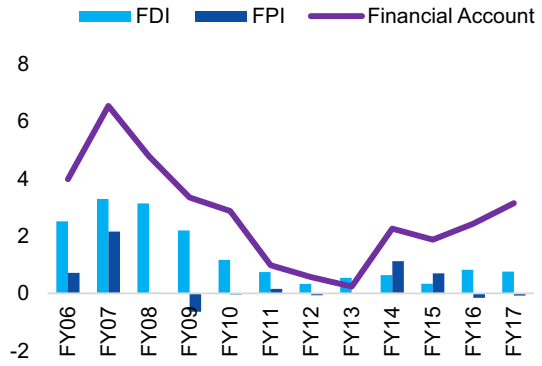
Source: State Bank of Pakistan.

High financial flows hedged the external sector gap to a large extent

Financial inflows from steady FDI and loan receipts from commercial and international financial institutions partially eased the growing pressure on the external sector (**Figure 15**). Pakistan's gross general government disbursements touched US$10 billion during FY17, which was a first in the country's history. Commercial borrowing touched US$4.4 billion compared to US$1.4 billion in FY16. Bilateral disbursements increased to US$1.8 billion in FY17, up from US$1.2 billion in FY16. This healthy inflow contained Pakistan's external sector financing gap to a large extent (**Figure 16**). Despite this, its foreign exchange reserves declined from US$18.2 billion at end-June 2016 to US$16.2 billion by end-June 2017, which was sufficient for 3.1 months' import coverage by end-June 2016 (**Figure 16**).[80]

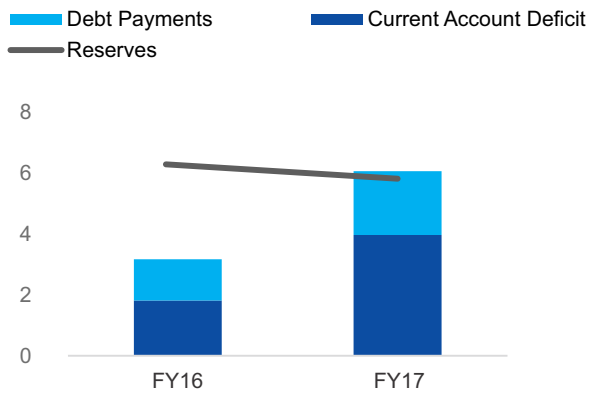
[80] Reserves touched their highest level of US$19.5 billion (sufficient for 3.7 months' import coverage) in mid-October 2016. The decline in reserves continued since July 2017, bringing them to US$13.8 billion on 25 October 2017 (sufficient for 2.7 months' import coverage).

Figure 15: Financial account
Percent of GDP



Source: State Bank of Pakistan.

Figure 16: External financing positon
Percent of GDP



Source: State Bank of Pakistan.

Despite a decline in international reserves, the official Pakistani rupee to US dollar exchange rate remained stable

Despite a substantial decline in international reserves, the nominal exchange rate remained largely steady with a mild depreciation of 0.2 percent against the US dollar during FY17. A stable nominal exchange rate with the US dollar and low inflation resulted in the REER appreciating by 3.4 percent during FY17. This appreciation contributed to the widening external financing gap and the decline in international reserves. Cumulatively, the REER has appreciated by 13 percent over the last three fiscal years.

Box 2: Exchange Rate Management in Pakistan

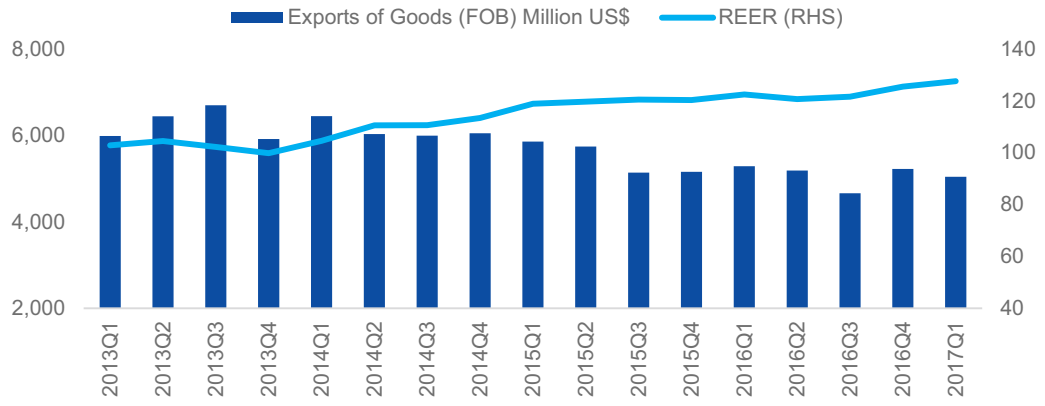
Pakistan officially switched to a flexible exchange rate regime in 1999 and the Pakistani rupee was allowed to float on July 21, 2000.[81] However, the country seems to have followed a managed float regime.[82] Pakistan is not the only country that has followed this policy path in exchange rate management: a significant number of countries with a flexible exchange rate de jure or de facto manage their exchange rates to avoid excessive volatility.[83] Over the past few years, the Pakistani rupee has been relatively stable against an appreciating US dollar, which has resulted in a strong Pakistani rupee compared to many other currencies in Asia. Recent analysis suggests that the Pakistani rupee is overvalued.[84] Such misalignment can contribute to the buildup of external account pressures and a loss in export competitiveness, leading to a decline in exports (**Figure 2A**).

Exchange rate volatility in emerging market economies can affect investment and growth.[85] Furthermore, large and frequent changes in the exchange rate can also reduce international trade by affecting the prices of intermediate goods.[86] However, a managed depreciation of the exchange rate to

[81] SBP F.E. Circular No. 08 and Financial Sector Assessment 1990–2000.
[82] Annual Report on Exchange Arrangements and Exchange Restrictions, IMF 2016.
[83] IMF Staff Report for Article IV Consultation, 2017.
[84] IMF Staff Report for Article IV Consultation, 2017.
[85] B. Gadanecz and A. Mehrotra. 2013. *The Exchange Rate, Real Economy and Financial Markets*, Paper No. 73. Basel: Bank for International Settlements.
[86] W. Thorbecke. 2008. 'The Effect of Exchange Rate Volatility on Fragmentation in East Asia: Evidence from the Electronics Industry', *Journal of the Japanese and International Economies*, 22: 535–544.

correct for the estimated overvaluation should have limited economic costs, while helping narrow the trade balance in the medium term, reducing pressure on the external accounts. This is in line with empirical evidence that suggests that moderate and gradual adjustments tend to have a positive impact on trade and growth, while larger sudden adjustments result in larger adjustment costs.[87]

Figure 2A: Relationship between exports and REER in Pakistan



Source: International Monetary Fund and State Bank of Pakistan.

Exchange rate flexibility is a key part of the macroeconomic adjustment process for open economies with liberalized capital accounts. Experience shows that countries with limited capital flows, such as Pakistan, are better able to use a flexible exchange rate as a tool to address emerging imbalances. In the medium term, this would support the external balance through improved competitiveness.

5. Monetary Policy and Inflation

The policy rate was kept unchanged, amid worsening external balances

The SBP kept the policy rate unchanged at 5.75 percent throughout FY17.[88] This approach was adopted in response to the moderate increase in inflation witnessed during the year, volatility in LSM growth, and pressure on the external account from rising imports, contracting exports, and falling remittances.

Monetary aggregates stayed put despite dwindling foreign exchange reserves

Broad money (M2) expanded (y-o-y) by 13.7 percent during FY17. The same growth rate was witnessed last year (**Table 8**). Despite a significant decline in net foreign assets (NFA),[89] M2 maintained its pace mainly due to growth in the net domestic assets (NDA) of the banking system, which registered a growth rate of 18.3 percent. Higher government borrowing from the SBP, better private sector credit, and a sharp increase in credit to PSEs contributed to this rise in NDA during FY17. The government

[87] M. Geiger. 2017. *Optimal Real Exchange Rate Management: Big Bang vs. Gradual Devaluation*. Washington, DC: The World Bank.

[88] Throughout the year, the majority vote of the Monetary Policy Committee favored keeping the policy rate unchanged. Interestingly, the last meeting of FY17 (held on May 20, 2017) concluded with a unanimous decision to maintain the status quo.

[89] NFA contracted by a huge 40.2 percent in FY17 as opposed to growth of 24 percent last year, primarily because of a US$2 billion drawdown in official foreign exchange reserves during the year.

borrowed Rs. 908 billion from the SBP as against retiring Rs. 487 billion in FY16. On the other hand, government borrowing from scheduled banks witnessed net retirement for the most part of the year and ended FY17 with a flow of only Rs. 179 billion – seven times lower than that of last year.[90]

Table 8: Monetary aggregates

Rs. billion unless mentioned otherwise

	Stock		Flow (July to June)	
	End-Jun-16	**End-Jun-17**	**FY16**	**FY17**
Net foreign assets	**1,008**	**602**	**195**	**(405)**
of which, SBP	1,033	829	311	(204)
Net domestic assets	**11,817**	**13,979**	**1,348**	**2,161**
Government borrowing:	7,820	8,955	861	1,136
Budgetary borrowing	7,195	8,282	791	1,087
from SBP	1,442	2,350	(487)	908
from scheduled banks	5,753	5,932	1,278	179
Commodity operations	637	687	72	50
Non-govt. sector borrowing:	5,013	6,120	557	1,107
Private sector	4,450	5,197	446	748
PSEs 1/	544	899	109	355
Other items	(1,015)	(1,096)	(70)	(81)
Broad money (M2)	**12,825**	**14,581**	**1,543**	**1,756**
Reserve money (RM)	**3,974**	**4,868**	**832**	**894**
Memorandum item				
Currency in circulation	*3,334*	*3,911*	*779*	*577*
Growth (y-o-y)				
M2	*13.7*	*13.7*	-	-
RM	*26.5*	*22.5*	-	-
Currency in circulation	*30.5*	*17.3*	-	-

Note: Rounded off to the nearest value.
1/ This is a sum of credit to Public Sector Enterprises (PSEs) and PSEs Special Account-Debt Repayment with SBP/PSPC. These indicators are reported in the Provisional Data on Monetary Aggregates released by SBP on weekly basis.
Source: State Bank of Pakistan.

Credit to the private sector picked up

As a result of the net retirement of government borrowing to scheduled banks and low real interest rates, private sector credit in FY17 has grown faster than a year ago. Credit to the private sector (mostly businesses) expanded by Rs. 748 billion, i.e., 16.8 percent (y-o-y). The improvement in credit off-take was concentrated in the manufacturing sector[91,92] (food products and beverages, and textiles).[93] Moreover, the growth was visible across all categories: working capital, fixed investment, and trade finance. Credit to PSEs[94] almost trebled during FY17 compared to the level observed last year. This strong growth was driven largely by energy sector PSEs. These loans generally feature inherent government guarantees, thereby allowing the scheduled banks to lend comfortably to this sector.

Inflation rose moderately…

Domestic demand experienced further recovery in FY17 due to the increase in domestic consumption. Despite this increase in domestic demand, headline inflation rose moderately to 4.2 percent over the year, staying below the target of 6 percent for the third consecutive year. This also reflects the better domestic supply situation,

[90] The government budgetary borrowing from scheduled banks amounted to Rs. 1,278 billion in FY16.
[91] Rs. 384 billion in FY17 (vs. Rs. 211 billion in FY16).
[92] This performance is in tandem with the impressive growth of 5.6 percent in LSM during FY17.
[93] These two sub-sectors contributed more than 60 percent of the increase in the manufacturing sector.
[94] The Water and Power Development Authority, Power Holding Private Limited, and Pakistan State Oil were among the major borrowers.

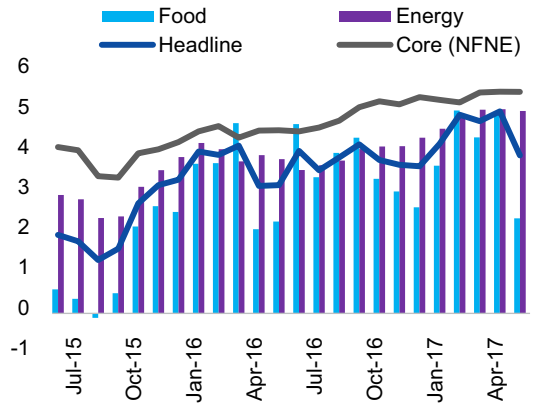
which helped keep headline inflation in check. Recovery in domestic demand is also evident from the gradually increasing non-food-non-energy (NFNE) inflation in FY17. However, it too remained well below levels of recent years. The increase in headline inflation was broad-based in FY17 as around 80 percent of the items in the consumer price index (CPI) basket recorded an increase over FY16 price levels. This translated into a 3.8 percent increase in food inflation and 4.4 percent non-food inflation in FY17 (**Figure 17**).

…mainly due to recovering international oil and commodity prices

The slight increase in headline inflation toward the end of FY17 was driven by a recovery in international oil and commodity prices. The fluctuation in global oil prices in H2FY17 resulted in frequent changes in HSD and petrol prices domestically. This pushed y-o-y inflation to 5 percent in May 2017 before it dipped in June 2017 due to a downward revision in petrol prices. Despite better domestic supply, food inflation increased to 3.8 percent in FY17 compared to 2.1 percent last year, mainly on the back of an increase in international prices of pulses. Nonetheless, Pakistan's headline inflation remains well below historical levels – enabled by low but rising underlying (core) inflation (see **Figure 18**). The stability of the Pakistani rupee, despite growing external account pressure in FY17, helped curtail the pass-through of mildly recovering international oil and commodity prices to domestic consumers.

Figure 17: Headline y-o-y inflation aided by falling energy prices and steady food prices

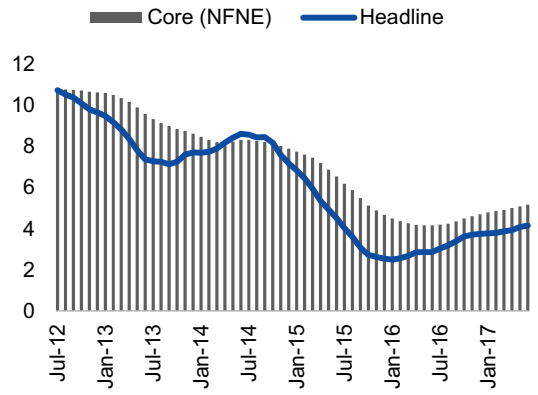
Percent



Source: State Bank of Pakistan.

Figure 18: Monthly moving average of core and headline inflation

Percent



Source: State Bank of Pakistan.

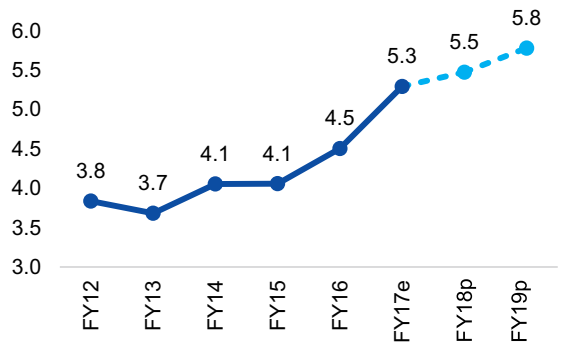
B. Outlook and Upcoming Challenges

1. Outlook

GDP growth is projected to increase moderately, provided macroeconomic risks are managed

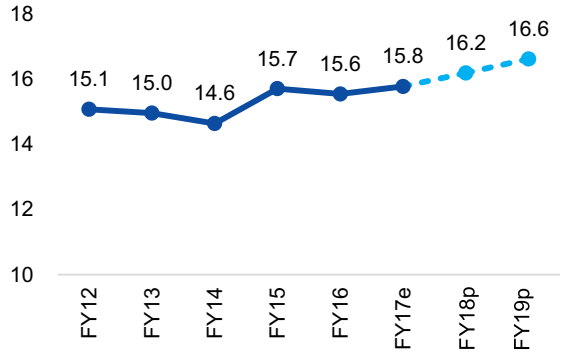
Despite an increase in macroeconomic imbalances during FY17, GDP growth is projected to increase moderately and touch 5.8 percent by FY19 (**Table 9** and **Figure 19**). This outlook is contingent on maintaining macroeconomic stability as well as steady progress in implementing the main pillars of the government's medium-term reform program, which targets key constraints to growth. The outlook assumes that oil prices will increase slightly but remain low, and that political and security risks are managed. On the demand side, acceleration will be driven by public and private consumption, aided by a moderate increase in investment. Aggregate consumption is expected to grow due to a marginal recovery in remittances and higher government expenditure during the election cycle. Investment is expected to grow moderately due to higher capital expenditures by the government and an increase in FDI and external loans for CPEC projects (**Figure 20** and **21**).

Figure 19: Real GDP growth, at constant factor prices
Percent



Note: e = estimate, p = projection.
Source: Pakistan Economic Survey and World Bank staff estimates.

Figure 20: Total investment
Percent of GDP



Note: e = estimate, p = projection.
Source: Pakistan Economic Survey and World Bank staff estimates.

Table 9: Key macroeconomic indicators
Percent growth unless mentioned otherwise

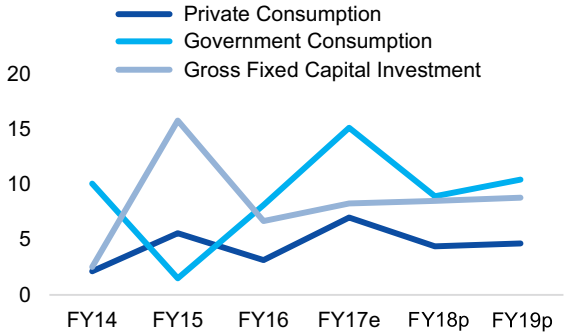
	Actual				Projected	
	FY14	FY15	FY16	FY17	FY18	FY19
Real GDP growth, at constant factor prices	**4.1**	**4.1**	**4.5**	**5.3**	***5.5***	***5.8***
Agriculture	2.5	2.1	0.3	3.5	*2.9*	*3.3*
Industry	4.5	5.2	5.8	5.0	*7.0*	*7.7*
Services	4.5	4.4	5.5	6.0	*5.8*	*5.9*
Real GDP growth, at constant market prices	**4.7**	**4.7**	**5.5**	**5.7**	***5.5***	***5.8***
Private consumption	5.6	2.9	6.9	8.6	*4.8*	*5.0*
Government consumption	1.5	8.1	8.2	10.7	*9.8*	*5.4*
Gross fixed capital investment	2.5	15.8	6.7	8.3	*8.5*	*8.8*
Inflation (CPI)	**8.6**	**4.5**	**2.9**	**4.2**	***6.0***	***7.0***
Current account balance (percent of GDP)	**-1.3**	**-1.0**	**-1.7**	**-4.1**	***-4.0***	***-3.9***
Exports of goods	1.1	-3.9	-8.8	-0.2	*4.7*	*10.5*
Imports of goods	3.8	-0.7	-0.2	17.6	*7.1*	*4.9*
Remittances	13.8	18.2	6.4	-2.8	*2.5*	*2.8*
Financial and capital account (percent of GDP)	**3.0**	**2.0**	**2.5**	**3.4**	***3.3***	***3.3***
Net FDI (percent of GDP)	0.6	0.3	0.8	0.9	*1.0*	*1.0*
Fiscal balance (including grants) (percent of GDP)	**-4.7**	**-5.2**	**-4.5**	**-5.6**	***-5.9***	***-5.8***
Primary balance (including grants) (percent of GDP)	**-0.2**	**-0.5**	**-0.2**	**-1.5**	***-1.5***	***-1.6***
Public debt (percent of GDP)	**64.4**	**64.3**	**68.6**	**68.1**	***67.7***	***66.4***

Source: Pakistani authorities and World Bank staff estimates.

The services and industry sectors will drive growth on the supply side

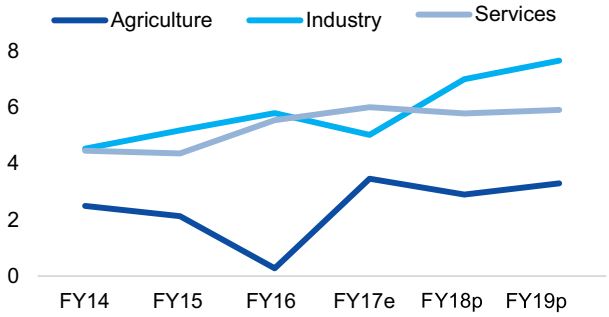
On the supply side, the impetus to growth is projected to come from the services and industry sectors (**Figure 22**). The services sector is expected to grow by 5.8 percent in FY18, compared to 6.0 percent in the previous fiscal year due to healthy growth in *wholesale and retail trade*, and *transport, storage, and communications*. Growth in the industry is expected to increase to 7.0 percent in FY18, compared to 5.0 percent in FY17, benefitting from an improved electricity supply and continued construction activity under CPEC during FY18. The agricultural sector's performance is expected to remain robust, with major contributions coming from the crops sector, particularly cotton and rice.

Figure 21: Growth (y-o-y) in consumption and investment
Percent



Note: e = estimate, p = projection.
Source: Pakistan Economic Survey and World Bank staff estimates.

Figure 22: Growth (y-o-y) in economic sectors
Percent



Note: e = estimate, p = projection.
Source: Pakistan Economic Survey and World Bank staff estimates.

External account pressure will persist due to a high trade deficit

The pressure on the current account is expected to continue as the trade deficit will persist during FY18 and FY19. This situation could potentially become unsustainable in the absence of timely corrective policy measures. Exports are expected to recover during FY18 and FY19 as supply-side factors ease, including an improved electricity supply and low domestic lending rates. This expectation is also supported by the double-digit growth recorded in exports during the first quarter of FY18. Imports, after touching 17.6 percent (y-o-y) growth in FY17, are expected to grow at a slower pace in FY18 and FY19. The slowdown in imports is mainly due to the high import base in FY17. Supported by a marginal improvement in the economic outlook of the GCC economies, remittance inflows will continue to partly finance the high trade deficit. Increased exchange rate flexibility could result in a depreciation of the Pakistani rupee, which may alleviate some of the pressure on the external account.

Financial flows aided by FDI will partly finance the current account deficit

It is also expected that FDI flows will strengthen with the accelerated implementation of CPEC projects. Capital and financial flows during FY18 and FY19 will not fully finance the current account deficit, which will result in a drawdown of reserves during these two years.

The fiscal deficit is expected to widen during the election cycle

Fiscal slippages are expected to continue through the election cycle, which will further widen the fiscal deficit during FY18, compared to the 5.8 percent fiscal deficit in FY17.[95] This increase in the fiscal deficit will be driven primarily by a slower increase in government tax revenues (both federal and provincial) and a sharper increase in expenditures. An adjustment in the fiscal position in FY19 post-election will help curtail the fiscal deficit.

Inflation is expected to rise steadily

Inflation, after remaining moderate during FY17, is expected to rise steadily in FY18 and FY19. This increase will be driven by higher domestic demand and a slight increase in international oil prices.[96]

2. Risks

Macroeconomic risks have increased with the widening of fiscal and external imbalances…

After significant improvements in macroeconomic stability for three years – primarily a result of prudent macroeconomic policies – macroeconomic imbalances have increased over the last year. As discussed above, a number of developments have contributed to the significant widening of the current account deficit. With insufficient financing, despite a considerable increase in debt-creating flows, reserves have declined over the past fiscal year. This was accompanied by a significant widening of the fiscal deficit after several years of successful fiscal tightening. The worsening external and fiscal balances coincided with the end of the IMF program. Policy adjustments will be necessary to reverse these imbalances and restore and maintain macroeconomic stability.

…and require policy intervention

Pressures on the balance of payments are projected to continue over the next few years. The trade deficit is expected to remain large even after exports recover, given strong import growth linked to CPEC investments. Remittances growth will remain subdued, given the gradual economic recovery projected in the GCC countries. A flexible exchange rate should help the economy adjust to these pressures.

A weaker Pakistani rupee would help improve the external accounts, with limited economic costs

Recent analysis by the World Bank shows that there is a strong and significant relationship between the REER and exports in the medium to long term, which suggests that increased Pakistani rupee flexibility would help narrow the trade deficit. Policymakers are usually concerned with the short-term adjustment costs of a weaker currency. Analysis by the World Bank suggests a moderate increase in inflation and a manageable increase in debt financing costs as a result of Pakistani rupee depreciation, in line with similar analyses conducted by the central bank and other institutions. Higher inflation could affect consumption negatively, but the overall impact of a moderate depreciation on growth is likely to be positive, as discussed in **Box 2** above.

Appropriate policy responses are needed to restore and maintain macroeconomic stability

The widening macroeconomic imbalances could increase the country's vulnerability to external and domestic shocks. With declining reserves and elevated debt ratios, Pakistan's ability to withstand external shocks will be compromised and the risks will remain predominantly on the downside. Increasing commodity prices, weaker global growth, or adverse geopolitical developments in the region could all test the economy's resilience. An appropriate policy response that corrects imbalances and increases

[95] During the previous two election cycles in Pakistan, the average fiscal deficit (excluding grants) was recorded at 6.3 percent of GDP.

[96] Average crude oil prices are projected to increase to US$60/bbl in 2018 and US$61.5/bbl in 2019 compared to US$55/bbl in 2017 (*Commodity Markets Outlook*, April 2017).

buffers able to absorb future shocks would reduce risks and support the positive growth outlook discussed in **Section B1** above. Such a policy response would entail maintaining a competitive REER – supporting exports and import-competing industries – as well as efforts to improve revenue collection and improved coordination between the federal and provincial governments to reduce public spending.

3. Progress and Next Steps on Structural Reforms

Short-term measures to preserve macroeconomic stability need to be combined with longer-term structural reform efforts

As discussed in this report, macroeconomic imbalances have significantly worsened over the last 9–12 months. Longer-term fiscal reforms, in particular those aiming to broaden the tax net and ensure tax compliance, would improve fiscal outcomes. Reforms to improve the competitiveness of the exports sector and the economy more generally will contribute to improved external balances and help attract more FDI to meet the country's external financing needs. These medium-term reforms are crucial to address stubborn structural imbalances and need to be implemented in parallel with the shorter-term measures discussed above to restore and maintain macroeconomic stability.

Recent tax reforms have generated important results, but continuity is crucial

In recent years, Pakistan's tax revenues have grown significantly (from 9.5 percent of GDP in FY11 to 12.4 percent in FY16) owing to federal and provincial efforts. The FBR has removed discriminatory exemptions provided through SROs, resulting in a significant reduction in tax expenditures. The provinces' contribution to total tax revenue reached 0.9 percent of GDP. Nonetheless, to sustain these gains, the next level of reforms needs to be implemented. The objectives of such reforms should include the broadening of the tax base, increased tax compliance, and reduced administrative and taxpayer compliance costs. To achieve these, a comprehensive review of tax policy is required, assessing it against the key principles of neutrality, fairness, and transparency. In addition, a fully automated and able tax administration is imperative to take advantage of modern IT infrastructure that uses the available data to reduce chances of tax evasion. Finally, post-18th Constitutional Amendment, the lack of coordination among different tax authorities has increased the compliance cost of taxpayers. There is a need to establish a coordination mechanism to resolve taxation issues between the federal government and the provinces, and among the provinces.

A number of reforms are needed to reverse the consistent decline in export competitiveness

The government's upcoming Strategic Trade Policy Framework (2018–23) will define its program to reverse the current decline in exports. This should include reforms in tariff rationalization, diversification, and integration with global value chains. These reforms need to be complemented by suitable trade facilitation measures, including the development and implementation of a national single window, among other areas, together with process streamlining to help Pakistan reduce trade costs and improve connectivity between domestic and foreign markets. Similarly, investment policy reforms and the development of a focused investment promotion strategy that *inter alia* restructures incentives, improves investor relationship management and inter-agency coordination, and establishes efficient one-stop services for investors, could unlock the significant potential of FDI in Pakistan.

The PFM Reform Strategy (2017–26) could substantially improve services delivery

The ultimate benefit of public financial management (PFM) reforms to citizens is that PFM and procurement systems help the government provide critical social services in a transparent and accountable manner and increase citizens' trust in the government. Key reforms include: improving the reliability of the budget by enacting a robust PFM law; eliminating discretion by standardizing internal controls and modernizing internal audit arrangements; and improving cash management, thereby reducing the cost of government borrowing. Value for money and integrity will be achieved by addressing inefficiencies in procurement regimes by eliminating restrictions in competition and improving transparency and efficiency through a robust e-procurement platform. Improving governance, internal controls, and automation related to salary and pension payments; and implementing an audit management information system to improve external audits and strengthen legislative scrutiny will enhance cost-efficiency once audit observations/queries can be tracked and the recommendations implemented. Pushing the boundaries of transparency by making key fiscal data readily available in user-friendly formats through open government data portals will provide a platform for holding the government accountable for the use of public funds. Improving SOE compliance with the Code of Corporate Governance for PSEs will instill confidence among citizens and stakeholders, complemented by efforts to improve the financial reporting framework, oversight by the Ministry of Finance, and improved transparency through availability of audited financial statements. Together, these reforms will result in a stronger, more transparent PFM and procurement systems that will support efforts to improve services delivery.

Ongoing investment climate reforms will help build investor confidence in long-term business opportunities

Pakistan has embarked on an ambitious investment climate reform initiative, which includes the implementation of a three-year Doing Business (DB) Reform Strategy as well as the simplification, streamlining, and automation of regulatory interfaces with the private sector. Both the federal and provincial governments are taking steps to improve their respective investment policies and promotion strategies to support greater linkages between local and foreign firms. In 2017, Pakistan made it to the list of the 10 economies that had carried out the most reforms in business regulation – the only country in South Asia to do so. However, into 2018 it declined to 147 out of 190 economies, compared to 144 into 2017. Pakistan's recent DB reforms include improvements relating to: business registrations, transparency in land records management and property registration, access to credit information, an electronic customs platform for easier trading across borders, and protection of minority investors. Regulatory authorities continue to develop electronic tools for improving business inspections while reducing the risks to investment (see **Box 3** for details of the Reform Strategy).

Box 3: Doing Business Reforms in Pakistan

Jumpstarting investment has proved difficult for Pakistan. Its investment-to-GDP ratio has stagnated since the 1990s, hovering around 15 percent. A combination of factors has contributed to this lackluster performance, one of which is the challenging operating environment for businesses. This is reflected in Pakistan's DB ranking [97] – 147 out of 190 economies (DB Report 2018). Furthermore, an analysis of the country's distance-to-frontier [98] score has decreased in recent years: from 52.9 in 2011 to 51.6 in 2018. This is well below most South Asian economies and Pakistan fares poorly when compared to the steady progress made by other regional economies such as India, Bhutan, and Sri Lanka.[99]

The worsening DB rankings galvanized the Government of Pakistan to launch a three-year DB Reform Strategy in 2017, with the goal of achieving an overall DB ranking below 100. Pakistan's wide-ranging and deep-seated investment climate constraints involve both federal and provincial jurisdictions. The strategy thus takes a 'whole-of-government' approach, involving both tiers of the state. Key areas where significant progress has been made include: improvements in land records management and property transfers in Punjab, enhanced access to credit information systems through expansion of coverage and strengthening borrowers' rights, and the launch of electronic customs platforms in Lahore and Karachi to increase ease of cross-border trade. These reforms led to Pakistan being recognized as one of the 10 economies [100] that had made the biggest improvements in business regulations in DB 2017.

The following major reforms are recognized in the DB Report 2018:

a. improved minority investor protection, by making it easier to sue directors in case of prejudicial transactions with interested parties;
b. improved transparency of the land registration process, by publishing online the fee schedule and list of documents necessary to complete any property registration in Karachi;
c. improved starting-a-business arrangements, achieved by replacing the need to obtain a digital signature for company incorporation with a less costly personal identification number; and
d. importing and exporting (trading across borders) made easier through a new container terminal and enhanced customs platform for electronic document submission.

The DB Report 2018 shows that Pakistan has made further progress in improving its business regulations over last year. But the pace of reforms is slower than regional and global competitors. Economies that have substantially improved their DB performance ensured highest level commitment and leadership as well as robust coordination between national and provincial authorities to drive such investment climate reforms. These factors can greatly benefit Pakistan in strengthening the existing momentum of reforms.

[97] The DB ranking highlights an economy's performance in business regulation relative to the performance of other economies for the year concerned.
[98] This score shows the average extent to which an economy's regulatory performance has progressed toward international best practice against each of the 10 DB areas. It is measured on a scale of 0 to 100, where 0 represents the worst performance and 100 the best practice (frontier), and shows the distance each economy has moved toward the frontier.
[99] The methodology for computation of countries' performance on the 10 DB indicators has undergone revision several times during the period examined (2006-2018); as a result, the rankings on the DB index as published in respective reports are not directly comparable.
[100] The 10 economies showing the most notable improvements in DB 2017 were: Brunei Darussalam, Kazakhstan, Kenya, Belarus, Indonesia, Serbia, Georgia, Pakistan, the UAE, and Bahrain.

C. Human Development: Moving the Needle

There have been some gains in human development in recent years, but the pace needs to be accelerated

If appropriate policies are put in place, Pakistan's population could become the country's main asset in the future, allowing it to benefit from the gains of a demographic dividend. As the fifth most populous country in the world, it continues to experience a youth bulge, with the share of young people [101] increasing faster than the growth of other age groups. Youth currently make up about 36 percent of the working-age population.[102] The labor force is expected to continue growing by 3.3 percent annually through to 2025. Meanwhile, employment has been growing at a slower rate since 2008, with new job creation unable to keep up with labor force growth. Economic development requires both *accelerated growth* enabling the *accumulation of capital* and the *enhancement of human capital* among the workforce to be productive in the labor market. Pakistan's human development base is poor. Some positive signs are starting to emerge in human development indicators, but much more needs to be done to increase and consolidate these gains.

School participation in early years is increasing…

Although only 4 out of 10 children in the pre-primary age group (aged 4–5) are enrolled in school, this number has increased by 7 percentage points for boys and 6 percentage points for girls since 2010.[103] It is worth noting that school participation for this age cohort is low even among the richest wealth quintile – with only 69 percent of children enrolled in school. School participation in the early years is essential to ensure that children are off to the right start, and pre-school participation is fundamental for school preparedness *(see Indicator 1 in Annex 1)*.

[101] Aged 15–24 years.
[102] Aged 15–64 years.
[103] Statistics derived from the Pakistan Social and Living Standards Measurement Survey (PSLM) for FY11 and FY15. Although the official early childhood education age is 3–5, the 4–5 age group is reported here, given that the PSLM does not capture enrollment information for children below the age of 4.

…as is participation in primary and secondary education, but progress varies regionally

Since 2010, the school participation rate (SPR) for primary-age children (aged 6–10) and lower secondary school-age children (aged 11–15) has increased by 3 percentage points, but 2 out of 10 children (aged 6–10) are still out of school. There are also gender disparities to note: there is a 10 percentage point difference between male and female participation for 6–10 year olds, and this gap widens to 14 percent for the 11–15 year age cohort. All the provinces have experienced an increase in SPR for 6–10 year olds, with the largest gains in school participation taking place in Balochistan and KP over this period. Punjab has the highest proportion of children enrolled in school (83 percent), followed by KP (80 percent).[104] In the 11–15 age cohort, KP has the highest share of children enrolled in school, with a 6 percentage point increase in school participation since 2010. School participation for 11–15 year olds in Sindh has remained unchanged since 2010 *(see Indicator 2 and 3 in Annex 1)*.

Enrollment in higher education and skills training remains low

Youth enrollment in higher education and skills training remains low across Pakistan. Only 9 percent of the 18–24 year age cohort in Pakistan is enrolled in either higher education or skills training, compared to 8 percent in 2010. This number is 9.7 percent for males and 8.5 percent for females. Less than 1 percent of the poorest wealth quintile is enrolled in higher education and skills training. In the richest wealth quintile, less than a quarter of the 18–24 year cohort is enrolled in higher education or skills training *(see Indicator 4 in Annex 1)*.

Access to skilled birth attendance has improved since 2010…

The percentage of births attended by skilled health personnel has increased by 15 percentage points since 2010[105] and all the provinces have made substantial gains. Overall, 58 percent of births in Pakistan took place in the presence of a skilled birth attendant, while for rural areas this number is only 49 percent. The impact of maternal care is also seen in the decrease of maternal mortality per 100,000 live births calculated for women aged 15–49 years (from 221 to 178 during the same period). KP has experienced the largest gains by increasing skilled birth attendance by 19 percentage points, followed by Punjab (a 16 percentage point increase). Skilled birth attendance is lowest in Balochistan – less than 38 percent *(see Indicator 6 in Annex 1)*.

…whereas child immunization has improved marginally

Child immunization rates remain above 80 percent, with a marginal increase nationally. Overall, the immunization rate for children between the ages of 12 and 24 months is presently 83 percent.[106] The immunization rate in Punjab is highest, currently touching 90 percent, while in Balochistan the current immunization rate is 53 percent. Approximately two thirds of children in the poorest wealth quintile are immunized as compared to 94 percent of children in the richest wealth quintile *(see Indicator 7 in Annex 1)*.

Stunting is chronically high among children under 5

Overall, 44 percent of children (under the age of 5) in the country are either severely or moderately stunted. Stunting levels are high across all the provinces. While malnutrition rates are high in all provinces, the nutritional status of children under 5 is worse than the national average in Sindh and Balochistan. Half the children under 5 in Balochistan (52 percent) and in Sindh (50 percent) are stunted and these rates have worsened in the two

[104] For comparability across provinces, PSLM data was used. Alternative sources of data on school participation are also available for some provinces: in Punjab, the SPR for children aged 5–9, derived from the Nielsen household survey data, is reported as 90 percent as per the latest round in January 2017. In 2014, the SPR for children aged 5–9 in Punjab, based on the Multiple Indicator Cluster Survey (MICS) and PSLM, was 81 and 80 percent, respectively, while the Nielsen SPR figure for 2014 was 89 percent. In Sindh, the SPR for children aged 5–9 in 2014 was 63 percent as reported by the MICS and 62 percent according to the PSLM.

[105] This includes births attended by a doctor, nurse, midwife, or lady health visitor (LHV). All statistics are calculated based on data from the PSLM FY11 and FY15.

[106] Child immunization rates are calculated as the proportion of children between the ages of 12 and 24 months (based on recall or record) who have received the following immunizations: BCG, DPT 1, DPT 2, DPT 3, polio 1, polio 2, polio 3, and measles (PSLM).

provinces since 2001. Chronic malnutrition (measured by stunting) in Pakistan starts during pregnancy and then doubles in the first two years of a child's life, i.e., the 'first 1,000 days'. At birth, one in five children is born with low birth weight; by 6 months, 24 percent of children are stunted; by 24 months, half (48 percent) of them are stunted, indicating that the period from 6 to 24 months is a critical risk period for growth faltering[107] *(see Indicator 8 in Annex 1)*.

Government spending on education has increased, but remains low…

Although there has been an improvement in education financing over the last five years, education expenditure as a proportion of GDP remains below 2.5 percent.[108,109] The provinces have increased allocations to the education sector since 2010. At present, provincial education budgets account for anywhere between a fifth and a fourth of the overall provincial budgets. Between 2010 and 2015, public education expenditure increased by 105 percent in nominal terms, while development expenditure increased by 119 percent[110] *(see Indicator 5 in Annex 1)*.

…as does expenditure on health

Although health expenditure (nationally) as a percentage of GDP has increased since 2010, it remains low. Health expenditure as a percentage of GDP was 0.6 percent of 2016[111] *(see Indicator 9 in Annex 1)*.

Poverty has fallen markedly, but there is an uptick in inequality

GDP in 2010, and this number increased to approximately 0.9 percent of GDP by Over the past decade and a half, Pakistan has seen a substantial decline in poverty. The poverty rate has more than halved over a period of 14 years, falling from 64.3 percent in 2001 to 29.5 percent in 2013. Provincially, a decline in poverty occurred in KP, Punjab, and Sindh. Balochistan remains the poorest province in the country, with a poverty rate of almost 57 percent in 2013. Growth was largely responsible for the gains in poverty reduction, with the bottom 40 percent of the distribution growing faster than average over the period between 2005–07 and 2007–10. Shared prosperity has, however, declined in more recent years. Between 2010 and 2013, the shared prosperity premium – the difference between the growth in average consumption of the bottom 40 percent of the distribution and the distribution average – was negative, indicating an uptick in inequality. Similar patterns emerge when looking at changes in the distribution of consumption in each province. The consumption growth of the bottom 40 percent of the population in Punjab and KP has increased over time, but at a lower rate than mean growth, as captured by a deterioration in the shared prosperity premium and inequality. On the other hand, the shared prosperity premium has improved markedly in Sindh *(see Indicator 10 and 11 in Annex 1)*.

While access to improved water has increased, a large share of the population remains unconnected to water supply and sanitation systems

Pakistan has seen some improvement in access to water and sanitation in the last five years. Most Pakistanis now have access to improved drinking water (89.5 percent in 2015), mainly driven by an increase in the use of hand pumps and motorized pumps. The piped water supply has decreased significantly all over the country and regionally, and only a quarter of the population (26.7 percent) has access to piped water. Rural areas are the most disadvantaged, with approximately 13 percent of the population having access to piped water. Although there has been an improvement in the share of households with toilet facilities, many lack toilet facilities connected to a drainage system. Low access to and the poor quality of improved toilets in rural areas, coupled with dismal drainage, can be a public health hazard in the absence of safe fecal

[107] National Nutrition Survey 2011.
[108] This includes all public expenditures on education (federal and provincial).
[109] Poverty Reduction Strategy Paper (PRSP) progress report for FY16.
[110] Pakistan Bureau of Statistics, 2016, *Social Indicators of Pakistan*.
[111] See footnote 109.

treatment and management. Combined with the lack of access to improved water, this is also a major factor contributing to stunting *(see Indicator 12 through 15 in Annex 1)*.

Female labor force participation is dismal…

Labor force participation has increased marginally since 2010, but only one in four women participates in the labor force. Overall labor force participation in 2014 was 53 percent compared to 52 percent in 2010. According to Labor Force Survey (LFS) data, male participation in the labor force is approximately 82 percent, while female participation remains very low at 25 percent[112] *(see Indicator 17 in Annex 1)*.

…and women's access to finance remains low

Gaps in women's access to finance in Pakistan are still very large. Gender discriminatory practices by microfinance field officers mean that two thirds of female borrowers need permission from male relatives before they can even qualify for a loan. Women's access to agricultural loans is merely 4 percent, and is only 3 percent for small-and-medium-enterprise (SME) loans. Studies indicate that 50–70 percent of the loans made to female clients may be used by their male relatives. Less than 5 percent of women have bank accounts and 2 percent of women use digital financial services. It is vital to reduce the barriers that women entrepreneurs, including women involved in agriculture, face in access to finance and digital financing to enhance women's economic empowerment *(see Indicator 20 in Annex 1)*.

There is (slow) progress on gender development indicators

While gender development indicators have improved, concerted efforts are required to accelerate the pace of these gains. Pakistan is doing comparatively better on women's political participation in national parliaments and is ranked 90th for political participation on the global gender gap index for 2016. However, the number of women ministers in provincial cabinets is still very low and Pakistan's rank drops to 139 in the category of women in ministerial positions.[113] The adolescent fertility rate is declining gradually, but will require concerted multi-sector efforts and improvements in social norms if it is to fall further. The maternal mortality ratio has also fallen since 2010 and stands at 178 per 100,000 live births, calculated for women aged 15–49 in 2015. This can be attributed, in part, to women's improved access to birth attendants and an increase in prenatal consultations in the country. However, provincial variations are stark *(see Indicator 16 and 18 through 20 in Annex 1)*.

The Way Forward

Human capital accumulation is a key driver of growth

Human development is a lifelong process – beginning from early childhood development (through the right nutrition, stimulation, and parenting) and encompassing formal learning (early childhood education, schools, training institutions, universities); non-formal learning (apprenticeships, on-the-job training, second-chance education[114]); labor intermediation services; and entrepreneurship and innovation. Further, it requires a healthy and well-nourished population. In moving forward, it is essential for Pakistan to focus on policies and interventions that can improve human development indicators quickly.

[112] Statistics calculated from the LFS for 2010 and 2014.
[113] Global Gender Gap Report 2016.
[114] Second chance education is education specifically targeted at individuals who have either never attended school or left school (UNESCO).

Productive inclusion of the poor, the unskilled, and women is required

With low human capital accumulation, women, the poor, and the unskilled largely remain excluded from the social, economic, and political process. Tailor-made interventions to facilitate the productive inclusion of the poor and vulnerable include linking training to financial inclusion and productive assets for business development. Low female labor force participation and lagging employment outcomes necessitate adapting the work environment and policy to the needs of women as they relate to social norms, mobility constraints, working hours, and household responsibilities.

A holistic approach to human development is required

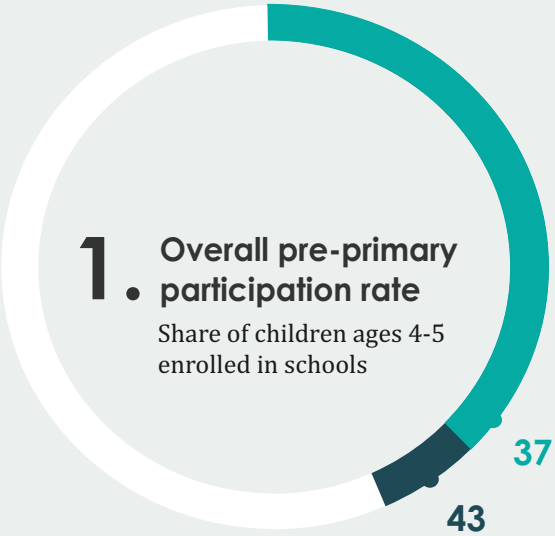
Without a comprehensive human development approach that connects the supply of quality services to the demand for such services, utilization will remain low. Targeted investments to improve service delivery must be complemented by instruments that enhance the utilization of these services, such as conditional cash transfers and behavioral change communication strategies for sustainable returns.

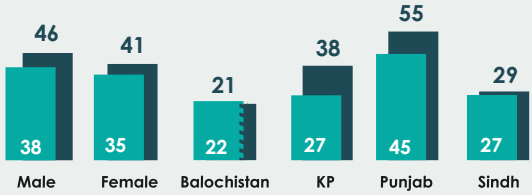
Social Indicators

2010 | 2014*

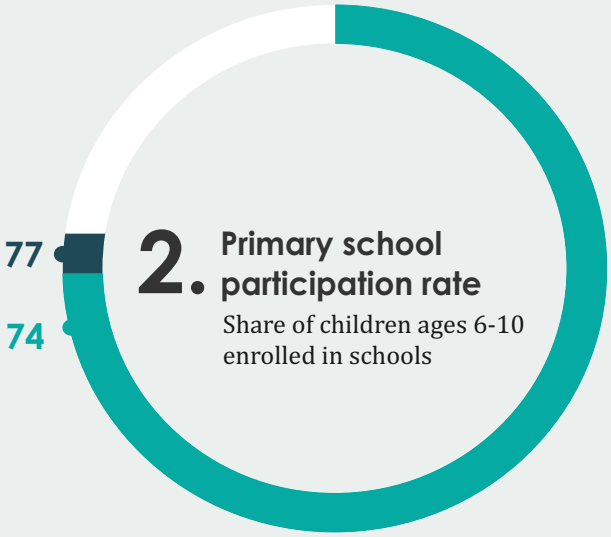
Education & Skills**

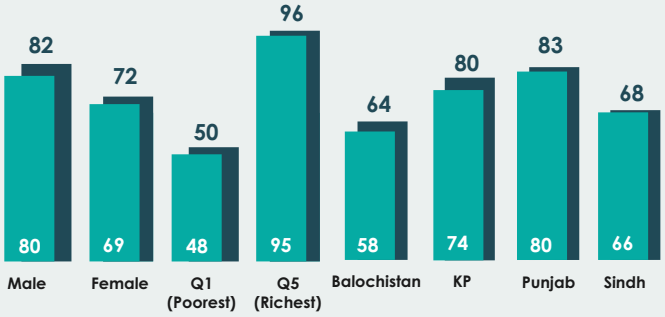
Only 4 out of 10 children in the pre-primary age group (ages 4-5) are enrolled in school; this number has **increased by 7 percentage points** for boys and **6 percentage points** for girls since 2010.





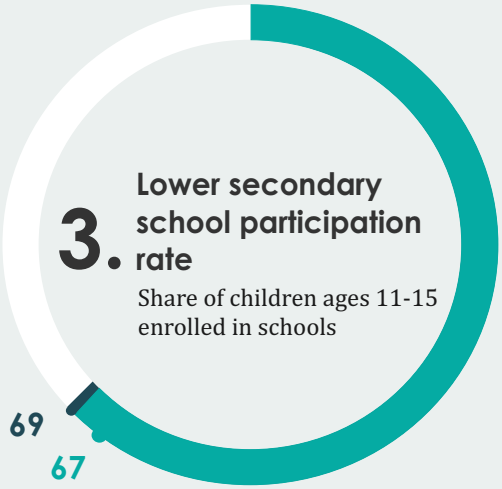
Source: PSLM

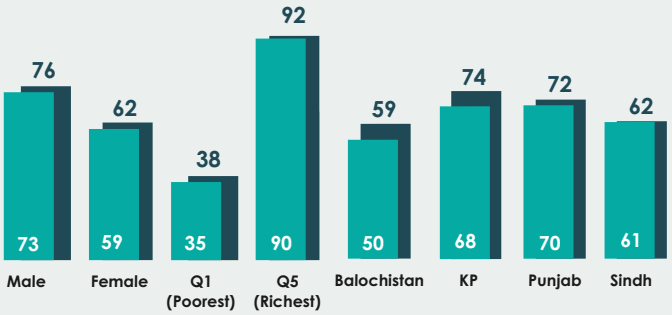




Source: PSLM

Since 2010, school participation for primary age children (ages 6-10) and lower secondary school age children (ages 11-15) has **increased by 3 percentage points**. However 2 out of 10 children (ages 6-10) are still out of school.





Source: PSLM

School participation increased for all wealth quintiles during this time period

* Most recent data has been reported where available.
** For issues of comparability between all provinces, PSLM data was used. Alternate sources of data to measure school participation are also present in some provinces.

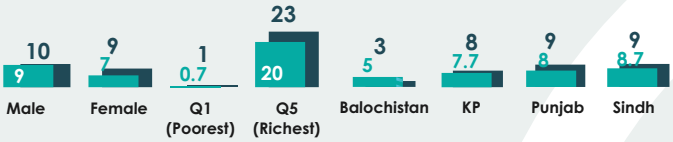
2010 | 2014*

Youth enrollment in higher education and skills training remains low across Pakistan.

Despite an improvement in education financing over the past 5 years, education expenditure as a proportion of GDP remains below 2.5 percent.

4. Percentage of 18-24 year olds enrolled in higher education or skills training

This captures the share of 18-24 year olds enrolled in either college/university or skills training



Source: PSLM

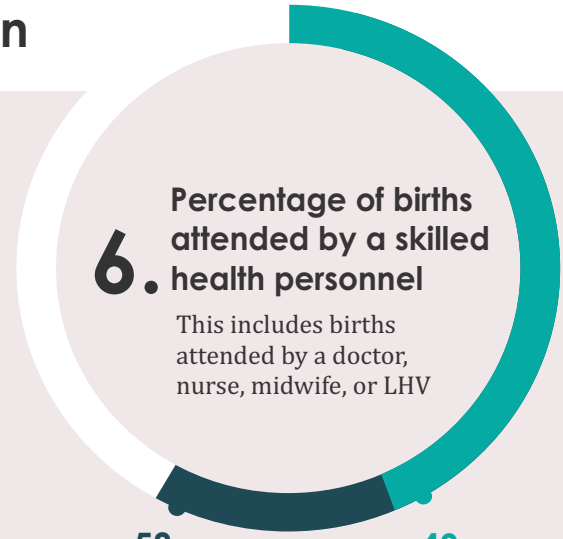
5. Expenditure on education (% of GDP)

Total public expenditure on education as a percentage of GDP

Source: PRSP Progress Report

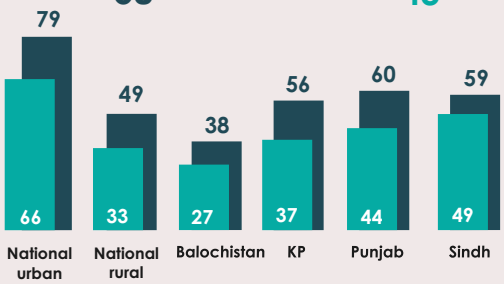
Health & Nutrition

The percentage of births attended by skilled health personnel has **increased by 15 percentage points** since 2010



6. Percentage of births attended by a skilled health personnel

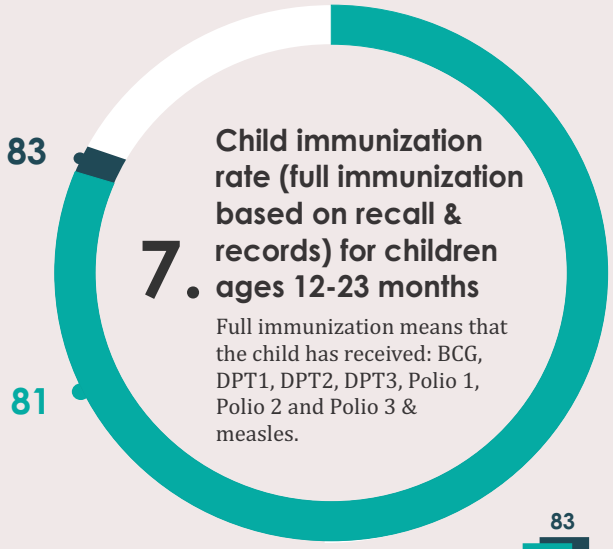
This includes births attended by a doctor, nurse, midwife, or LHV



Source: PSLM

* Most recent data has been reported where available.

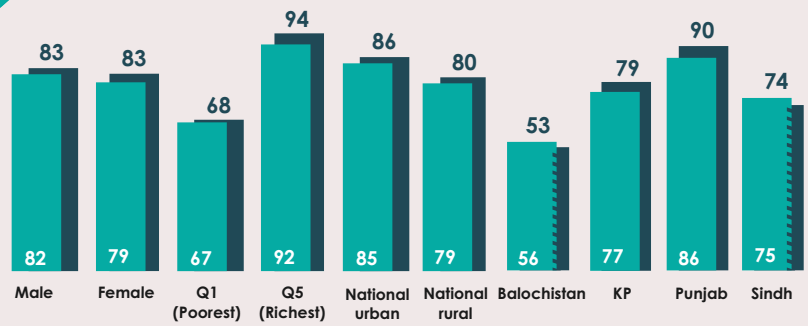
2010 | 2014*



7. Child immunization rate (full immunization based on recall & records) for children ages 12-23 months

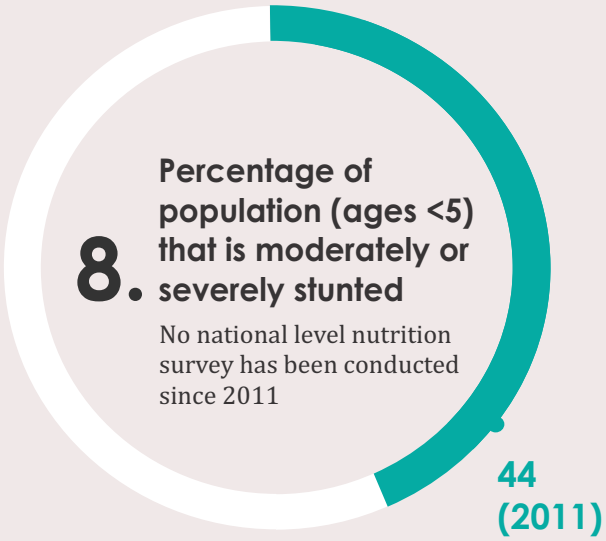
Full immunization means that the child has received: BCG, DPT1, DPT2, DPT3, Polio 1, Polio 2 and Polio 3 & measles.

Child immunization rates **remain above 80 percent with a marginal increase** nationally.



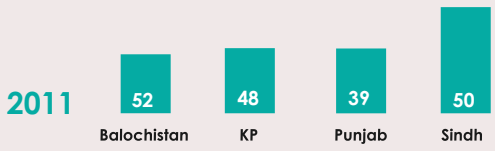
Source: PSLM

Overall, **4 out of 10 children (under the age of 5)** in the country are either severely or moderately stunted.



8. Percentage of population (ages <5) that is moderately or severely stunted

No national level nutrition survey has been conducted since 2011



Source: National nutrition survey 2011

Although health expenditure (nationally) as a percentage of GDP has increased since 2010, it remains low.

9. Expenditure on health (% of GDP)

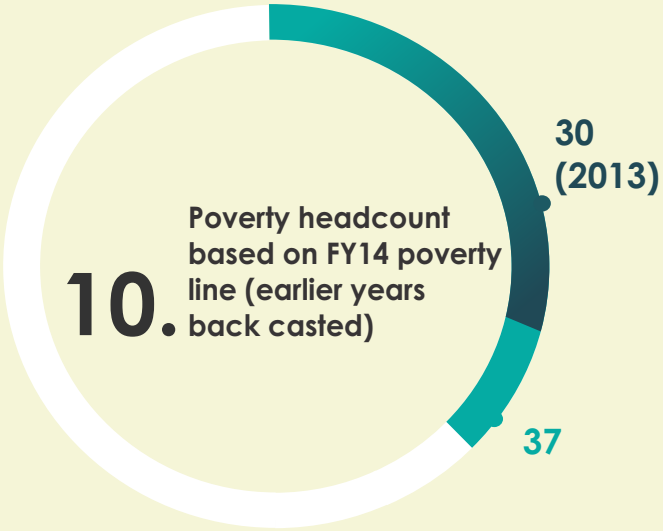
Source: PRSP Progress Report

* Most recent data has been reported where available.

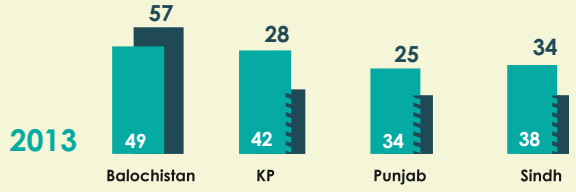
Poverty

2010 | 2014*

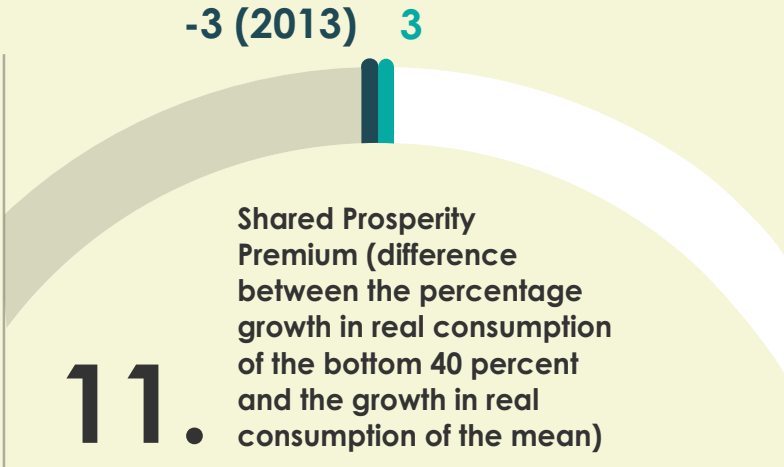
Over the past decade and a half, Pakistan has seen a substantial decline in poverty.



10. Poverty headcount based on FY14 poverty line (earlier years back casted)



Source: HIES



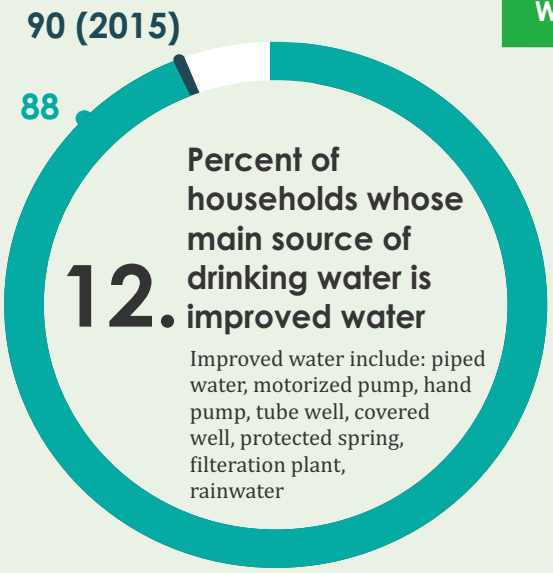
11. Shared Prosperity Premium (difference between the percentage growth in real consumption of the bottom 40 percent and the growth in real consumption of the mean)

Shared Prosperity in 2010 refers to consumption growth over the period 2007-08 to 2010-11. Shared Prosperity in 2013 refers to consumption growth over the period 2010-11 to 2013-14. Shared Prosperity at the province level is computed defining the bottom 40 percent in each province's distribution.

Source: HIES

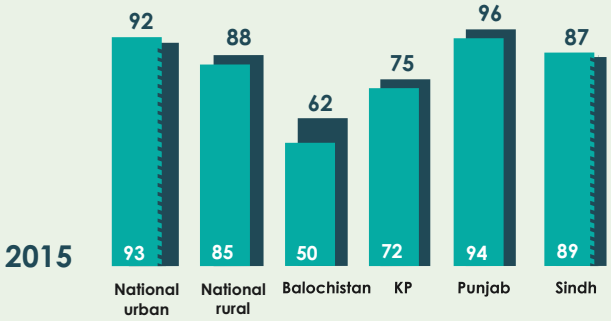
Water & Sanitation

Pakistan has seen some improvement in access to WASH infrastructure in the last five years



12. Percent of households whose main source of drinking water is improved water

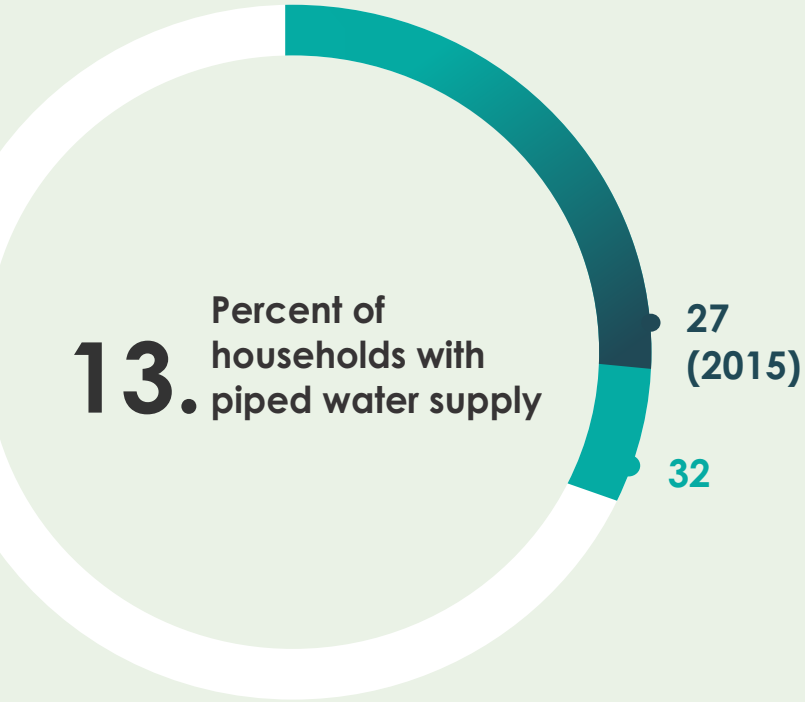
Improved water include: piped water, motorized pump, hand pump, tube well, covered well, protected spring, filteration plant, rainwater

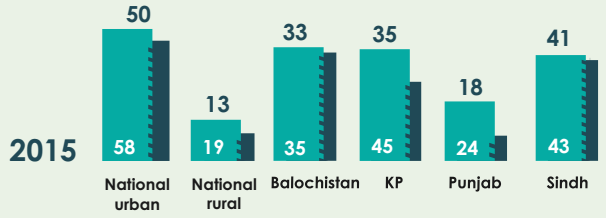


Source: PSLM

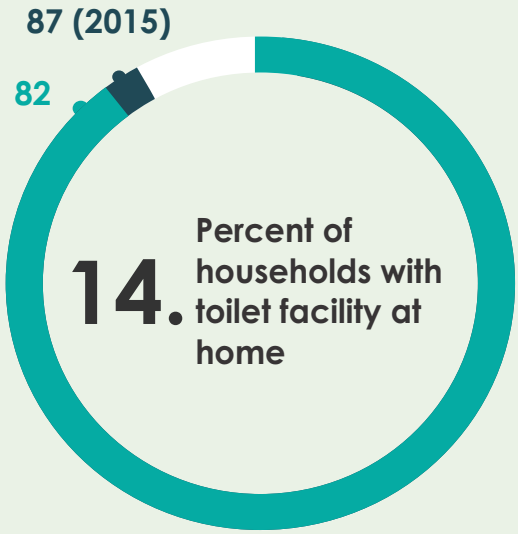
* Most recent data has been reported where available.

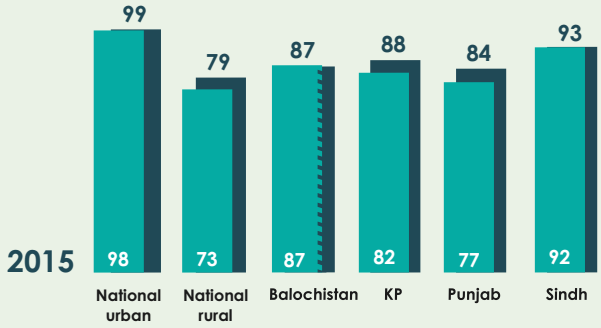
2010 | 2014*





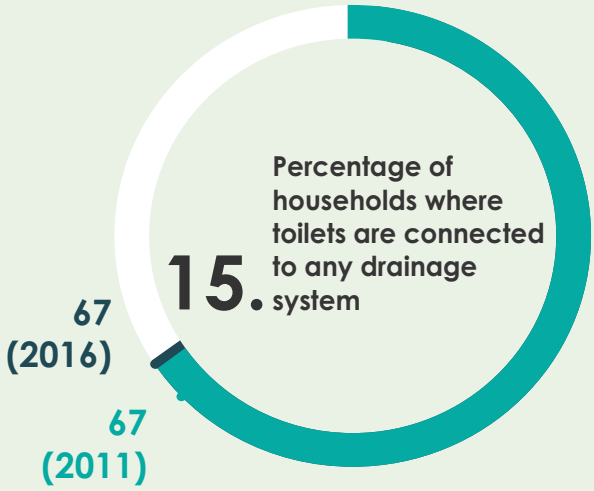
Source: PSLM

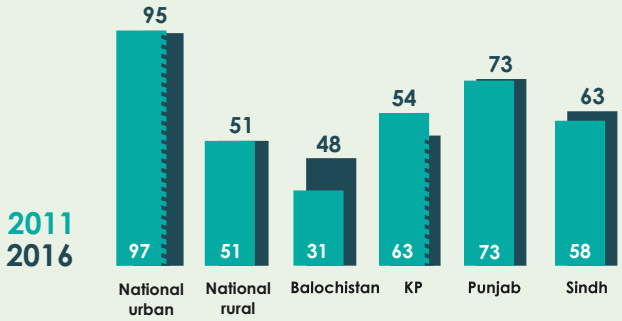




Source: PSLM

An essential factor for reducing stunting is access to improved water and sanitation.





Source: HIES

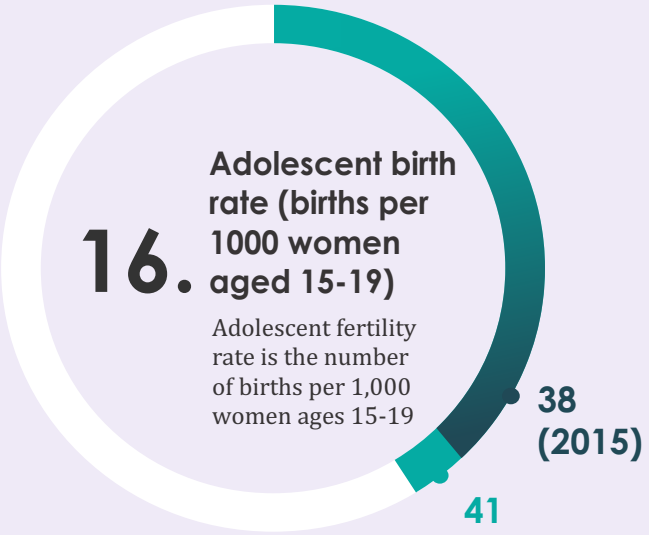
* Most recent data has been reported where available.

2010 | 2014*

Gender

16. Adolescent birth rate (births per 1000 women aged 15-19)

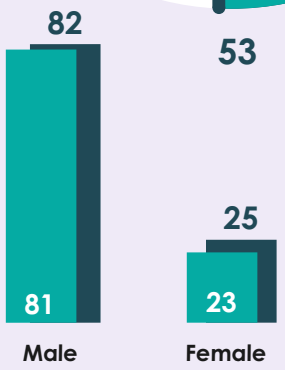
Adolescent fertility rate is the number of births per 1,000 women ages 15-19



Source: United Nations Population Division, World Population Prospects

17. Labor Force Participation Rate (Ages 15-64)

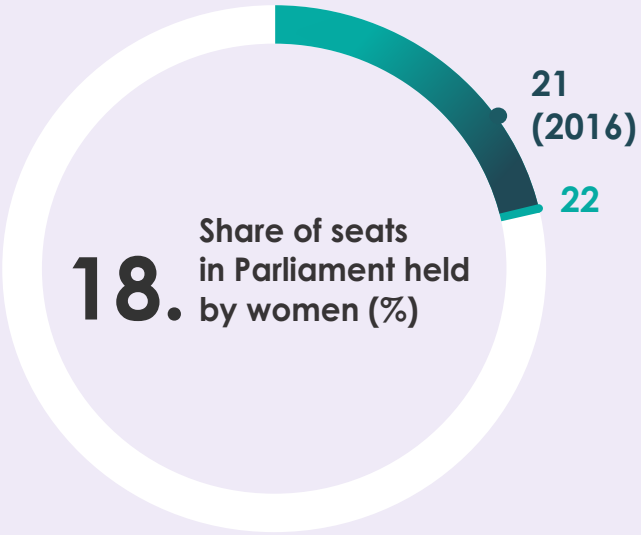
The share of the population ages 15 and above, engaged in economic activity



Source: LFS

Labor force participation has increased marginally since 2010, however only one in four women are participating in the labor force.

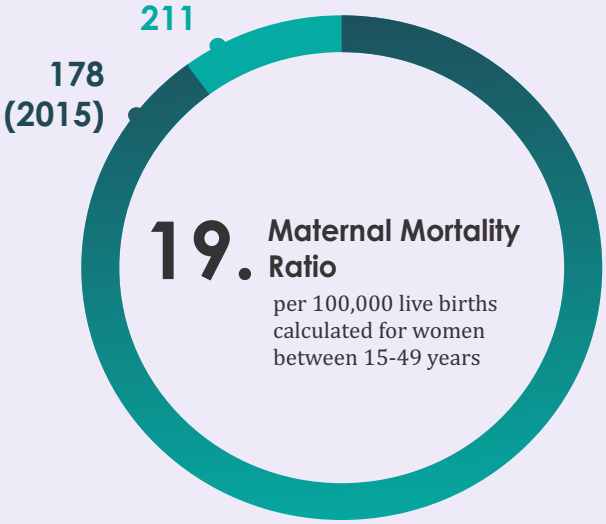
18. Share of seats in Parliament held by women (%)



Source: World Bank

19. Maternal Mortality Ratio

per 100,000 live births calculated for women between 15-49 years

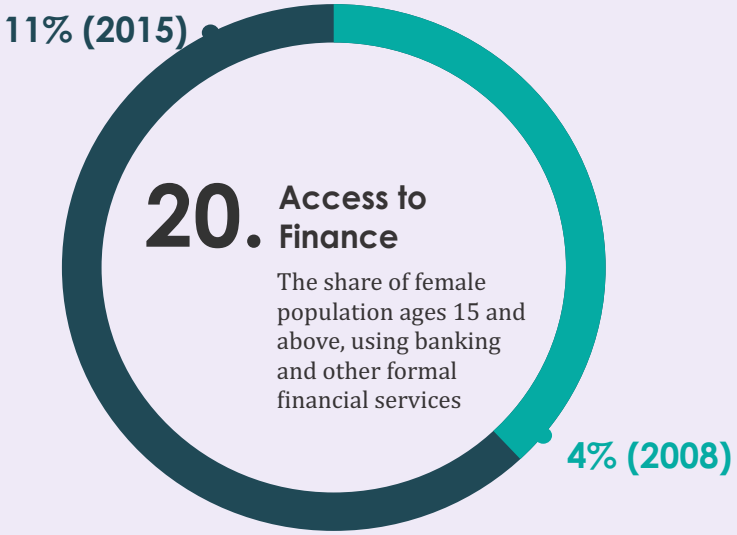


Source: Demographic Health Survey

* Most recent data has been reported where available.

2010 2014*

Gaps in women's access to finance are still huge in Pakistan.



20. Access to Finance

The share of female population ages 15 and above, using banking and other formal financial services

Source: Access to Finance Surveys

* Most recent data has been reported where available.

D. Special Sections

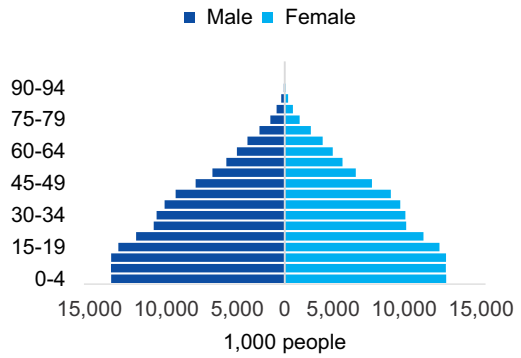
1. Jobs and Entrepreneurship in Pakistan

Pakistan faces the triple challenge of creating more jobs, improving access to jobs and economic opportunities for women, and improving the quality and productivity of jobs

Pakistan's job challenge is characterized by a youth bulge, low female labor force participation, and slow progress in improving the quality of jobs and labor productivity**.** With continuously high fertility rates, Pakistan's working-age population is expected to continue growing at 2.1 percent per year for the next decade (**Figure 23**). That said, labor force participation in Pakistan remains low, largely explained by low levels of female labor force participation, which is 57 percentage points lower than that of males and is especially low in urban areas. The nature of jobs has changed very little over the last 15 years in Pakistan (**Figure 24**).[115] Youth, despite being more educated, have significantly worse employment outcomes compared to older workers, as evidenced by a higher unemployment rate and a higher share of young workers in informal and unpaid jobs. Consistent with the slow pace of structural transformation, labor productivity and the quality of jobs remains low.

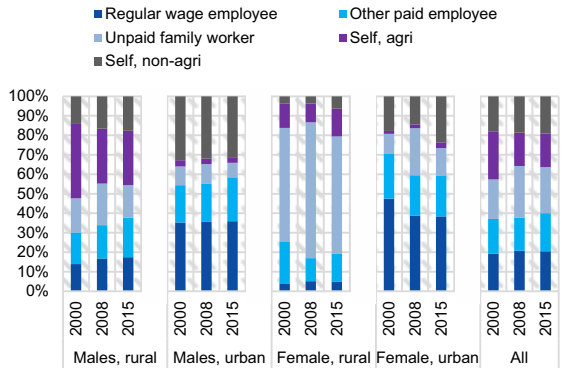
[115] Regular wage employment represents only 20 percent of the total number of jobs and is concentrated in urban areas. The share of unpaid workers is high in rural areas (Labor Force Survey FY15).

Figure 23: Demographic projections, Pakistan, 2030
Population by five-year age groups, medium fertility



Source: UN projections.

Figure 24: Employment by type in Pakistan (ages 15–64), 2000–15
Percent of total



Source: World Bank staff calculations using Labor Force Survey data for individuals aged 15–64.

a. The State of Entrepreneurship in Pakistan

Self-employment and entrepreneurship provide livelihood opportunities to a large share of the workforce

More than a third of those participating in the labor force are self-employed (own-account workers and employers) and every second household owns a small business (informal household enterprises).[116] These household enterprises employ family workers, many of whom are unpaid.[117] A higher share of rural males are involved in self-employment in agriculture, while a higher share of urban males are involved in self-employment in non-agriculture sector. Women, on the other hand, are grossly underrepresented in self-employment, whether in agriculture or non-agriculture, and overrepresented among unpaid family workers, pointing to the significant constraints to female entrepreneurship. Youth also appear to face additional challenges: the share of self-employed youth (aged 15–24 years) is 18 percent compared to 41 percent for adults.

Most entrepreneurship is driven by necessity rather than opportunity

The share of 'growth-oriented' entrepreneurship is still low. Growth-oriented entrepreneurship, defined as businesses with the potential to grow and generate employment, contrasts with 'necessity' entrepreneurship, which provides livelihoods to those who opt for self-employment for lack of other opportunities and do not necessarily have the skills or aspirations to grow their business. While there is no perfect metric for defining growth entrepreneurs vis-à-vis necessity entrepreneurs, only 1 percent of the employed are employers, e.g., those entrepreneurs who employ others (**Figure 25**). This share is only slightly higher in urban areas (3 percent). Women represent just 2 percent of all employers – a negligible share – and only 14 percent of own-account workers (**Figure 26**).

[116] Authors' calculations based on the PSLM FY14 data.
[117] The share of unpaid workers among working individuals in Pakistan is 22 percent overall and 53 percent among working females (LFS FY15).

Figure 25: Distribution of employment type, 2015
Percent of total

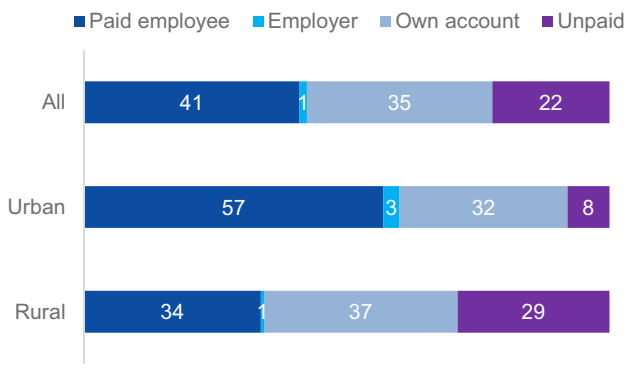
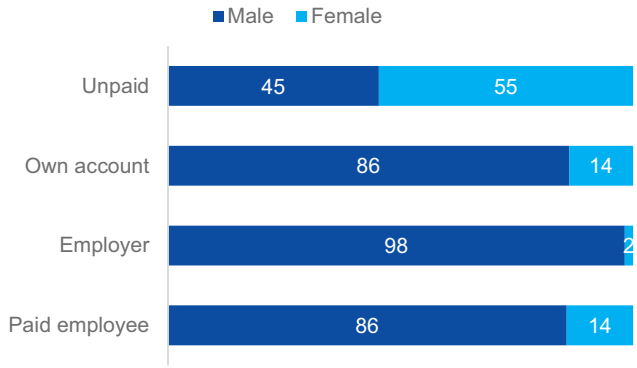


Figure 26: Distribution of employment type by gender, 2015
Percent of total



Source: World Bank staff calculations using LFS FY15 data. Figures are for individuals aged 15–64.

Opportunity entrepreneurs tend to be more educated and more likely to operate in the formal sector

Employers are very different from own-account workers in many respects, with different needs. Controlling for other characteristics, employers tend to be more educated than own-account workers and even more so than wage workers (**Figure 27**). They also tend to be older than those who are self-employed without employees, which is consistent with the literature on other countries. It is also consistent with the high capital requirements for setting up a business which, in the presence of limited access to credit, only better-educated and older individuals may be able to accumulate. Employers are more likely to work in manufacturing and services, as opposed to own-account workers, almost half of whom work in agriculture (**Figure 28**). Employers are also more likely to operate in the formal sector: 44 percent of employers report having written accounts, relative to only 12 percent of own-account workers.

Figure 27: Distribution of education levels by employment type, 2015
Percent of total

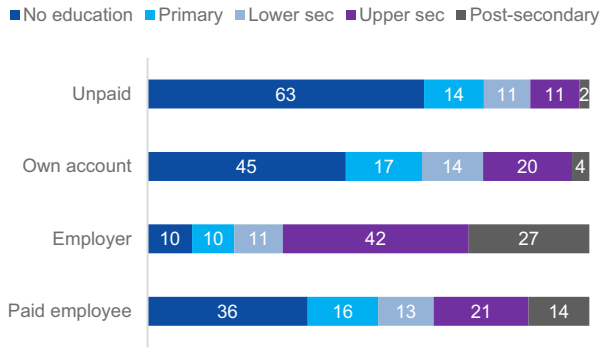
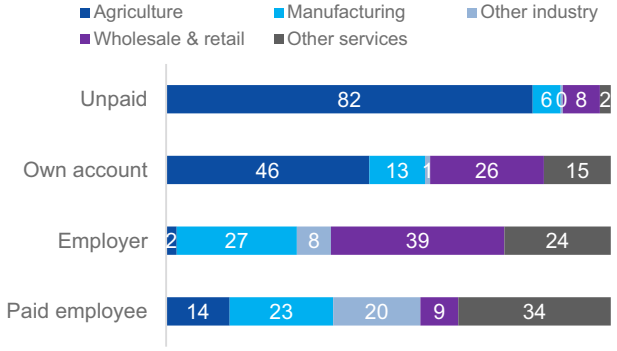


Figure 28: Distribution of sectors by employment type, 2015
Percent of total

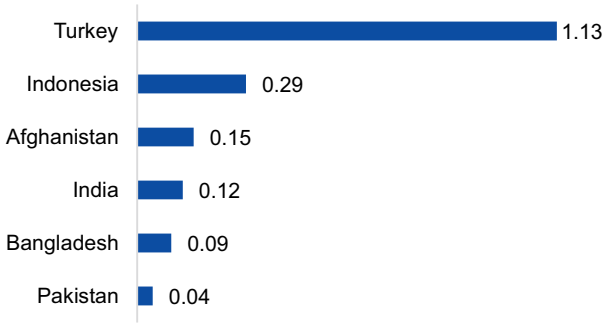


Source: World Bank staff calculations using LFS FY15 data. Figures are for individuals aged 15–64.

Pakistan's formal private sector is quite small…

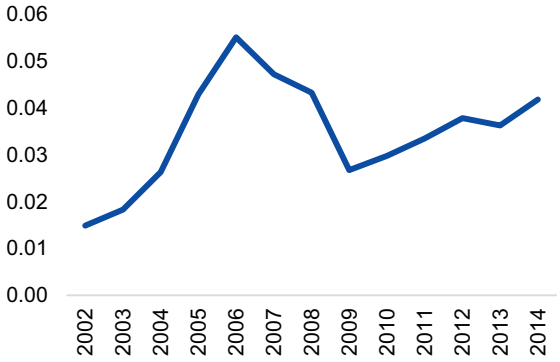
The low prevalence of employers among the self-employed is consistent with the low entry of firms, especially in the formal private sector, which is very small, accounting for only 6 percent of all employed. Entry into the formal private sector appears to be limited, with just 4,830 new limited liability companies established in 2014. This corresponds to a rate of just 0.04 new companies per 100,000 people – the lowest among comparator countries (**Figure 29**). The peak entry rate was achieved in 2006 at the height of economic growth and structural reforms, but has dropped dramatically in the years that followed and not fully recovered since 2009 (**Figure 30**). While this statistic underestimates entry by considering only formal companies, it nevertheless points to significant barriers to growth-oriented entrepreneurship – the kind that can provide more and better employment opportunities to a growing workforce.

Figure 29: New firm entry rate
Number of new limited liability companies per 100,000 people



Source: World Bank Doing Business database.

Figure 30: New firm entry rate in Pakistan, 2002–14
Number of new limited liability companies per 100,000 people



Source: World Bank Doing Business database.

…with significant barriers facing growth-oriented entrepreneurship…

There are significant barriers to growth for SMEs. While information on private sector firms in Pakistan is very limited, the existing data suggests that there are substantial constraints to the ability of entrepreneurs to grow their businesses. In the manufacturing sector, for which data tends to be more easily available and more reliable, the transition matrices indicate that very few firms are able to grow (**Table 10**). Almost all (99 percent) small firms with fewer than 20 employees are unable to increase employment within the first 10 years of operation and 54 percent remain in this category even after. While small and young firms may be underrepresented in this data, the results suggest that, even in formal manufacturing, there is very little growth in the SME sector.

Table 10: Transition matrix for manufacturing firms[118]

Current size (number of employees)

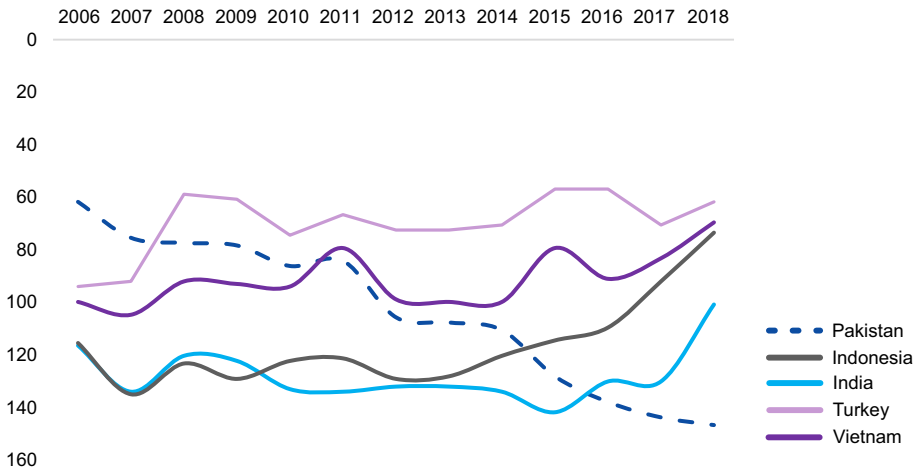
	1-19		20-99		100+	
Size at birth (number of employees)	**age<10**	**age 10+**	**age<10**	**age 10+**	**age<10**	**age 10+**
1-19	99%	54%	1%	16%	0%	30%
20-99	8%	9%	83%	40%	9%	51%
100+	0%	0%	0%	91%	100%	9%

Note: Current size refers to the number of full-time permanent employees. Size at birth refers to full-time employees at startup. Age refers to the number of years since the establishment began operations.
Source: World Bank staff calculations using 2013 Enterprise Survey data.

…as reflected in the deteriorating DB rankings of the country

Pakistan's low ranking on the DB index suggests that the lack of entry and dynamism among SMEs is driven by deficiencies in the investment climate. Moreover, its ranking against DB indicators has fallen substantially in recent years. As of 2006, Pakistan's business climate was considered generally more favorable than those of India, Indonesia, Turkey, or Vietnam, but the most recent rankings suggest that deficiencies in Pakistan's investment climate now inhibit firm growth – not just more than in any of these four countries, but (with a ranking of 147 out of 190 economies) also in most of the world (**Figure 31**). Of the 10 constituent indices that determine the overall ranking, Pakistan scores relatively well in protecting minority investors, getting credit, and resolving insolvency, but falls behind in starting a business, dealing with construction permits, getting electricity, registering property, paying taxes, trading across borders, and enforcing contracts.

Figure 31: DB rankings, 2006–18



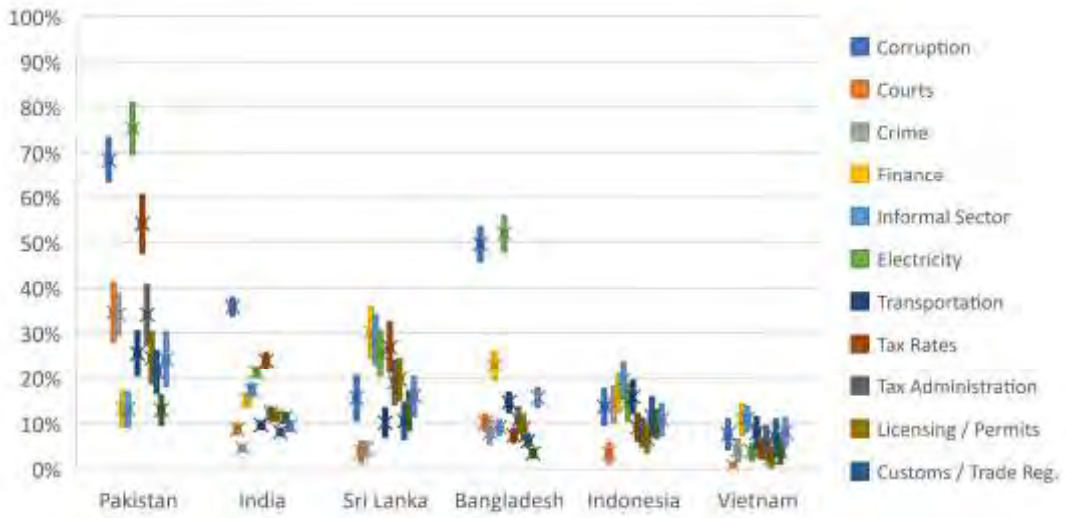
Source: World Bank Doing Business database.
Note: The methodology for computation of countries' performance on the 10 DB indicators has undergone revision several times during the period examined (2006-2018); as a result, the rankings on the DB index as published in respective reports are not directly comparable.

[118] The transition matrix shows in each cell the percentage of firms of a given size and age bracket compared to their size at birth. For example, among firms that had fewer than 20 employees when the firm started operating (size at birth), 99 percent were still in the same size bracket (1–19 employees) for firms under 10 years old and 54 percent among firms older than 10 years in 2013.

Corruption, electricity supply, and tax rates are commonly identified constraints to business growth

Survey-based measures of enterprise constraints in the formal sector indicate that the ability of firms in Pakistan to grow is inhibited by several factors. The World Bank's Investment Climate Surveys conduct detailed interviews with a representative sample of firm managers and/or owners across a large number of developing countries to identify factors that discourage investment and restrict firm-level productivity. In comparison with other countries in the region – and with other fast-growing developing economies such as Indonesia and Vietnam – firm managers and/or owners in Pakistan are significantly more likely to identify corruption, electricity supply, or tax rates as constraints to the growth of their business (**Figure 32**).

Figure 32: Investment climate constraints, 2013



Note: The length of the bar indicates the confidence intervals.
Source: World Bank staff calculations using 2013 Enterprise Survey data.

Social norms and lack of access to business networks make it harder for women to start or grow a business

In addition to general business constraints, specific factors hinder the ability of women to start businesses, secure investments, and increase productivity. Female economic participation – through both employment and entrepreneurship – is discouraged by social norms. Women entrepreneurs do not enjoy the same opportunities as men due to a number of deep-rooted sociocultural values and traditions. Informal networking, the moral support of the immediate family, and cultural barriers to interacting with the opposite gender have been identified as important factors for women entrepreneurs in Pakistan.[119] Generally, women lack autonomy and decision-making power and are thereby often inhibited from operating businesses outside their homes, which means that their businesses are often smaller and less likely to be profitable.[120]

[119] M. A. Roomi. 2011. 'Entrepreneurial Capital, Social Values and Islamic Traditions: Exploring the Growth of Women-Owned Enterprises in Pakistan', *International Small Business Journal*, 31(2): 175–191.
[120] X. Gine, G. Mansuri, and M. Picon. 2012. *Does a Picture Paint a Thousand Words? Evidence from a Microcredit Marketing Experiment*, Impact Evaluation No. 54; Policy Research Working Paper No. 6020. Washington, DC: World Bank.

b. The Way Forward

Entrepreneurship will be an important factor in creating sufficient jobs for a growing labor force

Going forward, Pakistan will need to tackle the triple challenge of creating enough jobs for its growing labor force, improving access to jobs and economic opportunities for women, and improving the quality and productivity of jobs. Entrepreneurship can play a bigger role in meeting these challenges: through more productive self-employment, a more vibrant SME sector, and greater opportunities for women and youth. The challenge is to help those self-employed or potential entrepreneurs who aspire to grow by helping them overcome the barriers to entry and subsequent growth. The SME sector also needs support to address barriers to growth. Some of the current self-employed could benefit from comprehensive entrepreneurship or personal initiative training[121] as well as access to finance to improve the productivity of their activities and earnings. At least some may be better off if they had other job opportunities, including in the wage sector, and could benefit from complementary support to access those jobs. Women and youth face additional constraints that require tailored solutions and support. New and existing firms could benefit significantly from an improved business environment and overall investment climate.

[121] F. Campos, M. Frese, M. Goldstein, L. Iacovone, H. Johnson, D. McKenzie, and M. Mensmann. 2017. 'Teaching Personal Initiative Beats Traditional Training in Boosting Small Business in West Africa', *Science*, 357(6357): 1287–1290.

2. Pakistan's Startup Ecosystem: A 360-Degree Analysis

Startups have the potential to stimulate job creation, drive innovation, and contribute to growth...

Startups are an important aspect of opportunity entrepreneurship, which contributes globally to job creation and economic growth, introduces innovation, and addresses key market gaps. Studies find that opportunity entrepreneurs who are part of the formal economy are more likely to grow their businesses faster, hire more people, and fill market gaps with their innovations[122] than necessity entrepreneurs. 'Startups', or businesses in their first stage of operations, are an important component of opportunity entrepreneurship because they can introduce new, innovative, and potentially high-growth ideas into the market. Well-known companies such as Facebook, Uber, Google, and Airbnb were once startups that introduced ideas with the potential to disrupt various industries. However, because the global failure rate of early-stage businesses is quite high (in Silicon Valley, 9 out of 10 startups fail[123]), it is critical to equip startups with the support they need to grow and become larger and more established businesses that are engines for job creation and economic growth.

…and a healthy ecosystem can improve their probability of success

A strong startup 'ecosystem' plays a critical role in determining the success of startup businesses. While nascent businesses, i.e., 'startups', may not have an immediate impact on job creation, market gaps, and the economy, the provision of financial, business, and policy support to entrepreneurs can improve their survival and enable their transition to more established high-growth firms. The players and factors that make up such support – incubators, accelerators, public policy, human capital, investors – are referred to as the entrepreneurship 'ecosystem'. The health of such an ecosystem correlates to better success outcomes for startups, their growth, and subsequent impact on the economy. While different frameworks have been used to evaluate the strength and 'health' of a startup ecosystem, three parameters are commonly considered to be key: 'support', 'finance' and 'policy'.[124] If a startup space performs well in these domains, the ecosystem is considered healthy or more conducive to the growth of startups. A strong entrepreneurial ecosystem, for example, would be South Korea, which has become a leader in patent activity, boasts the highest broadband activity in the world, and provides strong policy support for businesses in the country.[125] The strength of this ecosystem is a major reason that South Korea continues to be ranked first in the world on the Bloomberg global innovation index.[126]

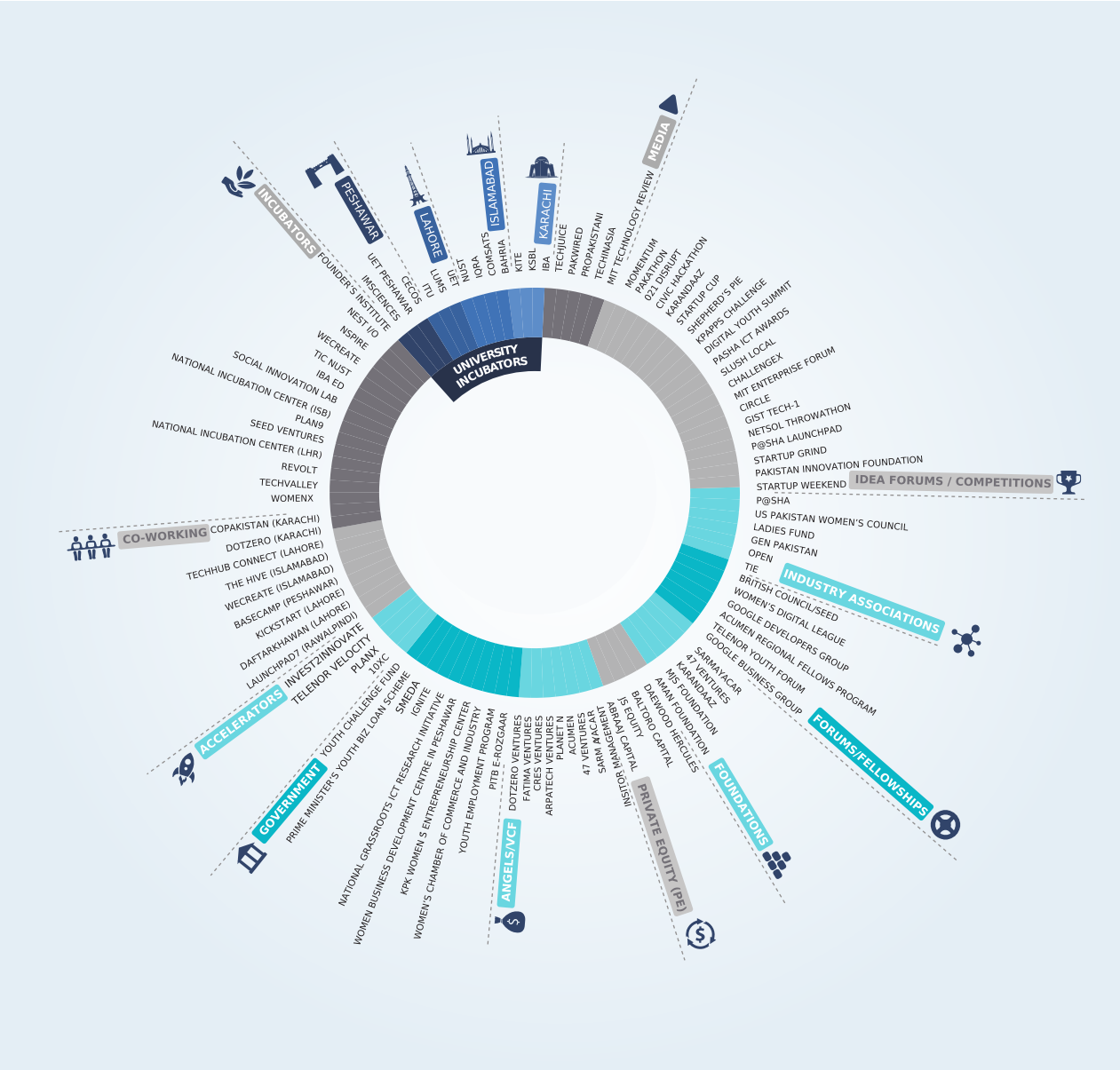
Pakistan's startup ecosystem has expanded substantially in recent years…

The startup ecosystem in Pakistan is nascent, but growing fast. There has been significant growth in the 'support' domain within Pakistan's entrepreneurial ecosystem (**Figure 33**). This encompasses business incubators and accelerators, which are dedicated programs that provide shared office space, business support, mentorship and, potentially, funding to startups, as well as startup competitions and networking forums for budding entrepreneurs. In 2012, aside from a handful of university

[122] M. Jha 2016. 'Opportunity Entrepreneurs are Key to Jobs and Growth', Jobs and Development Blog, The World Bank.
[123] E. Griffith. 2014. 'Why Startups Fail', *Fortune*, http://fortune.com/2014/09/25/why-startups-fail-according-to-their-founders/ (accessed 13/10/17).
[124] Other factors that are deemed important include: markets, human capital, infrastructure, research and development, and culture (The Entrepreneurial Ecosystem Diagnostic Toolkit of the Aspen Network of Development Entrepreneurs).
[125] K. Lakhani. 2015. 'Why Global Startups Need Our Support', World Economic Forum, https://www.weforum.org/agenda/2015/09/why-global-start-ups-need-our-support/ (accessed 13/10/17).
[126] Bloomberg. 2017. 'These Are the World's Most Innovative Economies', https://www.bloomberg.com/news/articles/2017-01-17/sweden-gains-south-korea-reigns-as-world-s-most-innovative-economies (accessed 13/10/17).

incubation spaces, there were just two major business incubators and accelerators in the country, with almost no investors and funding sources. In 2017, there are 12 incubation and five acceleration programs across Pakistan; nine co-working spaces operating in major cities; more than 20 running competitions, conferences, and forums for entrepreneurs; and nine active investor groups or funds.[127]

Figure 33: Pakistan's startup ecosystem snapshot, 2017



Source: Invest2Innovate.

[127] Pakistan Startup Map. Invest2Innovate, http://invest2innovate.com/ecosystem-map/ (accessed 13/10/17).

…and is dominated by young entrepreneurs interested in leveraging technology

Startup entrepreneurs in Pakistan can be characterized as young and technology-enabled. Studies find that entrepreneurs are increasingly more global – spread across both developed and developing economies – but are also increasingly young, with nearly half of all entrepreneurs globally being between 25 and 44.[128] This trend is even more prevalent in emerging market countries experiencing a youth bulge, such as Pakistan. This youth demographic is also increasingly connected. In Pakistan, Internet penetration overall has increased from 10 percent in 2012 to 17.8 percent in 2016. As of March 2017, the number of annual cellular subscribers is more than 139 million (approximately 67 percent penetration) [129] and 17 million new unique subscribers will be added by 2020.[130] These statistics, coupled with the fact that the country's youth unemployment rate is 10.8 percent,[131] mean that Pakistan's population is not only disproportionately young, but is also more connected, particularly via mobile telephones, and seeks to create opportunities for itself. This is reflected in the country's startup ecosystem, which is dominated by young entrepreneurs building technology-enabled solutions.

More players do not always translate into high-quality and appropriate support for startups

While the increased activity since 2012 is encouraging, more players does not always mean better programs or outcomes, with some initiatives failing to create value for entrepreneurs. Standardized monitoring and evaluation guidelines and impact measurements are critical as the ecosystem continues to grow. For example, while incubation centers may measure success by the number of graduates, this merely focuses on an output and does not necessarily imply that the business is more equipped to survive once the program ends. Incubators and accelerators need to measure impact and success by outcome indicators such as the average percentage revenue growth of a company, the amount of funding raised, and the number of startups that continue to be operational after they leave a support program. These programs need to continue strengthening their curriculum and offerings to improve their outcomes and provide value to startups.

Most of the activity remains concentrated in large cities

Most of the activity is concentrated in Pakistan's major cities. The country's entrepreneurial ecosystem has grown considerably, but the major efforts and initiatives are concentrated in Tier 1 cities such as Islamabad, Karachi, Lahore, and Peshawar.[132] The strength of an entrepreneurial ecosystem is also measured by how inclusive its programs and support are. There is, therefore, a need to expand support, launch initiatives, and build the capacity of young entrepreneurs in other urban areas of the country that have a large number of universities and technical schools, such as Hyderabad, Sialkot, Abbottabad, and Sukkur.

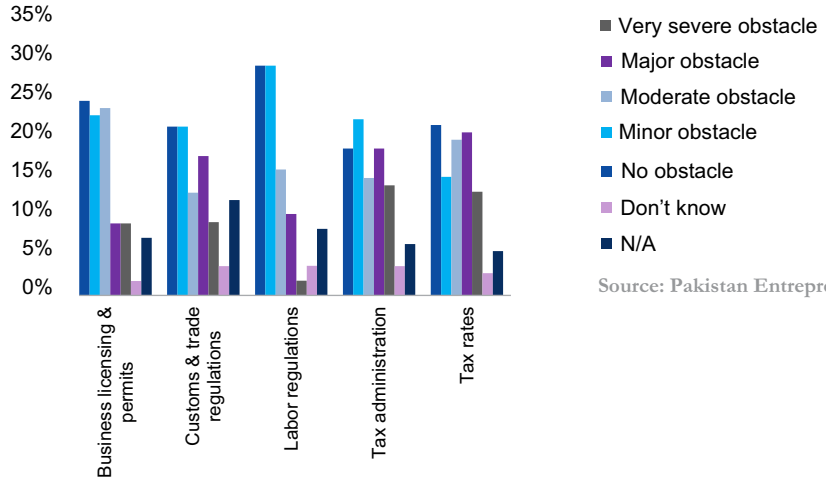
Startups face significant policy and regulatory barriers

The policy and regulatory environment remains challenging for startups and small growing businesses alike. As discussed above, Pakistan performs well within the 'support' domain, as indicated by the frequency of startup activity. However, it could improve in the 'policy' domain. The country continues to rank low on the World Bank's DB index (see **Box 3** in this report). By 2018, Pakistan's ranking in terms of

[128] Ernst & Young. 2015. *EY Global Job Creation and Youth Unemployment Survey 2015*, http://www.ey.com/Publication/vwLUAssets/EY_global_job_creation_and_youth_entrpreneurship_survey_2015/$FILE/EY-job-creation-youth-entrepreneurship-survey-2015.pdf
[129] Pakistan Telecommunications Authority. http://www.pta.gov.pk/index.php?Itemid=599 (accessed 13/10/17).
[130] GSMA Mobile Economy 2017. https://www.gsmaintelligence.com/research/?file=f33c20f8cb4ed3f9834c2fe038c8c204&download (accessed 13/10/17).
[131] World Bank. https://data.worldbank.org/indicator/SL.UEM.1524.ZS (accessed 13/10/17).
[132] See Invest2Innovate's Startup Ecosystem Map. http://invest2innovate.com/ecosystem-map/

starting a business deteriorated to 142 compared to 135 in 2016, with entrepreneurs needing about 18 days to complete 12 procedural requirements at a cost of 7.6 percent of income per capita.[133] While entrepreneurs may find the process of setting up a business relatively easy (in surveys conducted in February 2014 with 119 small and medium businesses, 48 percent felt they faced either no obstacle or minor obstacles in attaining a business license or permit[134]) (**Figure 34**), it is widely accepted that maintaining and shutting down a business in Pakistan is significantly more difficult, given the multitude of procedures and tax-related issues. Taxation for businesses is applied across the board, regardless of whether the business is a startup or more established. These costs are an issue for businesses overall, but are most debilitating for startups. As a result, many startups are reluctant to officially register and, as they grow, they fall into the practice of 'double books' to avoid paying these levies. The issue of double or even triple books ultimately increases risk for investors as well, affecting the level of interest they may have in the startup space.

Figure 34: Policy obstacles for startups
Percentage of survey respondents



Source: Pakistan Entrepreneurship Ecosystem Report 2016.

Improvements in the payments and financial infrastructure could be critical for technology-based startups

Payments are a major barrier to startups and investors in Pakistan. Internet-based or technology-enabled companies are globally perceived as being high-growth and exciting for investors, but the issue of payments remains a key challenge facing startups in the country. Global payment platforms such as Paypal that can be leveraged by Internet-based companies to send and receive money do not exist in Pakistan (mainly due to regulatory barriers), and players who try to resolve this problem – be it a payment service provider, payment processor, or an ATM switch – are required to obtain costly licenses that make it impossible to run their initiative. This issue is especially debilitating for startups in the financial technology industry. Regulators can play a critical role in reducing these barriers by making the legislation and financial infrastructure more favorable for international solution providers to enter the market and for local solutions to launch and survive.

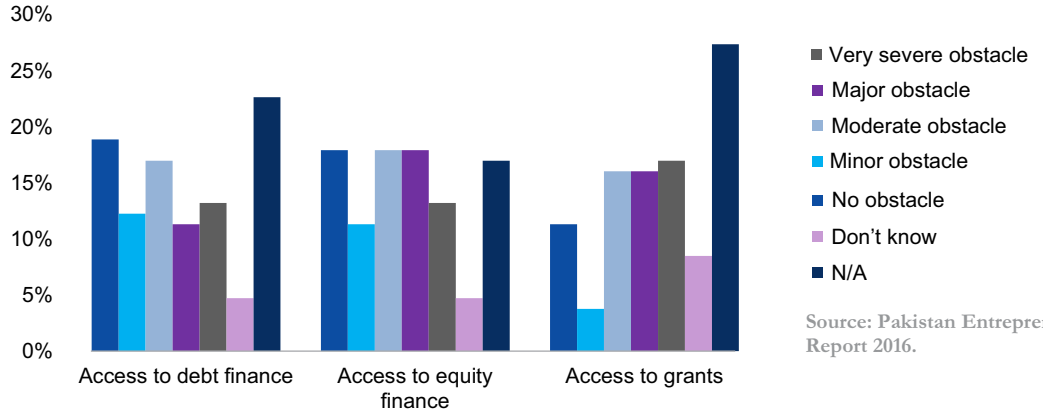
[133] World Bank. Doing Business database. http://www.doingbusiness.org/data/exploreeconomies/pakistan#starting-a-business
[134] Pakistan Entrepreneurship Ecosystem Report 2016. Invest2Innovate. November 2016. http://invest2innovate.com/insights/peer/ (accessed 6/10/17).

Most startups struggle to access appropriate financial support…

These regulatory barriers exacerbate access to capital issues for early-stage businesses. The complex regulatory environment in the Pakistan market not only impedes entrepreneurship, but also acts as an obstacle to commerce and investment. As a result, Pakistan does not fare very well when evaluated against the 'finance' domain of startup ecosystems. In a survey conducted by Invest2Innovate in 2014, 84 percent of respondents said it was either 'difficult' or 'somewhat difficult' to raise investment for startups (**Figure 35**). Issues such as double and triple books and the lack of industry-level data make due diligence costs high, and are a key reason that investors and funds choose to invest in businesses that are at a slightly later stage versus startups. The regulatory challenges and risk perception of Pakistan also dissuade international investors from entering the market. For example, all foreign investors and shareholders must obtain approval from Pakistan's Ministry of Interior prior to investing – an arduous process that can take upward of six months – and apply for a Proceeds Realization Certificate to remit funds from Pakistan. Investors who fail to apply for a certificate prior to investing will not be able to move their money out of the country. These barriers and associated risks have exacerbated the early-stage capital gap in the country, with many startups struggling to raise investment that would allow them to grow their businesses.

Figure 35: Access to finance as an obstacle for startups

Percentage of survey respondents



Source: Pakistan Entrepreneurship Ecosystem Report 2016.

…although investment activity has picked up in recent years

That said, the funding landscape is improving gradually, with more angel and venture capital funds operating in Pakistan and initiatives led mostly by local players. The increased activity by investors has also been in response to higher-quality startups and potential deals. In 2016, there were 23 reported early-stage investment deals, although there have only been nine so far in 2017.[135] While the early-stage capital gap still exists, the increase in seed-stage investors is a positive trend.

[135] Data obtained by Invest2Innovate through interviews with sector stakeholders in the Pakistani startup ecosystem.

The Way Forward

Support at the policy level is key to improving the health of the ecosystem

While the Pakistan startup ecosystem has evolved considerably, with growth mainly in the domains of support and finance, the policy environment remains the biggest and most pressing challenge. The government has taken tangible steps to engage in the country's startup ecosystem in the last few years, from launching incubation centers in major cities to providing startup financing.[136] However, issues related to taxation, payments, intellectual property, and investor regulations continue to be major barriers to innovation and access to capital. Players such as the SBP, Board of Investment, Ministry of Interior, and FBR can play a critical role in overcoming these regulatory challenges to improve the health of Pakistan's startup ecosystem.

[136] The launch of national incubation centers and startup financing was under the umbrella of the federal government's Ministry of Information Technology and via IGNITE, formerly known as the National ICT R&D Fund. See https://ignite.org.pk/

3. Catalyzing Women's Growth Entrepreneurship in Pakistan's Cities: Data from Karachi and Lahore

Enabling women's entrepreneurship can help boost growth, create jobs, and encourage more women to enter the labor force

Pakistan has the lowest rate of women's entrepreneurship in the world – only 1 percent of women are entrepreneurs compared to 21 percent of men.[137] Less than 12 percent of firms have female participation in ownership compared to more than 18 percent in South Asia and 34 percent globally.[138] Of these, only 6 percent of firms have majority female ownership, which is nearly half the South Asian average of 11 percent.[139] Enabling women to start a business and reducing growth bottlenecks for women who already own businesses can play an important role in boosting growth, creating jobs, and encouraging more women to enter the workforce.[140] This is particularly relevant in the case of Pakistan where more than 2 million people are expected to join the labor force every year over the next 20 years with 1 million women expected to join the labor force every three years[141] – thereby accentuating the need to stimulate entrepreneurship that can provide labor force entrants with viable job opportunities.

In Pakistan, however, women's entrepreneurship is still limited...

Gender disparities in entrepreneurship are stark in Pakistan. According to the 2012 Global Entrepreneurship Monitor (GEM) Women's Entrepreneurship Report (the last GEM gender report to include Pakistan), women are about 60 percent less likely to perceive business opportunities than men and only 34 percent of women consider themselves capable of starting a business compared to 61 percent of men. This situation persists despite the relatively high participation of women in higher education in Pakistan, with more than 45 percent of tertiary students being women.[142] Moreover, 72 percent of the women who engage in entrepreneurship have done so due to 'necessity' motivations[143] compared to 52 percent of men. This is much larger than the regional figure, where 43 percent of women report 'necessity' motivations. Women are almost three times less likely to know an entrepreneur compared to men,[144] pointing to a glaring disparity in women's networks and, consequently, their ability to gain access to information and business networks – considered crucial for entrepreneurial success. Women entrepreneurs also tend to have smaller businesses, with 89 percent of new women-led businesses reporting no employees compared to 26 percent of the businesses led by men. Even among established businesses,[145] 48 percent of women-led businesses have no employees compared to 24 percent led by men.

…due to the disproportionate barriers women face when starting a business

The gender disparity in entrepreneurship is not surprising when one considers the disproportionate challenges facing Pakistani women. They face legal constraints that directly affect their ability to engage in entrepreneurship. Married women in Pakistan cannot register a business in the same way married men can; inheritance laws disadvantage women and limit their access to assets,[146] thereby affecting initial endowments for businesses and their ability to access credit using collateral; and discrimination based on gender or marital status is not explicitly prohibited.[147]

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137 Global Entrepreneurship Monitor 2012 Women's Report (Pakistan was not included in the 2014 Women's Report).
138 Enterprise Surveys, World Bank, 2013. http://www.enterprisesurveys.org/data/exploreeconomies/2013/pakistan#gender
139 Ibid.
140 http://www.worldbank.org/en/programs/women-entrepreneurs
141 Pakistan Country Partnership Strategy FY15–19, World Bank, 2014.
142 UNESCO UIS.
143 Those with 'necessity' motives entered entrepreneurship mostly because they have no other options for work, while entrepreneurs with 'opportunity' motives chose to pursue an opportunity.
144 GEM 2012.
145 Established business owners are those who have run their business for more than 3.5 years.
146 There are province-level variations in laws influencing women's access and ownership of assets.
147 *Women, Business and the Law*, World Bank, 2016.

New granular data has helped understand these barriers better

With data on Pakistani female entrepreneurship being dated and not specifically focused on the 'opportunity' entrepreneur segment, there is a gap in understanding the scale and characteristics of the cadre of growth-potential women entrepreneurs operating in the country. To gain a deeper understanding of this growth-potential segment of women's businesses, beyond the usual subsistence level of entrepreneurship, unique pioneering surveys of over 1,000 women entrepreneurs were undertaken in the two largest commercial centers in the country, Karachi and Lahore, in 2015 and 2016 respectively. The objective was to better understand the characteristics of opportunity-seeking women entrepreneurs in these cities and to inform policymaking and program design, particularly given the very limited data available on women entrepreneurs prior to these surveys.[148]

a. Drilling Down: City-Level Surveys in Karachi and Lahore

Even in metropolises such as Karachi and Lahore, very few women run their own business

The city-wide survey in Karachi finds that the entrepreneurship rate is very low among women and there is significant geographic variation in the rates across the city. As **Figure 36** illustrates, women's entrepreneurial activities vary significantly across geographical areas in the city. Interestingly, only two high-income areas, Jamshed and the Defence Housing Authority, are among those with higher entrepreneurship rates. Moreover, women-led businesses are concentrated in the services sector (e.g., beauty, business support), with around 66 percent of the women-owned businesses in the sample located in this sector. About 10 percent operate in the retail/sales sector. The remaining 24 percent are in manufacturing. On average, 5 percent of women are engaged in entrepreneurship of some kind, but only 3.2 percent fit the proxy criteria for growth-potential entrepreneurs (in business for at least 18 months and employing two full time employees).

[148] The methodology used in both city surveys was similar, but not identical. In total, 626 interviews were conducted in Karachi in 2015 and 423 interviews were conducted in Lahore in 2016/17, with both surveys seeking to survey a representative stratified sample of women entrepreneurs from the various districts and towns of Karachi and Lahore, using 1998 census information. The survey was administered in Karachi to women entrepreneurs already in business for a minimum of 18 months and employing at least two full-time employees, while in Lahore the survey was administered to women entrepreneurs in business for a minimum of 12 months. Both surveys employed additional sampling strategies to account for security considerations, the growth and change of both cities since the 1998 census, and the low incidence of women's entrepreneurship experienced (2.72 percent in Lahore, 5 percent in Karachi, with even lower rates emerging when factoring in the additional respondent selection criteria). Despite these methodological challenges, the survey provides revealing information about the characteristics and challenges of growth-potential women entrepreneurs in Pakistan's two largest cities.

Figure 36: Geographic distribution of women's economic activities in Karachi
Percent

Source: World Bank survey of women entrepreneurs in Karachi, 2015.

Women-owned businesses are concentrated in traditional sectors associated with women…

The rate of women's entrepreneurship is lower in Lahore, at 2.72 percent. Almost three quarters of the surveyed entrepreneurs are concentrated in education, salons, and apparel. Within the education sector, home-based tuition centers and medium-to-large schools are most prominent, with an average of four employees, followed by beauty salons, which tend to be smaller with an average of two employees. The apparel sector constitutes 18 percent of the sample and the primary motivation to enter the sector is the ability to earn while working from home. Overall, services far outweigh 'buying and selling' and 'retail', with over 75 percent of Lahore's female entrepreneurs in this category.

…and their owners tend to be more educated than the average Pakistani woman

Women entrepreneurs in Karachi and Lahore tend to be more educated than the average national population and are confident in their entrepreneurial traits and abilities. More than 65 percent of the women in the Karachi survey had completed middle school, followed by 16 percent with higher education. About 17 percent had no formal education or only primary schooling. In Lahore, more than half the sample (56 percent) had attained higher education (a graduate or postgraduate degree or a doctorate), followed by 37 percent who had matriculated or obtained an intermediate

degree. Only 7 percent of respondents in Lahore had no formal education, or primary and secondary schooling. This result contrasts with the overall educational attainment levels in Pakistan: according to the Barro-Lee educational attainment database[149], 59.2 percent of women over 15 in Pakistan have no formal education, 11.2 percent have primary education, 14.6 percent have secondary education, and 3.5 percent have attained tertiary education.[150] The data also shows that most women in both cities have little work or business experience before starting their businesses and that gaining independence and entrepreneurial motivation are important reasons for starting a business.

Encouragingly, basic management practices are in place in such businesses…

Women entrepreneurs in both cities follow some management practices, but there are other practices that are not followed widely. The Karachi survey reveals that best managerial practices are far from being adopted, and both the quality of managerial practices and education levels are strong predictors of business performance in the sample. The Karachi and Lahore entrepreneurs in the sample tended to follow good bookkeeping practices, including records of sales (79 percent Karachi, 94 percent Lahore) and of what is owed (71 percent Karachi, 94 percent Lahore); examined and assessed their business at least monthly (70 percent Karachi, 75 percent Lahore); and had business plans (54 percent Karachi, 89 percent Lahore). There is room for improvement in several other commonly regarded good practices, such as keeping good documentation appropriate for loan applications (52 percent Karachi, 19 percent Lahore), gathering information on competitors' prices (12 percent in Karachi, 8 percent in Lahore), implementing special offers (15 percent in Karachi, 10 percent in Lahore), and using formal accountancy services (11 percent Karachi, 8 percent Lahore).

…but women entrepreneurs often lack autonomy

However, the women entrepreneurs surveyed lacked autonomy. Entrepreneurial attitudes such as self-efficacy, autonomy, and self-confidence are crucial aspects of entrepreneurial success. The survey reveals that lack of autonomy does not emerge in terms of the time available for the business, but in the choice of business premises (probably because about 61 percent of the Karachi respondents and 80 percent of the Lahore respondents had businesses located at home) and, above all, in the ability to make key business decisions (for example, 80 percent of the respondents in the Karachi services sector required permission from their families to start a business, as did 85 percent of respondents in Lahore). However, a related dimension of lack of autonomy is heavy family involvement in the business (for example, around two thirds of Karachi women, 65 percent in manufacturing and 70 percent in other sectors, had family support to start their businesses). This limited autonomy explains differences in firm performance, with the need for family permission negatively correlated with business performance (sales and employment). In Lahore, family involvement had the positive element of translating into tangible financial support that women entrepreneurs received from family and friends, with nearly 30 percent borrowing money from family and friends. However, this presumably is accompanied by the ability of lenders to interfere in the operation of the business.

Most women start a business out of necessity rather than opportunity…

Most entrepreneurs appear to have 'necessity' aspirations or a mixture of both 'necessity' and 'opportunity' aspirations, although these differing motivations do not seem to affect firm performance. In Lahore, almost 80 percent cited income generation as their primary motivation for starting a business (potentially implying necessity

[149] R. J. Barro and J. W. Lee. 2013. 'A New Data Set of Educational Attainment in the World, 1950–2010', *Journal of Development Economics*, 104: 184–198.
[150] World Development Indicators 2016.

motivations). Only 19 percent cited the desire to be independent or to capitalize on business opportunities as the impetus for starting a business. The most commonly cited reason for engaging in the current business were its perceived profitability, followed by the desire to work from home, and the availability of business opportunities. This potentially implies that, even though women-led businesses are concentrated in the typically low-productivity services sector, women entrepreneurs perceive these as being high-profitability ventures – pointing to an information gap.

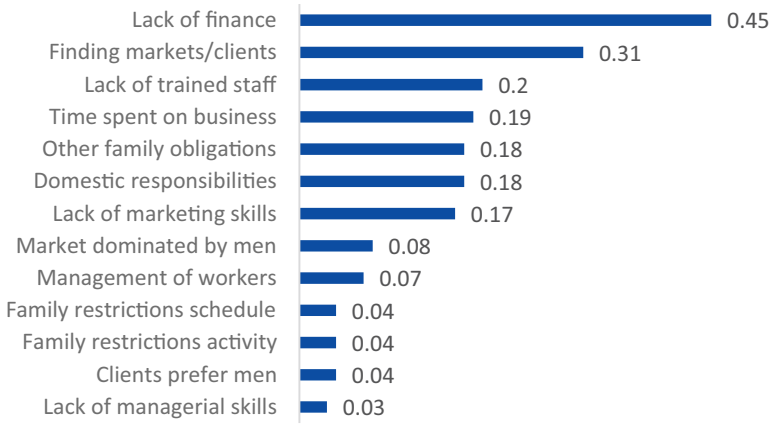
…but they remain informal

Women entrepreneurs in both cities are largely informal, which undermines their potential to grow, and tend to operate in isolation from associations or chambers of commerce. For example, 89 percent of women-owned businesses in Lahore were not registered with any official authority.

…and struggle to access appropriate financial services

Access to finance and social constraints were identified as the main challenges for women entrepreneurs in Karachi and Lahore. As **Figure 37** illustrates, social constraints, including family restrictions and domestic obligations, were identified as the main constraints by most Karachi women,[151] followed by access to finance. A significant proportion of entrepreneurs found access to finance to be the main constraint to their business and had never applied for credit. Family loans were the most common source of business finance. **Figures 38 and 39** illustrate the situation in Lahore, where lack of finance also dominates as a constraint (respondents were asked to identify three main constraints), followed by family responsibilities and finding new markets. This is a significant finding, given Karachi and Lahore's status as the largest commercial centers in the country, where presumably there would be greater availability of finance and a culture more open to women's entrepreneurial activities. These challenges are likely to be more intense in smaller urban centers.

Figure 37: Main constraints for women entrepreneurs in Karachi
Scale of 0 to 1

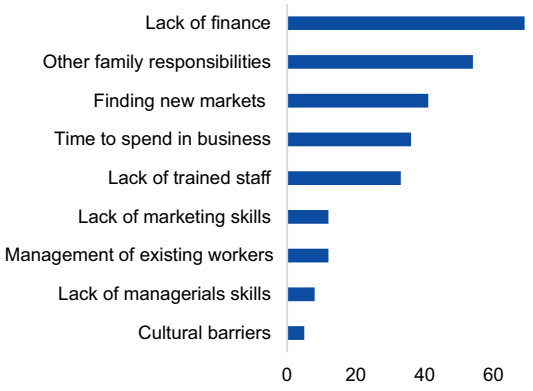


Source: World Bank survey of women entrepreneurs in Karachi and Lahore, 2015 and 2016.

[151] Aggregating categories: family restrictions – schedule, family restrictions – activity, a market dominated by men, domestic responsibilities, other family obligations, and clients' preference for men.

Figure 38: Main constraints for women entrepreneurs in Lahore

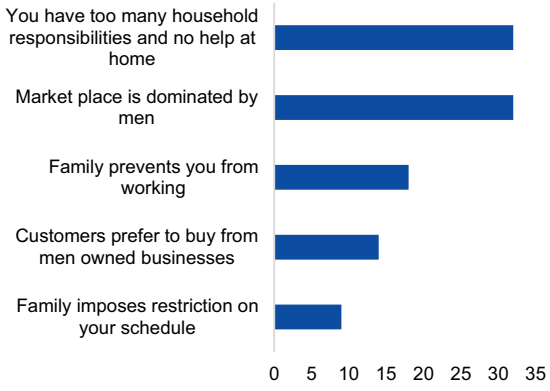
Percentage of survey respondents



Source: World Bank survey of women entrepreneurs in Karachi and Lahore, 2015 and 2016.

Figure 39: Sub-set of cultural barriers

Percentage of survey respondents



Source: World Bank survey of women entrepreneurs in Karachi and Lahore, 2015 and 2016.

b. Looking Ahead: How Can Pakistani Women Entrepreneurs Best Be Supported?

Tailored approaches are required to ensure that programs for women entrepreneurs meet their needs

What is of concern is that, even in the largest commercial centers of the country, entrepreneurship rates remain low among women. This implies that not many women enter entrepreneurship despite the relatively high proportion of women in higher education. Bringing more women toward entrepreneurship, therefore, is a key area of focus. This data, along with program implementation experience from Pakistan and elsewhere, suggests some key areas for future support delivered to women entrepreneurs:

i. **Improving the business-enabling environment for women is key to incentivizing their participation in entrepreneurship and their economic participation more generally.** Also, legislation to make work places safe and policies and programs to boost women's access to infrastructure, like public transport, improves the overall conditions for women's economic participation.

ii. **Peer networking and learning is the most useful form of support, according to women entrepreneurs.** Women entrepreneurs report isolation from peers and mainstream business networks, which directly affects their access to information, markets, and growth opportunities. Moreover, networking requires communication and negotiation skills, which can also be delivered through support programs.

iii. **Women's entrepreneurship support programs in Pakistan need to enhance the managerial capacity of participants.** As the baseline surveys show, management practices in women-led enterprises have considerable room for improvement. High-quality training curricula, leveraging easily accessible delivery channels (in-class and/or digital), is key to scaled-up capacity building.

iv. **Support strategies to enhance women's autonomy and reduce social constraints need to be an explicit focus.** With lack of autonomy being a consistent characteristic of women's reported interactions, from when and where to start a business to the time allocated to business activities and growth planning, women entrepreneurs are forced to navigate complex, competing demands on their time. In Pakistan, women's economic participation and role in public life is circumscribed by norms that restrict their mobility and access to male-dominated spaces (such as markets and trading places). Opening up these places to women's role and presence requires facilitating networks and mentoring. Social norms that constrain women will take longer to change and increasing women's domestic autonomy is likely to be an iterative, incremental process, helped along by strategies that engage with communities, families, and men. These strategies may potentially include public awareness campaigns to positively influence social norms related to women's access to public spaces such as transportation; decision making roles; and unpaid care work.

v. **The role of finance needs to be better understood and designed in a way that best suits women.** While access to finance was one of the most commonly cited challenges among women entrepreneurs in the sample, they did not consider formal finance to be a viable option, given their aversion to paying interest, lack of knowledge about the implications of taking on debt, and the perception that their financing needs were well met by personal sources such as family and friends. Financial products more closely tailored to the needs of women entrepreneurs may thus be needed.

vi. **Customizing entrepreneurship support programs for women.** First, one of the main challenges of existing support programs is to screen 'necessity' from 'opportunity' entrepreneurs. The results from the surveys suggest that managerial practices and education can be important predictors of opportunity entrepreneurship among women. Second, outreach is a problem. Most women-led businesses do not belong to any networks and operate in isolation. Even where groups exist, such as the Women's Chambers of Commerce, they are perceived as inhospitable by most women entrepreneurs. The creation of women's networks, not only for participants to programs, but more generally, such as via chambers, accelerators, SME development

agencies, trade associations and universities, needs to be a priority. Third, trainings need to move beyond technical issues and focus on managerial practices and soft skills. Fourth, and most important, the content of these programs needs to aim, in addition to improving the quality of managerial practices, at increasing the autonomy of women in business decision-making, possibly by including male and older family members in programs to address social norms around control over assets and decision-making.

4. Export Competitiveness, Entrepreneurship, and Innovation[152]

Pakistan's trade performance since 2000 has been disappointing…

Trade has not been fully leveraged to catalyze growth in Pakistan. Over the period 2005–16, Pakistan's exports of goods rose from US$16.05 billion to US$20.4 billion – an increase of only 27.3 percent compared to an increase of 276 percent in Bangladesh, 445 percent in Vietnam, and 165 percent in India. Similarly, Pakistan's trade-to-GDP (T/GDP) ratio was close to that of Bangladesh at 28.1 percent in 2000. Over the past decade, Bangladesh's T/GDP ratio has increased to 42.1 percent, while Pakistan's T/GDP has remained almost unchanged at 28.1 percent. In the last six years alone (FY11–17), export earnings have declined by approximately 20 percent.

…as exports have lost their competitiveness

Pakistan's poor trade performance in recent years is an outcome of diminishing export competitiveness. Export competitiveness, as indicated by the country's market share of global exports, has been declining over the years, while market shares of peer economies such as Malaysia, Mexico, and Thailand have doubled. Pakistan has lost 1.5 percent annually in export market share over the past decade. This number is put in perspective when broken down by markets and products. Over the period 2013–15, Pakistan only managed to increase its export share in 9 out of its 20 biggest export markets. World exports to China dropped by 5.4 percent over the period 2013–15, while Pakistan's exports to China dropped by a higher rate of almost 10 percent. Similarly, world exports to the UAE dropped by 2.9 percent over the period 2013–15, while Pakistan's exports dropped by 20.2 percent. Pakistan's higher 'decay' rate,[153] as opposed to the world decay rate for China and the UAE, points to the existence of barriers to trade that have hindered growth in exports.

Entrepreneurship and innovation in export-oriented sectors have been dampened…

Declining export competitiveness has discouraged entrepreneurship and innovation in the export sector, as evident from Pakistan's export dynamics in recent years. The World Bank Group's Enterprise Survey for 2013 shows that trade policy, trade facilitation, logistics and infrastructure, and the broader investment climate, all of which are parameters for gauging export competitiveness, are not homogeneous in their impact when impact is disaggregated by firm size. The Enterprise Survey shows that only 5.5 percent of firms classified as small (5–19 employees) directly export their output as opposed to 36.6 percent of large firms (100+ employees). While this disparity might be attributed to fundamental differences in outward orientation grounded in firm size, the disparity holds in comparison to other countries and regions. Globally, an average of 8 percent of all small firms directly export their output. Similarly, only 12.3 percent of small firms in Pakistan used material/inputs or supplies of foreign origin in their production processes as opposed to a global average of 55 percent, indicating barriers and informational asymmetries that prevent small firms from accessing quality inputs at globally competitive prices. This number is in sharp contrast to that of large firms in Pakistan, 44.9 percent of which use foreign inputs. Pakistan's export base and its evolution – or lack thereof – over the years also alludes to dampened entrepreneurship and innovation. Its exports are heavily dependent on intensive margins, and lack sophistication and dynamism, while exporters have difficulty retaining export relationships.

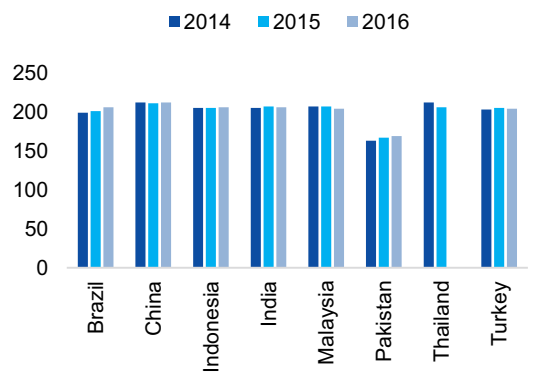
[152] This special section, is content, data and figures are predominately synthesized from World Bank, forthcoming "Pakistan: Unlocking Private Sector Growth through increased Trade and Competitiveness". Washington DC: World Bank. The data in this section is sourced from WITS database and UNCTAD statistics.

[153] The 'decay' rate is the rate of decrease in exports, as opposed to growth.

…and the country's export basket remains undiversified

Pakistan's export basket is relatively concentrated in terms of both products and markets, leaving the country exposed to price- and partner-specific shocks (**Figures 40 and 41**). Just one product category, cotton manufactures, has over the past decade accounted for approximately 55 percent of Pakistan's export basket. Its three largest exports – cotton manufactures, leather, and rice – together amount to over 70 percent of total exports. This share has remained unchanged for over a decade. Pakistan's export market base and penetration, much like its product base, has also remained stagnant over the past decade. Five markets have historically accounted for over 60 percent of Pakistan's exports. Geographically, the European Union and the US represent the most important destinations of Pakistani exports, with the US absorbing 17 percent and the European Union 22 percent of all exports.

Figure 40: Concentration by destination
Number of destinations reached



Source: World Integrated Trade Solutions Database.

Figure 41: Concentration by products
Share of total

Source: World Integrated Trade Solutions Database.

Pakistan's exports are heavily dependent on intensive margins

Peer countries in the region and around the world have gradually increased their export product offering and expanded their export market base – growth along extensive margins. Growth in Pakistan's export base over the years has been derived primarily from deepening existing relationships – along intensive margins. During 2010–15, growth along extensive margins accounted for only 18.4 percent of growth along intensive margins. While the increase in exports from FY10 to FY15 attributable to an 'increase in existing products in established markets' or the intensive margin was US$1.19 billion, the increase in exports attributable to 'product diversification in established markets', the 'introduction of new products in new markets', and the 'introduction of existing products in new markets' – all of which are measures of extensive margin – amounted to only US$219 million.

Smaller firms are struggling to survive…

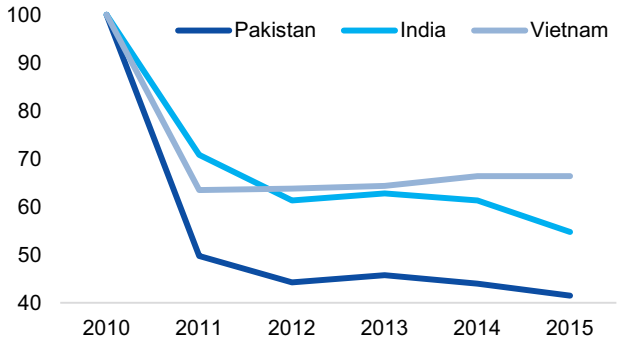
Dependency on intensive margins is not uniform across Pakistan's export sector. Larger firms are less likely to switch export strategies and therefore rely primarily on the intensive margin for growth. This is noteworthy, given that the top 1 percent of

Pakistan's exporters account for 45 percent of the country's exports. In contrast, smaller firms rely primarily on extensive margins. This reliance is reflected in the higher turnover among firms with lower export values. Each year, 16–37 percent of firms exit and 19–37 percent enter the export market. Most of the churning in the market takes place at the lower end of the export value distribution; similarly, most of the churning takes place in smaller destinations by export size.[154] Higher churning at the lower end of the export value distribution also indicates that smaller firms might not be accorded or are unable to utilize the benefits or export promotion schemes are available to larger firms.

…and exporters are finding it hard to retain trading relationships due to the lack of dynamism in a changing global marketplace

Exporters in Pakistan have difficulty retaining export relationships. The persistence[155] of trading relationships is a recognized sign of economic maturity and dynamism. During 2010–15, exporters in Pakistan succeeded in maintaining only 41.5 percent of export relationships; that is, of the 400 relationships in 2010, only 166 remained in 2015. This is in contrast to India and Vietnam, which maintained 54.7 percent and 66.4 percent of their relationships over the same time horizon, respectively (**Figure 42**). The significant rate at which trade relationships have expired over the last five years, especially when paralleled with regional and peer group comparators, reflects exporters' inability and lack of dynamism to adjust output in line with changing global trade dynamics. This holds true even for Pakistan's textiles sector, which accounts for approximately 60 percent of exports and in which Pakistan has a comparative advantage. Of the 53 textile export relationships in 2010, only 27 remained in 2015.

Figure 42: Evolution of export relationships, 2010–15
Percent



Source: World Integrated Trade Solutions Database.

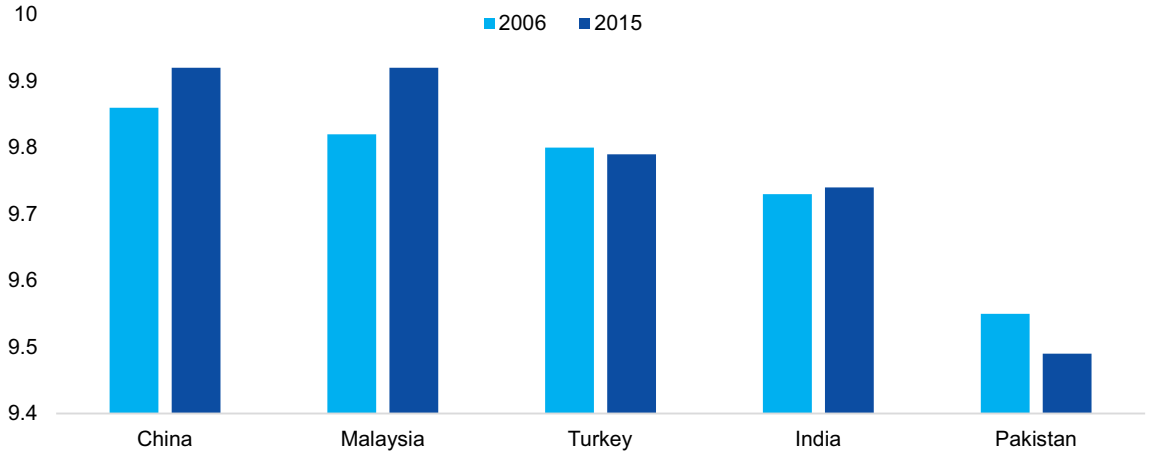
Unlike its peers, Pakistan has not managed to break into the growing market for high-tech, high-value-added products…

Export-oriented enterprises in Pakistan have continued to focus on, and specialize in, low-tech, low-value-added exports**.** Unlike its peers, Pakistan has been unable to tap into the global market for goods with a high or medium technological content. The technological content of Pakistani exports is very low: high-tech exports constituted less than 1 percent of all exports during 2010–15, while low-tech exports constituted over 60 percent of exports during the same period. This share of low-tech and high-tech exports in Pakistan's total exports has, for the most part, remained unchanged in the last 25 years (1990–2015). Comparable countries, both in the region and elsewhere, have had far more success not only in diversifying their export basket, but also in

[154] J. G. Reis and D. Taglioni. 2013. *Determinants of Export Growth at the Intensive and Extensive Margins: Evidence from Product and Firm-Level Data for Pakistan*, Policy Research Working Paper No. 6341. Washington, DC: World Bank.
[155] Persistence measures the survival rate over successive years of new product-market relationships of at least US$10,000.

diversifying their basket toward high-tech, high-value-added products. Vietnam is a notable example, having increased the share of its high-tech exports from 12 percent in 2010 to 29 percent in 2015. India also has a more diversified basket of exports with high technological content. Low-tech exports constituted only 27 percent of all Indian exports in 2015 (**Figure 43**).

Figure 43: Evolution of export relationships, 2006-15
Logarithm of product sophistication



Note: Estimating the level of technological sophistication embodied in a country's export portfolio gives an indication of that country's economic development. The country's expected GDP per capita, EXPY, is given by summing all the PRODY (weighted average of per capita GDP of countries producing that product, with weights derived from revealed comparative advantage) values for the products exported by the country, each weighted by the product's share of total exports.
Source: World Integrated Trade Solutions Database.

…even in textiles, which remain primarily cotton-based

Lack of sophistication is also evident in the textiles sector where production is primarily cotton-based, despite global demand increasingly shifting toward apparel made of synthetic materials. Synthetic fibers are increasingly in demand for high-performance garments such as sports uniforms and protective gear, and require greater technological sophistication than products made of traditional fibers. However, production in Pakistan's textiles sector is tilted heavily toward cotton, which constitutes 84 percent of its apparel exports. In comparison, cotton apparel accounted for only 46 percent of global apparel exports.

What is Needed to Revive Export Competitiveness?

Holistic reforms are required…

Reviving export competitiveness – and therefore dynamism, sophistication, and entrepreneurship and innovation – requires reforms in three areas: (i) trade policy; (ii) trade facilitation, logistics, and infrastructure; and (iii) the overarching investment climate.

…starting from the tariff regime…

Pakistan needs to commit to a simple and transparent tariff structure with low average tariffs, minimum dispersion, and minimal use of para-tariffs. Its current tariff policy has been shaped more by revenue and protectionist considerations than long-term competitiveness-enhancing measures. Pakistan's tariffs are almost twice as high as the world average and three times higher than those in Southeast Asia. Tariff rates in Pakistan are also considerably higher than in other countries in South Asia. Pakistan's simple average tariff rate was 13.6 percent in 2014, compared to an average of 11.7 percent in South Asia – this measure excludes the impact of para-tariffs such as regulatory duties. Pakistan also imposes high import duties on intermediate inputs and raw materials used by exporters, thereby compromising the competitiveness of its exports. High tariffs on imports for exports (for example, intermediates) and high tariff rate differentials between primary, intermediate, and consumer goods have led to rising production costs, which has eroded processing margins. High tariff differentials and other complexity-enhancing ad-hoc policy measures are especially harmful to smaller companies: not only do they add to the cost of doing business, but they also introduce uncertainty.

…a differentiated trade policy that accounts for the requirements of different firm categories…

Trade policy needs to be sensitized to the differences in firms' requirements by size, location, and sector. Exemptions granted to importers and exporters through different government schemes shed light on the need for disaggregating policy measures based on specific firm characteristics. Although duty exemptions reduce the effective customs duty paid by exporters, they do not benefit all firms in Pakistan and their impact is skewed toward larger firms. Exporters need to import their own intermediate inputs to benefit from the main customs duty exemptions; less than a third of exporters (31 percent) did so in FY16. Furthermore, smaller exporters are less likely to import. Only 19.2 percent of micro-exporters and 31.5 percent of small exporters imported goods and services, compared to 84.1 percent of large firms in FY16. Larger firms have also benefited the most from duty exemption schemes. The top 100 firms in Pakistan accounted for roughly three quarters of duty-exempted value, and only five firms accounted for about a third of that total.

…investment in infrastructure to reduce costs and improve connectivity…

Pakistan needs to invest in its logistics and transportation infrastructure to improve trade facilitation. Reducing trade costs, upgrading service quality, and improving connectivity between domestic and foreign markets can play a decisive role in attaining export competitiveness by allowing countries to trade goods and services on a timely basis and with lower transaction costs, in addition to enabling integration with global value chains. Costs associated with logistics – both monetary costs and costs associated with processing times – despite having fallen overall and over time, are still considerably higher in Pakistan than in peer group comparators and the region. As of 2015, border and documentary compliance to export from Karachi took 141 hours, compared to 20

hours in OECD countries. Similarly, border and documentary compliance to import takes 294 hours, compared to 13 hours in OECD countries.[156]

…and broad-based measures to improve the investment climate

Investment climate-related constraints need to be removed to promote investment in Pakistan's productive sectors**.** It has not been able to capitalize on international investors' appetite for high-return investments in developing countries. While other countries in the region have used FDI as seed capital to support high-potential, high-growth, and entrepreneurial industries within their export sector, Pakistan has failed to draw meaningful long-term FDI to revitalize its lagging export sector. Net foreign investment was negative in Pakistan in three of the last five years. Foreign investment has also been more volatile compared to other countries in the region. Pakistan drew US$842 million in FDI in 2015, down US$902 million from 2014 (it received US$1.7 billion in FDI in 2014). This is considerably lower than the US$2.1 billion drawn by Bangladesh and the US$10.7 billion drawn by Vietnam in the same year. Low levels of FDI, in addition to low domestic investment (as embodied in the ratio of private sector investment to GDP, which has declined from a high of approximately 16 percent in 2006 to less than 10 percent in 2015), and limited access to finance (as per the Enterprise Survey, one fourth of small firms surveyed had their recent loan applications rejected) have all contributed to a decrease in the financial capital available for entrepreneurs to start a business in Pakistan.

[156] Customs clearance time for small exporters is less than that for large exporters. The difference suggests that trade facilitation and logistics are less of an issue for small firms as compared to trade policy, investment climate etc.

ANNEX: PAKISTAN'S SOCIAL INDICATORS

No.	Indicator	2010	2014*
	EDUCATION AND SKILLS**		
1.	*Overall pre-primary participation rate, ages 4–5 (%)*	**36.5**	**43.3**
	Male	38.4	45.7
	Female	34.5	40.6
	Balochistan	21.7	20.8
	KP	27.0	38.3
	Punjab	45.2	54.9
	Sindh	27.0	29.4
2.	*School Participation Rate ages 6–10 (%)*	**74.3**	**77.4**
	Male	79.5	82.3
	Female	68.6	72.0
	Q 1 (poorest)	47.9	50.0
	Q 5 (richest)	94.6	96.1
	Balochistan	57.6	63.9
	KP	74.1	79.8
	Punjab	80.2	82.9
	Sindh	66.1	68.0
3.	*School Participation Rate, ages 11–15 (%)*	**66.5**	**69.3**
	Male	73.3	76.0
	Female	58.6	61.9
	Q 1 (poorest)	34.7	37.5
	Q 5 (richest)	90.4	91.5
	Balochistan	49.7	59.1
	KP	68.2	74.2
	Punjab	69.6	72.0
	Sindh	61.2	61.9
4.	*Percentage of 18–24-year-olds enrolled in higher education or skills training (%)*	**8.1**	**9.1**
	Male	9.4	9.7
	Female	6.9	8.5
	Q 1 (poorest)	0.7	0.9
	Q 5 (richest)	19.9	23.4
	Balochistan	5.3	3.0
	KP	7.7	8.1
	Punjab	8.0	9.4
	Sindh	8.7	9.3
5.	*Expenditure on education (% of GDP)*	**1.7**	**2.3 (2016)**

No.	Indicator	2010	2014*
	HEALTH AND NUTRITION		
6.	***Percentage of births attended by a skilled health personnel (%)***	**43**	**58**
	National – urban	66	78.7
	National – rural	33	48.8
	Balochistan	27	37.5
	KP	37	56.3
	Punjab	44	60
	Sindh	49	59.0
7.	***Child immunization rate (full immunization based on recall and record) for children aged 12–23 months (%)***	**81**	**83**
	Male	82	83
	Female	79	83
	Q 1 (poorest)	67	68
	Q 5 (richest)	92	94
	National – urban	85	86
	National – rural	79	80
	Balochistan	56	53
	KP	77	79
	Punjab	86	90
	Sindh	75	74
8.	***Percentage of population (aged <5) that is moderately or severely stunted (%)***	**43.7 (2011)**	--
	Balochistan	52.2 (2011)	--
	KP	47.8 (2011)	--
	Punjab	39.2 (2011)	--
	Sindh	49.8 (2011)	--
9.	***Expenditure on health (% of GDP)***	**0.6**	**0.9 (2016)**
	POVERTY		
10.	***Poverty headcount based on FY14 poverty line (%) (poverty, earlier years back-casted)***	**36.8**	**29.5 (2013)**
	Balochistan	48.9	56.8 (2013)
	KP	42.3	27.6 (2013)
	Punjab	34.0	25.3 (2013)
	Sindh	37.7	34.2 (2013)
11.	***Shared prosperity premium (difference between the percentage growth in real consumption of the bottom 40 percent and growth in real consumption of the mean)(%)*** ***	**2.9**	**-2.6 (2013)**
	Balochistan	-4.6	1.3 (2013)
	KP	3.0	-4.6 (2013)
	Punjab	2.7	-5.4 (2013)
	Sindh	1.3	5.2 (2013)

No.	Indicator	2010	2014*
	WATER AND SANITATION		
12.	*Percentage of households whose main source of drinking water is improved water (%)*	**87.7**	**89.5 (2015)**
	National – urban	93.2	92 (2015)
	National – rural	84.8	88 (2015)
	Balochistan	49.5	62.2 (2015)
	KP	72.3	75 (2015)
	Punjab	93.6	95.5 (2015)
	Sindh	89.4	87.2 (2015)
13.	*Percentage of households with piped water supply (%)*	**31.8**	**26.7 (2015)**
	National – urban	57.7	50.1 (2015)
	National – rural	18.5	12.7 (2015)
	Balochistan	35.4	33.4 (2015)
	KP	45.1	34.6 (2015)
	Punjab	24.1	17.8 (2015)
	Sindh	43.3	41.1 (2015)
14.	*Percentage of households with toilet facility at home (%)*	**81.7**	**86.7 (2015)**
	National – urban	98.3	99.2 (2015)
	National – rural	73.2	79.4 (2015)
	Balochistan	86.9	86.7 (2015)
	KP	82.1	88.3 (2015)
	Punjab	76.9	83.7 (2015)
	Sindh	92.4	92.5 (2015)
15.	*Percentage of households where toilets are connected to any drainage system (%)*	**66.5 (2011)**	**67.2 (2016)**
	National – urban	96.5 (2011)	95.3 (2016)
	National – rural	50.7 (2011)	51 (2016)
	Balochistan	31 (2011)	47.8 (2016)
	KP	62.5 (2011)	53.8 (2016)
	Punjab	72.5 (2011)	73.2 (2016)
	Sindh	57.8 (2011)	62.7 (2016)
	GENDER		
16.	*Adolescent fertility rate (births per 1,000 women aged 15–19)*	**41**	**38 (2015)**
17.	*Labor force participation rate (ages 15–64)(%)*	**51.9**	**53.4**
	Male	81.0	82.1
	Female	22.9	25.0
18.	*Share of seats in Parliament held by women (%)*	**22.2**	**21.0 (2016)**
19.	*Maternal mortality ratio (per 100,000 live births calculated for women aged 15–49)*	**211**	**178 (2015)**
20.	*Access to finance (percentage of female population aged 15 and above, using banking and other formal financial services)(%)*	**4 (2008)**	**11 (2015)**

Notes:
* The most recent data is reported where available. Years mentioned in parentheses, otherwise data pertains to 2014.
** For comparability across provinces, PSLM data was used. Alternative sources of data on school participation rate are present for some provinces. See Chapter C for details.
*** Consumption growth is being measured over the period FY08-FY11 for the year 2010, and over the period FY11-FY14 for the year 2013.
Sources: PSLM (various years), PRSP progress reports, National Nutrition Survey 2011, HIES (various years), LFS, World Bank gender data portal, Pakistan Demographic Health Survey FY13, Access to Finance Surveys (2007/08 and 2015), World Population Prospects (United Nations Population Division).

Rationale for the Choice of Indicators

Indicator	Definition	Rationale
School Participation Rate (SPR (pre-primary, ages 6–10 and ages 11–15)	Defined as the share of children in each age cohort enrolled in school (regardless of grade level).	The SPR allows greater flexibility for late entrants into the school system. Although the official primary school entrance age is 5 years, late entry into the schooling system is common in Pakistan as approximately one fourth of all children begin schooling at the age of 6 or older.
Percentage of youth enrolled in higher education or skills training	Calculated as the number of individuals between the ages of 18 and 24, enrolled in either higher education or skills training courses.	This indicator is aligned with the SDG 4 indicator relating to youth participation in higher education and skills training.
Labor force participation rate (youth, by gender, and overall)	Calculated as the total labor force divided by the total working-age population (ages 15–64).	This is a widely reported indicator internationally and allows for inter-country comparisons.
Percentage of births attended by skilled health personnel	Calculated as the percentage of births attended by any one of the following: doctor, nurse, midwife, or LHV.	This indicator is aligned with SDG 3, in particular with target 3.1 (*by 2030, reduce the global maternal mortality ratio to less than 70 per 100,000 live births*).
Child immunization rate (full immunization based on recall and record) for children aged 12–23 months	Calculated as the percentage of children between the ages of 12 and 23 months, who have received the following immunizations (based on record or recall): BCG, DPT1, DPT2, DPT3, and measles.	This indicator is aligned with SDG 3 and serves as a proxy for universal coverage.
Percentage of population that is moderately or severely stunted	Defined as the proportion of the population under 5 years of age that is less than –2 standard deviations from the median height for age of the reference population.	This indicator is widely reported internationally and is essential to the case of Pakistan where stunting rates have been stagnant for the past 40 years.
Public expenditure on education as a percentage of GDP	Includes all public expenditure on education at various levels of education expressed as a percentage of GDP.	This is a widely reported indicator internationally and allows for inter-country comparisons.
Public expenditure on health as a percentage of GDP	Includes all public expenditure on health, expressed as a percentage of GDP.	This is a widely reported indicator internationally and allows for inter-country comparisons.

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