PAKISTAN
DEVELOPMENT UPDATE

April 2022

FINANCING THE REAL ECONOMY

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Preface

The World Bank Pakistan Development Update (PDU) provides an update on the Pakistani economy, its economic outlook, together with the development challenges it faces and the structural reforms that should be considered.

This edition of the Pakistan Development Update (PDU) was prepared by the Macroeconomics, Trade, and Investment Global Practice under the guidance of Najy Benhassine (Country Director, SACPK), Zoubida Allaoua (Regional Director, ESADR), Shabih Ali Mohib (Practice Manager and Lead Country Economist, ESAMU) and Gabi George Afram (Practice Manager, ESAF1). The core PDU team was led by Zehra Aslam (Task Team Leader and Economist, ESAMU) and Namoos Zaheer (Co-Task Team Leader and Senior Financial Sector Specialist, ESAF1), and includes Miquel Dijkman (Lead Financial Sector Specialist, ESAF1), Derek H. C. Chen (Senior Economist, ESAMU), Gonzalo J. Varela, (Senior Economist, ESAMU), Adnan Ashraf Ghumman (Senior Economist, ESAMU), Sayed Murtaza Muzaffari (Economist, ESAMU), Aroub Farooq (Research Analyst, ESAMU), Franz Ulrich Ruch (Economist, EPGDR), Rafay Khan (Economist, ESAF1), Fahad Hasan (Financial Sector Specialist, ESAF1), Noor Yasin (Extended Term Consultant, ESAF1) Arsianti (Consultant, ESAMU), and Ali Shahid (Team Assistant, SACPK).

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Lists of Abbreviations and Acronyms

ADR	Average Advances to Deposit ratio
BISP	Benazir Income Support Programme
BPM6	Balance of Payments Manual 6
CAD	Current Account Deficit
CAR	Capital Adequacy Ratio
CDNS	Central Directorate for National Savings
CPI	Consumer Price Index
CRR	Cash Reserve Requirement
DFI	Development Finance Institution
DSSI	Debt Service Suspension Initiative
e-CIB	Electronic Credit Information Bureau
EFF	Extended Fund Facility
EFS	Export Financing Scheme
EMBI	Emerging Market Bond Index
EMDE	Emerging Market and Development economy
EU	European Union
FBR	Federal Board of Revenue
FDI	Foreign Direct Investment
FIFRDLA	Fiscal Responsibility and Debt Limitation Act
FY	Fiscal Year
GDP	Gross Domestic Product
GCC	Gulf Cooperation Council
GFP	Gross Loan Portfolio
GST	goods and services tax
IFC	International Finance Corporation
IFS	International Financial Securities
IMF-EFF	International Monetary Fund-Extended Fund Facility
IPP	Independent Power Producers
JFE	Journal of Financial Economics
LSM	Large Scale Manufacturing
LTFF	Long-Term Financing Facility
MFB	Microfinance banks
MFP	Micro Finance Provider
MOC	Ministry of Commerce
MOF	Ministry of Finance
MPC	Monetary Policy Committee
MSE	Medium and small enterprises
MSME	Micro, Small and Medium Enterprises
NBFI	Non-Bank Finance Institution
NCOC	National Command and Operation Center
NFLP	National Financial Literacy Program
NPL(s)	Non-Performing Loan(s)
OECD	Organization for Economic Co-operation and Development
PBS	Pakistan Bureau of Statistics
PCRCL	Pakistan Credit Restructuring Company
PD	Primary Dealers
PDU	Pakistan Development Update
PDL	Petroleum development levy
PE	Public Equity
PFI	Public Financial Institute
PKR	Pakistani Rupee
PPP	Purchasing power parity
PSCB	Public Sector Commercial Bank
PSX	Pakistan Stock Exchange
REITS	Real Estate Investment Trusts
REER	Real Effective Exchange Rate
SBP	State Bank of Pakistan
SCRR	Special Cash Reserve Requirement
SECP	Securities Exchange Commission
SME	Small and Medium Enterprise
SOE	State Owned Enterprises
STR	Secured Transactions Registry
TERF	Temporary Economic Refinance Facility
UNCTAD	United Nations Conference on Trade and Development
VC	Venture Capital
WDI	World Development Index
WBG	World Bank Group
y-o-y	Year-on-year

1. Executive Summary – Financing the Real Economy

Economic activity has remained strong since July 2021

Economic momentum continued over July–December 2021 (H1 FY22) as indicators mostly signaled positive trends. With sustained improvement in community mobility and still-robust official remittance inflows, private consumption is estimated to have increased. Similarly, public and private investment is expected to have grown with the strong growth of machinery imports and government development expenditure. Government consumption is also estimated to have grown due to vaccine procurement. On the production side, agricultural output, mainly rice and sugarcane increased, reflecting better weather conditions. Large-scale manufacturing (LSM) growth rose to 7.5 percent y-o-y in H1 FY22, higher than the 1.5 percent for H1 FY21. However, with higher inflation, increasing borrowing costs and political uncertainty, business and consumer confidence have been trending lower after reaching a pandemic high in June 2021.

Average headline inflation increased largely due to higher energy prices

Headline inflation rose to an average of 9.8 percent y-o-y in H1 FY22 from 8.6 percent in H1 FY21, driven by surging global commodity and energy prices and a weaker exchange rate. Similarly, core inflation has been increasing since September 2021. Accordingly, the State Bank of Pakistan (SBP) has been unwinding its expansionary monetary stance since September 2021, raising the policy rate by a cumulative 525 basis points (bps) and banks' cash reserve requirement by 100 bps.

The current account deficit widened sharply, heightening external sustainability risks and reinforcing downward pressures on the Rupee

The current account deficit (CAD) in H1 FY22 widened to US$9.0 billion, from a surplus of US$1.2 billion in H1 FY21, as imports values surged by 54.4 percent, doubling the 27.3 percent growth in exports values. The record-high trade deficit was partially financed by remittances that registered double-digit growth in H1 FY22. The financial account recorded net inflows of US$10.1 billion, supported by the new IMF SDR allocation, short-term government deposits from Saudi Arabia, and a Eurobond issuance in July 2021. In January-February 2022, the Government obtained US$2.1 billion from an International Sukuk issuance and the IMF Extended Fund Facility (EFF). Despite these inflows, foreign exchange reserves fell to US$12.9 billion at end-March 2022, the lowest since June 2020, and equivalent to 1.9 months of imports of goods and services.[1] Meanwhile, the Rupee depreciated by 14.3 percent against the U.S. dollar from July 2021 to end-March 2022, reaching multiple record lows over the period.

The fiscal deficit widened due to higher spending

Despite high tax revenue growth on the back of surging imports, the fiscal deficit widened by 20.6 percent in H1 FY22 due to higher spending on vaccine procurement, settlement of power sector arrears, and development projects. Public and publicly guaranteed debt stood at PKR45.3 trillion at end-December 2021, an increase of PKR3.1 trillion since end-June 2021. As part of reforms to increase domestic revenues, the Government also approved a Supplementary Finance Bill in January 2022, withdrawing two-thirds of tax exemptions on the General Sales Tax (GST).

With the economic recovery in FY21, poverty is estimated to have declined

With the economic recovery and improved labor market conditions, poverty measured at the lower middle-income class poverty line of $3.20 PPP 2011 per day is estimated to have declined from 37.0 percent in FY20 to 34.0 percent in FY21. Rising food and energy inflation is expected to diminish the real purchasing power of households, disproportionally affecting poor and vulnerable households that spend a larger share of their budget on these items. In response, the Government introduced a targeted food subsidies program and announced a universal fuel price cut in February 2022.

GDP growth is projected to moderate in FY22–23, before strengthening over the medium-term

On the back of high base effects, recent monetary tightening and stronger inflation, real GDP growth is expected to moderate to 4.3 and 4.0 percent in FY22 and FY23, respectively before recovering to 4.2 percent in FY24 (Table 1). This recovery is predicated on continued macroeconomic stability and a narrowing of the fiscal and external deficits in the medium-term. Inflation is estimated to rise to an average of 10.7

[1] However, part of the decline in reserves is expected to be reversed in the coming weeks as official creditors rollover their loans.

percent in FY22, reflecting higher oil and commodity prices, but is then expected to decrease over the forecast horizon.

Table 1: Projections of Key Economic Indicators

	FY19	FY20	FY21	FY22e	FY23f	FY24f
Real GDP growth, at constant factor prices	3.1	-1.0	5.6	4.3	4.0	4.2
Current Account Balance (% of GDP)	-4.2	-1.5	-0.6	-4.4	-3.1	-3.0
Fiscal Balance (% of GDP), excluding grants	-7.9	-7.1	-6.1	-6.3	-6.1	-5.3
Public Debt, including govt. guaranteed debt (% of GDP)	78.0	81.1	76.0	76.0	74.4	72.5

Sources: Pakistan Bureau of Statistics, State Bank of Pakistan, World Bank staff estimates.
Note: This macroeconomic outlook uses the re-based national accounts data at 2015-16 prices. It was prepared by World Bank staff and differs from that of the Government.

The CAD is expected to increase in FY22 before narrowing over FY23–24

Due to faster import than export growth in H1 FY22, the CAD is expected to increase to 4.4 percent of GDP in FY22. Moderating demand pressures due to monetary tightening, lower global commodity prices and the weaker currency are expected to dampen imports in FY23. With the implementation of reforms to reduce import tariffs on relevant intermediates for the export sector and increased allocations for export refinance schemes, the CAD is expected to further narrow to 3.0 percent of GDP in FY24.

The fiscal deficit is projected to widen in FY22

The fiscal deficit (excluding grants) is projected to widen slightly to 6.3 percent of GDP in FY22, on the back of higher spending on COVID-19 vaccine procurement, settlement of energy sector arrears, development spending, and the recently announced food and energy subsidies. It is projected to gradually narrow over the medium term as revenue mobilization measures take hold, particularly GST harmonization and Personal Income Tax (PIT) reform. Public debt as a share of GDP is projected to remain high, but gradually decline over the medium term. However, in the absence of the implementation of these critical reforms, fiscal sustainability risks can increase. The macroeconomic outlook is predicated on the IMF-EFF program remaining on track.

Multiple external and domestic factors pose downside risks to the outlook

Macroeconomic risks are strongly tilted to the downside. They include faster-than-expected tightening of global financing conditions, potential further increases in world energy prices, and the possible risk of a return of stringent COVID-19-related mobility restrictions. Moreover, domestic political uncertainty and policy reform slippages can lead to protracted macroeconomic imbalances.

Macroeconomic adjustment measures are urgently needed to address external imbalances

Strong aggregate demand pressures, in part due to accommodative fiscal and monetary policies, paired with the continued anti-export bias of the national trade tariff structure, have contributed to a record-high trade deficit, weighing on the Rupee and the country's limited external buffers. Given the severity of the imbalances, macroeconomic adjustment measures, specifically fiscal consolidation to complement the ongoing monetary tightening, are urgently needed.

A deep, innovative, and inclusive financial sector is key for sustained growth

A well-functioning financial sector that allocates capital to its most productive uses and shifts risks to those who can best bear them, is central to unlocking private investment and Pakistan's growth potential. However, the country's financial sector remains underdeveloped. Credit to the private sector is low compared to peers and has trended downward since 2005. It is also concentrated in the corporate segment with most of the financing being extended for working capital and trade, rather than growth-enhancing fixed investments.

Unlocking higher financial flows to the real economy requires addressing structural impediments impacting the demand and supply of finance

The underperformance of the financial sector is driven by structural impediments in not only the supply but also in the demand for finance. Extensive government borrowing from the financial sector has been the single largest constraint to the enhanced flow of financing to the private sector. Other important factors include low domestic saving, growing but still limited financial inclusion, and market failures in the form of inadequate financial infrastructure. Resolving these constraints in the medium- to long-term requires concerted efforts by the government, regulators, and other stakeholders. In addition, five growth areas offer significant potential to unlock greater financing flows toward the real economy in the short- to medium-term. These are: a) digital finance; b) risk capital; c) microfinance; d) development finance; and e) capital markets.

2. Recent Economic Developments

a. Context

Economic activity recovered in FY21, however, long-standing structural issues pose risks to sustainable economic growth

The Government undertook timely policy measures to mitigate the adverse socioeconomic impacts of the COVID-19 pandemic. The State Bank of Pakistan (SBP) lowered the policy rate and announced supportive measures for the financial sector to help businesses and the Government expanded the national cash transfer program on an emergency basis.[2] These measures contributed to economic growth rebounding to 5.6 percent in FY21.[3] However, long-standing structural weaknesses of the economy, particularly consumption-led growth, low private investment rates, and weak exports have constrained productivity growth and pose risks to a sustained recovery. Aggregate demand pressures have built up, in part due to previously accommodative fiscal and monetary policies, contributing to double-digit inflation and a sharp rise in the import bill with record-high trade deficits in H1 FY22 (Jul–Dec 2021). These have diminished the real purchasing power of households and weighed on the exchange rate and the country's limited external buffers.

b. Real Sector

Growth

Economic momentum continued, but business confidence has declined

During H1 FY22, y-o-y growth in car production and sales, petroleum sales, and foreign remittance inflows indicate continued momentum in economic activity and private consumption. Similarly, investment is also expected to have increased with a strong growth in machinery imports and government development expenditure. Government consumption is also expected to have expanded given the 16.0 percent increase in consolidated current expenditure in H1 FY22. Activity in the external sector was also vibrant, with import and export values growing by 54.4 percent and 27.3 percent, respectively. While the flow of bank loans to private businesses grew in this period, it was led by an increase in working capital or short-term financing, particularly as businesses faced higher input costs, as opposed to long-term or fixed investment financing. The business confidence survey index also declined from a pandemic high of 64.0 in June 2021 to 53.4 in December 2021, indicating lower optimism in the business sector regarding the economic outlook.[4]

Favorable weather conditions are expected to support higher overall crop production

In agriculture, estimates suggest that rice, sugarcane, and maize production will be higher this year, reflecting better weather conditions.[5] With regards to agriculture inputs, agriculture credit disbursement grew 3.9 percent, and farm tractor sales increased by 21.2 percent in H1 FY22.[6] Similarly, 97.7 percent of the sowing target for wheat has been met.[7] However, fertilizer and urea off-take declined y-o-y over Oct-Dec 2021, which is likely to negatively impact wheat production. Cotton production, though likely higher than last year, is also expected to be substantially lower than the government estimate of 10.5 million bales.[8]

Large-scale industrial production growth strengthened

The LSM index, a key indicator for industrial activity, increased by 7.5 percent y-o-y during H1 FY22 compared to a muted growth of 1.5 percent in H1 FY21. Growth was broad-based with 16 out of the 22 sectors recording higher production. Only pharmaceuticals, rubber products, electronics, fabricated metal, computers, electronics,

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[2] Through the Ehsaas Emergency Cash program, the Government delivered PKR179.2 billion as emergency cash assistance to 14.8 million beneficiaries who were at risk of falling into extreme poverty. Ehsaas Dashboard, Government of Pakistan. https://www.pass.gov.pk/ecs/uct_all.html.
[3] GDP at constant 2015-16 factor prices. The Government updated national accounts data in January 2022, changing the base year from 2005-06 to 2015-16. As part of this rebasing exercise, the coverage of economic activities included in GDP estimates was improved through new and updated surveys. The re-basing of GDP led to a revision in real GDP growth rates since FY17.
[4] A score above 50 indicates optimism. State Bank of Pakistan.
[5] Monthly Economic Update & Outlook: October 2021. Ministry of Finance.
[6] Ibid.
[7] Monthly Economic Update & Outlook: January 2022. Ministry of Finance.
[8] Monetary Policy Statement: March 08, 2022. State Bank of Pakistan.

and optical products, and other transport equipment sectors witnessed a contraction. Domestic cement dispatches, an important indicator of construction sector activity, increased by 2.0 percent during H1 FY22.[9] Financing for construction activities also picked up by 75.3 percent in H1 FY22.[10]

Despite intermittent lockdown restrictions, services sector activity remained strong

Services sector activity was the most impacted by intermittent disruptions due to COVID -19 related mobility restrictions. From early-August to end-September 2021, the Government placed restrictions on indoor gatherings and restaurants, limited market timings, and constrained public transport, schools, and workplaces to operate at only 50 percent occupancy.[11] Similar restrictions were re-imposed for various durations over mid-January to mid-March 2022, when infection rates surged with the Omicron wave.[12] However, despite these restrictions, Google mobility trends indicate that activity in retail and recreation, parks, grocery and pharmacy, and transport-related services remained strong in H1 FY22 with the average improving from 0.9 percent in H1 FY21 to 35.1 percent in H1 FY22.[13]

Inflation

Average headline inflation increased in H1 FY22…

Average headline inflation during H1 FY22 reached 9.8 percent y-o-y compared to 8.6 percent in H1 FY21 due to surging global commodity and energy prices and a weaker Rupee. Most product categories saw higher y-o-y average inflation in H1 FY22, and only three categories recorded lower inflation: (1) food and non-alcoholic beverages; (2) alcoholic beverages and tobacco; and (3) miscellaneous goods and services. The broad-based increase in inflationary pressures also reflects the buildup in domestic demand pressures during this period. Headline inflation in Pakistan was the highest in South Asia, where the regional average was 6.0 percent during H1 FY22.[14]

…driven in large part by higher energy prices

Energy inflation reached 25.1 percent y-o-y in urban areas and 22.6 percent in rural areas in H1 FY22 compared to -3.2 percent in urban areas and 1.4 percent in rural areas during the same period last year.[15] The increase in global oil prices and depreciation of the Rupee led to more expensive energy imports. This led to domestic petrol prices rising by 25.0 percent in H1 FY22, while kerosene and high-speed diesel prices rose by 27.7 and 20.7 percent, respectively.[16,17] Meanwhile, the Government also raised electricity tariffs in October and November as part of its energy sector reforms (Figure 2.1 and Figure 2.2).[18]

Food inflation eased slightly but continues to remain elevated, with a risk of further increases

Average food inflation fell from 13.0 percent in urban areas and 15.7 percent in rural areas during H1 FY21 to 10.6 percent in urban areas and 8.4 percent in rural areas in H1 FY22.[19] Higher domestic production of wheat, maize, rice, and sugarcane in FY21 contributed to lower food price pressures in H1 FY22.[20] However, as Pakistan is a net importer of edible oil, wheat, sugar, and pulses,[21] the higher global food prices together with the weaker exchange rate have added to domestic food inflationary pressures.

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[9] Monthly Economic Update & Outlook: January 2022. Ministry of Finance.
[10] Loans classified by borrowers (by type of finance). State bank of Pakistan.
[11] In August, educational institutes were allowed to remain open but for only three days a week and at 50 percent attendance. See: NCOC expands stricter Covid restrictions to 27 cities citing pressure on healthcare system. Dawn. August 29, 2021.
[12] See: 1) NCOC imposes fresh curbs on schools, other sectors in cities with over 10% positivity. The News. January 19, 2022; and 2) Which Pakistani cities has NCOC lifted COVID-19 restrictions in? Geo News. February 22, 2022; 3) Govt lifts all Covid-related restrictions as pandemic wanes. Dawn. March 16, 2022
[13] Source: Our World in Data. Notes: the Google mobility data represents percentage change in number of visitors to categorized places, relative to pre-Covid-19 baseline (median value for the five-week period between January 03, 2022, to February 06, 2022). It is based on a rolling 7-day average.
[14] World Bank staff calculations based on data from the CEIC, and the Afghanistan and Bhutan National Statistics Bureau.
[15] Energy inflation consists of electricity charges, gas prices, liquified hydrocarbons, solid fuel, and motor fuel.
[16] The Pakistani Rupee depreciated by 10.9 percent against the U.S. dollar in H1 FY22, as calculated using end-period exchange rates for June 2021 and December 2021. Source: International Monetary Fund, International Financial Statistics.
[17] Source: World Bank calculations using data from Ministry of Finance, press releases.
[18] International Monetary Fund. 2021 Article IV Consultation, Sixth Review under the Extended Arrangement under the Extended Fund Facility. Staff report. February 2022.
[19] Food inflation consists of two product categories: 1) food and non-alcoholic beverages, and 2) alcoholic beverages and tobacco, and the ready-made food products from the restaurants and hotels category in the CPI.
[20] See Footnote 5.
[21] Ministry of Finance. Press Release no 616. September 29, 2021.

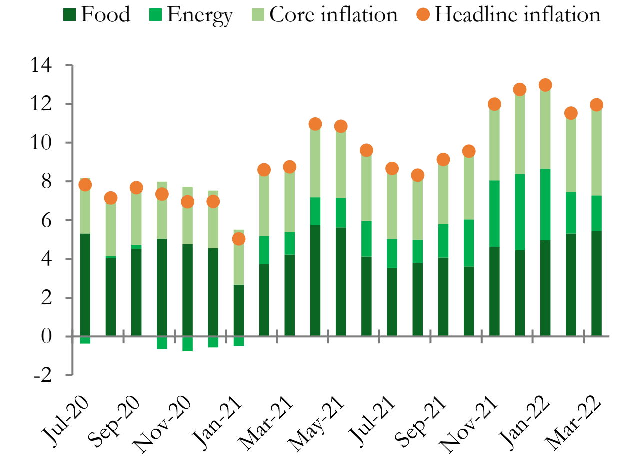
Core inflation has been gradually rising

Urban core inflation (non-food non-energy) rose to an average of 7.0 percent y-o-y in H1 FY22 from 5.5 percent during H1 FY21. Although rural core inflation fell to an average of 7.2 percent in H1 FY22 from 7.7 percent in H1 FY21, it has been on an upward trend since October 2021. Price increases were recorded across a range of goods and services including garments, footwear, construction inputs, transport, education, and health services. The increase in core inflation partly reflected the depreciation of the Rupee, and higher domestic demand pressures.

Headline inflation continued its upward trend in January-March 2022

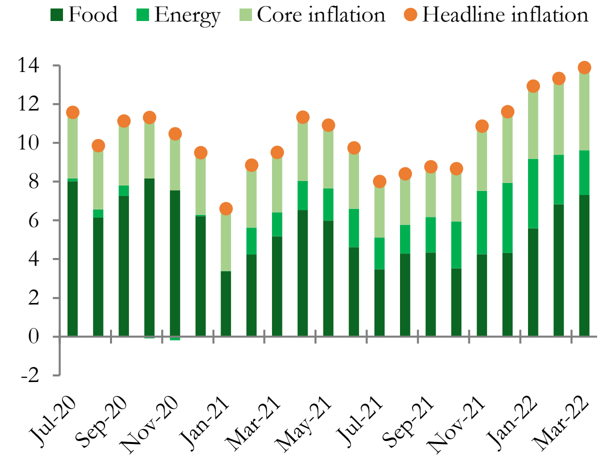
More recently, headline inflation stood at 12.7 percent in March, after reaching 13.0 percent in January 2022 – the highest in two years. Energy inflation eased on a y-o-y basis while food inflation climbed in Jan-Mar 2022. However, in March, rural core inflation reached 10.3 percent whereas urban core inflation was 8.9 percent – the highest in recent years and indicative of broad-based inflationary pressures.

Figure 2.1: Contribution to headline inflation in urban areas
(Percentage points)



Source: Pakistan Bureau of Statistics and World Bank staff calculations

Figure 2.2: Contribution to headline inflation in rural areas
(Percentage points)



Source: Pakistan Bureau of Statistics and World Bank staff calculations

Poverty and Equity

With the economic recovery in FY21, poverty is estimated to have declined...

Supported by higher growth and the recovery in the manufacturing and services sectors, the poverty headcount, measured at the lower-middle-income class line of US$3.20 PPP 2011 per day, is estimated to have declined from 37.0 percent in FY20 to 34.0 percent in FY21.

…but rising food and energy inflation has diminished the real purchasing power of households

Rising inflation has disproportionally affected poor and vulnerable households that spend a relatively larger share of their budget on food and energy. More specifically, the poor spend around 50 percent of their total consumption on food items, whereas this share is only 43 percent among the non-poor. In response, the Government inaugurated a targeted commodity subsidy program, Ehsaas Rashan Riayat, in February 2022 to compensate eligible households for higher prices.[22]

[22] Under this initiative, 20 million eligible families identified through the Ehsaas Socioeconomic Registry Survey will receive PKR1,000 per month to purchase flour, pulses, and cooking oil at a 30 percent subsidized rate. Poverty Alleviation and Social Safety Division. Government of Pakistan. November 3, 2021.

c. Monetary and financial sector

Monetary

In response to rising domestic demand pressures, the SBP raised the policy rate and took measures to normalize monetary conditions

To manage increasing domestic demand pressures, the SBP has been unwinding its accommodative monetary policy stance – raising the policy rate by a cumulative 275 basis points between September and December 2021 to 9.75 percent.[23] However, with headline inflation averaging 9.8 percent in H1 FY22, real interest rates has remained negative. In a move aimed at normalizing monetary conditions, the SBP also raised banks' cash reserve requirement by 100 bps in November 2021.[24] Moreover, to enhance the predictability of monetary policy conditions and to reduce uncertainty, the SBP increased the number of Monetary Policy Committee (MPC) meetings from six to eight a year in November 2021.[25] In January 2022, the National Assembly approved the State Bank of Pakistan Amendment Act 2021, which prohibits Government borrowing from the central bank, strengthens the functional and administrative autonomy of the SBP, and sets price stability as its primary objective (Box 2.1). Moreover, with higher-than-expected inflation in March, growing pressures on the Rupee and tighter global conditions, the SBP further raised the policy rate by another 250 basis points in April 2022 to 12.25 percent.[26]

Box 2.1: Strengthening the Autonomy of the SBP – State Bank of Pakistan Amendment Act 2021

The role of the State Bank of Pakistan (SBP) is defined in the State Bank of Pakistan Act 1956. Further, the Act has been amended several times over the years to bring its operational and administrative function in line with international best practices and to allow it to deal with evolving economic conditions more effectively. Most recently in January 2022, the Parliament approved the SBP Amendment Act 2021, which strengthens the SBP's functional and administrative autonomy, defines its objectives clearly, and improves transparency in SBP's operations. The key changes introduced in this Act are as follows:

(i) <u>**Objectives:**</u> **The primary objective of the SBP shall be to achieve and maintain domestic price stability,** followed by financial stability and support for the general economic policies of the Government for fostering development and fuller utilization of Pakistan's productive resources (Preamble, Section 4B). Here price stability is defined as the maintenance of low and stable inflation guided by the government's medium-term inflation target. As per the previous preamble, the SBP's mandate was to secure monetary stability and fuller utilization of the country's productive resources whereas Section 4 is a new addition to the SBP Act.

(ii) <u>**Prohibition on Government borrowing:**</u> **The SBP shall not extend any direct credits to or guarantee any obligations of the Government,** or any government-owned entity or any other public entity, barring government or publicly owned bank and other regulated entities (Section 9C). In practice, since July 2019, the Government has not borrowed directly from the SBP.

(iii) <u>**Discontinuation of quasi-fiscal operations:**</u> **The SBP shall not undertake any quasi-fiscal operations (Section 20, clause 5A),** defined as monetary actions taken on behalf of the government. However, it can continue to extend refinance facilities to financial institutions with appropriate checks and balances and as the lender of last resort, provide temporary liquidity facilities to banks against appropriate collateral (Section 18, Clause 1A and Section 20, clause 17G).

(iv) <u>**Financial resources:**</u> To facilitate smooth functioning and the achievement of its objectives, the SBP's authorized and paid-up capital has been increased from a total of PKR100 million to PKR500 billion (authorized capital) and PKR100 billion (paid-up capital) (Section 4).

(v) <u>**Coordination between the SBP and the Government:**</u> The Monetary and Fiscal Policies Coordination Board has been abolished as its terms of reference overlap with the MPC's mandate. Instead, the Finance Minister and SBP Governor will establish a close liaison and keep each other informed of matters that jointly concern the Ministry of Finance and the SBP (Section 9G).

(vi) <u>**Protection of SBP officials:**</u> In line with international best practices, the amendments provide protection to SBP employees and officers from any legal proceeding for actions taken in good faith (Section 52A).

(vii) <u>**Executive committee**</u>, consisting of the Governor and the Deputy Governors, Executive Directors and other officers will be responsible for formulating policies related to the SBP's core functions as well as those related to

[23] The SBP had maintained the policy rate at 7.0 since June 2020 to mitigate the pandemic-associated economic downturn.
[24] Average CRR to be maintained by scheduled banks for a period of two weeks, was increased from 5 percent to 6 percent and the minimum CRR to be maintained each day was raised from 3 percent to 4 percent. State Bank of Pakistan, Press Release November 13, 2021.
[25] State Bank of Pakistan. Press Release, November 19, 2021.
[26] State Bank of Pakistan. Monetary Policy Statement, April 07, 2022.

administration and management matters, excluding those matters falling in the purview of the MPC or the Board of Directors (Section 9F).

(viii) **Accountability to Parliament:** The Governor shall submit an annual report before the Parliament regarding the achievement of the SBP's objectives, conduct of monetary policy, state of the economy, and financial system (Section 39).

Other amendments approved pertain to conflict of interest, the appointment of a Chief Internal Auditor and establishment of an Audit Committee; the appointment of external auditors; and the appointment, terms of office and removal of non-executive directors of the board, external members of the MPC, and the Governor and Deputy Governors of the SBP.

Source: (a) State Bank of Pakistan Act, 1956 (https://www.sbp.org.pk/about/act/SBP-Act.pdf), (b) Ministry of Finance, Brief on SBP Amendment Act 2021 (https://www.finance.gov.pk/SBP_Act_2021.pdf and http://www.finance.gov.pk/SBP_Amendment_Act_2021.pdf).

Financial Sector

Financial sector buffers remain strong but emerging risks may accentuate vulnerabilities

The banking sector, which accounts for 74.1 percent of the overall financial sector assets, has remained profitable throughout the pandemic, and displayed strong solvency, with a capital adequacy ratio (CAR) of 16.7 percent in December 2021— above the SBP's minimum requirement of 11.5 percent. However, it should be noted that the CAR is at its lowest since June 2019, which may be attributed to the strong private sector credit growth witnessed since the start of the pandemic. Unlike lending to the Government, increases in the private sector lending portfolio may increase the total amount of risk-weighted assets, thereby lowering the CAR. Additionally, increasing exposure to the sovereign in a deteriorating macroeconomic environment means that the health of the banking sector is deeply intertwined with the Government's fiscal strength.

NPLs are on a declining trend and are well-provisioned for

Banking sector asset quality has improved with gross non-performing loans (NPLs) down from 8.9 percent at end-June 2021 to 7.9 percent in December 2021. Along with lower NPLs, the bank NPL provision coverage ratio has risen to 91.2 percent—the highest in recent history, warding off any immediate stability concerns. The gains realized in recent months, however, may unwind with the increase in the key policy rate and its associated cascading impact on floating rate loans.

SBP's refinancing facilities contributed to expansion in private sector credit

Outstanding loans to private sector businesses grew by 15.4 percent in H1 FY22, up from a growth of 4.5 percent in the same period last year. Credit to the corporate sector increased by 16.7 percent, whereas that to the SME sector grew 18.3 percent. Disbursements under the SBP's Temporary Economic Refinance Facility (TERF) and Long-Term Finance Facility (LTTF) grew 32.7 percent during the same period.

However, banks continue to underdeliver on their role as a financial intermediary to the private sector

Credit to the public sector was 66.8 percent of all bank credit extended at end-December 2021.[27] Although this appetite for government paper does not pose an immediate credit risk to the system, if the sovereign starts to face stress, then credit risks can escalate very rapidly. At present, the greatest risk of this dependency on lending to the sovereign remains the continued crowding out of the private sector. For a more detailed discussion of the issues faced by the financial sector and opportunities for growth, see Chapter 4.

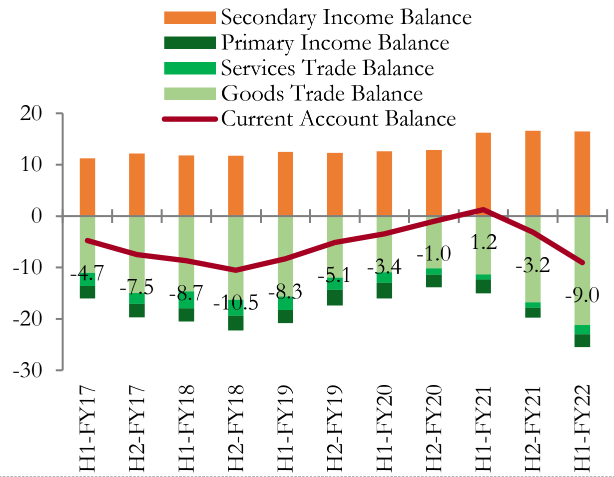
d. External sector

The CAD widened sharply in H1 FY22…

The current account registered a deficit of US$9.0 billion in H1 FY22, the largest since H2 FY18, from a surplus of US$1.2 billion in H1 FY21 (Figure 2.3). The expansion of the CAD was led by a record-high trade deficit due to the elevated import bill. Remittances registered a robust growth of 11.3 percent y-o-y in H1 FY22, partially financing the trade deficit.

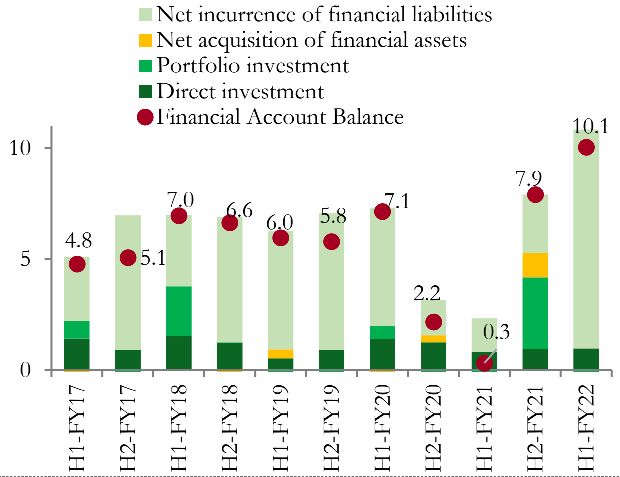
[27] Includes direct lending to government, lending to state-owned enterprises (SOEs), and investments in government securities

Figure 2.3: H1 Current Account Balances (Jul–Dec)
(US$ billion)



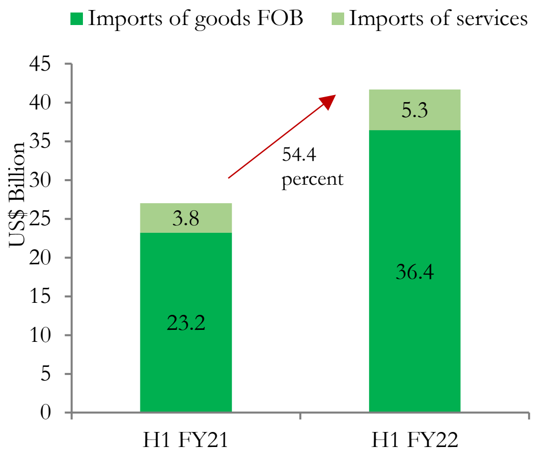
Source: State Bank of Pakistan, World Bank staff calculations

Figure 2.4: H1 Financial Account Inflows (Jul–Dec)
(US$ billion)



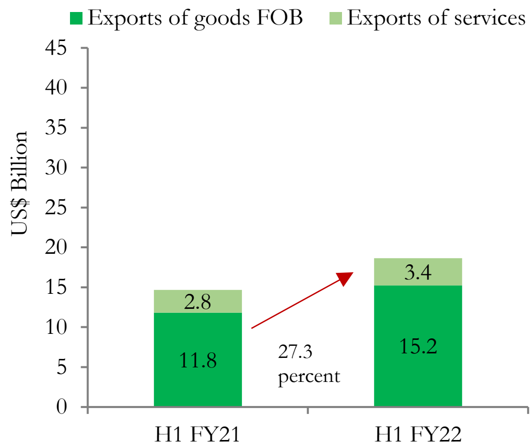
Source: State Bank of Pakistan, World Bank staff calculations
Note: A positive financial account balance represents inflows

Figure 2.5: Import of goods and services (Jul–Dec)
(US$ million)



Source: State Bank of Pakistan, World Bank staff calculations

Figure 2.6: Export of goods and services (Jul–Dec)
(US$ million)



Source: State Bank of Pakistan, World Bank staff calculations

…as goods and services imports surged, amid higher domestic demand and global prices

The overall trade deficit increased from US$12.3 billion in H1 FY21 to US$23.0 billion in H1 FY22. The increase in the trade deficit reflected sharp increases in both the goods and services trade accounts. The goods trade deficit widened to US$21.2 billion in H1 FY22 up from US$11.4 in H1 FY21 as goods imports surged by 57.0 percent, reflecting growing domestic demand and higher global commodity prices (Figure 2.5). Goods imports grew strongly across most categories, particularly petroleum products, machinery, transport vehicles, metals, food products, and fertilizers. Using Pakistan Bureau of Statistics data on goods import quantum and values, around 53 percent of the increase in total goods imports in H1 FY22 can be attributed to an increase in prices, while the remaining 47 percent was due to an increase in the quantity imported. For primary goods, namely soybean oil, palm oil, cotton, crude oil, and petroleum products – around 84 percent of the growth in import values was due to the increase in global prices. Meanwhile, goods exports grew 28.9 percent on the back of a jump in textile exports, mainly attributable to increased international orders and recent investments to expand and modernize the sector (Figure 2.6).[28,29] Likewise, with services imports growing faster than services exports, the services trade deficit grew to US$1.8 billion in H1 FY22. This was mainly driven by a sharp increase in trade-related transport services imports, due to higher shipping costs.[30]

[28] Textile machinery imports grew by 121.6 percent in H1 FY22, compared to a growth of 1.4 percent in H1 FY22.
[29] (i) Dawn: https://www.dawn.com/news/1662021/textile-exports-projected-to-cross-20bn-target, and (ii) Bloomberg: https://www.bloomberg.com/news/articles/2022-01-30/pakistan-s-textile-exports-to-surge-as-orders-move-from-rivals.
[30] Review of Maritime Transport 2021, UNCTAD

The income account recorded a marginally higher surplus in H1 FY22

The overall income account surplus increased by 3.0 percent y-o-y to US$14.0 billion in H1 FY22. Within the income account, the primary income account deficit decreased by 7.2 percent in H1 FY22, supported by debt service relief under the G20 Debt Service Suspension Initiative (DSSI), which was extended till December 2021. The secondary income account surplus increased marginally by 1.3 percent as well, as remittances, the largest contributor to this account, increased to US$15.8 billion in H1 FY22 up from US$14.2 billion in H1 FY21.[31]

The financial account recorded a large surplus due to a significant inflow of fresh loans

The financial account saw net inflows of US$10.1 billion in H1 FY22, compared to US$0.3 billion in H1 FY21 (Figure 2.4). The increase was driven by inflows from the IMF as per the revised SDR allocation, a Eurobond issuance in July 2021, and short-term government deposits from Saudi Arabia. Pakistan also made a repayment of US$1.0 billion against a previous Sukuk issuance in October 2021, which led to overall portfolio outflows of US$0.4 billion in H1 FY22. Meanwhile, at US$1.0 billion, FDI inflows remained significantly below pre-pandemic levels, partly reflecting protracted uncertainty in international markets regarding the global economic outlook. The surplus in the overall balance of payments declined from US$1.3 billion in H1 FY21 to US$0.8 billion in H1 FY22, due to the wider CAD.

The CAD has widened further in recent months, increasing external sustainability risks

The CAD in January 2022 reached a monthly high of US$2.5 billion – as imports continued to increase sharply but narrowed to US$0.5 billion in February as measures taken by the Government to curtail non-essential imports, higher prices and the weaker Rupee began to take effect. Cumulatively, the CAD in Jul–Feb FY22 was recorded at US$12.1 billion, compared to a surplus of US$1.0 billion in the same period in FY21. In January-February 2022, Pakistan received inflows of US$1.0 billion against an International Sukuk issuance and US$1.1 billion from the IMF, taking net financial inflows in Jul–Feb FY22 to US$12.1 billion. Despite these inflows, foreign exchange reserves fell to US$12.9 billion at end-March 2022, the lowest since June 2020, and equivalent to 1.9 months of imports of goods and services.[32,33]

Increased current account pressures and elevated political uncertainty contributed to the Rupee's depreciation

After appreciating by 6.9 percent in FY21, the Rupee depreciated by 14.3 percent against the U.S. dollar from July to end-March 2022,[34] in part due to pressures from the rising import bill, policy normalization among advanced economies, safe-haven effects associated with the Ukraine war, and domestic political uncertainty. Meanwhile, Pakistan's Real Effective Exchange Rate (REER) depreciated by 3.0 percent between Jul-Feb FY22.[35]

e. Fiscal and Debt Sustainability

Pakistan's fiscal deficit widened

The consolidated fiscal deficit reached PKR1,372 billion in H1 FY22 from PKR1,138 billion in H1 FY21– an increase of 20.6 percent y-o-y. Higher taxes on imported items and sales tax on goods led to an 18.0-percent growth in revenues, but this was outweighed by higher government spending, which grew 18.7 percent (Figure 2.7). With most of the increase in spending coming from non-interest expenditures, the primary surplus shrank to PKR81 billion. In H1 FY22, all provinces except for Khyber Pakhtunkhwa (KP) recorded a surplus leading to a consolidated provincial surplus of PKR481 billion, almost double of that a year ago. However, a sharp increase in federal current expenditure led to a 33.0-percent increase in the federal fiscal deficit – leading to the wider consolidated fiscal deficit.

[31] Remittances from E.U. countries increased by 37.8 percent, the United States by 24.0 percent, the United Kingdom by 14.4 percent, the UAE by 1.8 percent), and other GCC countries by 11.7 percent in H1 FY22.
[32] However, part of the decline in reserves is expected to be reversed in the coming weeks as official creditors rollover their loans.
[33] Based on the next 12 months' projected imports of goods and services.
[34] Calculated using end period exchange rates (for June 2021 and March 2022). International Financial Statistics, International Monetary Fund.
[35] Real Effective Exchange Rate based on Consumer Price Index. Ibid.

Figure 2.7: Consolidated Fiscal and Primary Balance (excluding grants) in H1
(PKR billion)

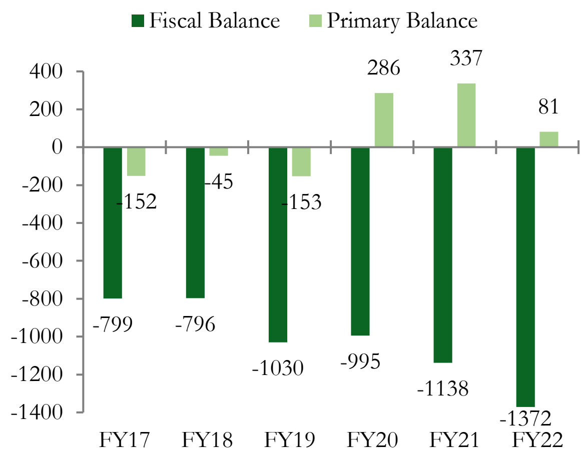
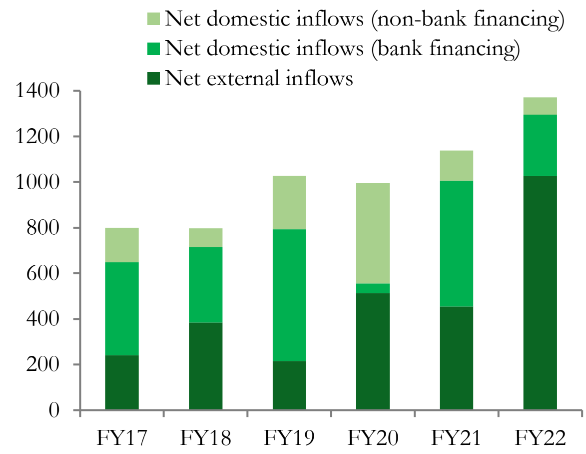


Figure 2.8: Budgetary Financing: Net External and Domestic Inflows in H1
(PKR billion)



Source: Ministry of Finance, World Bank Staff Calculations
Note: Other federal current expenditure includes subsidies.

Taxes on imports drove the overall increase in tax revenues in H1 FY22

In H1 FY22, tax revenues grew 19.2 percent y-o-y, up from a growth of 12.0 percent in H1 FY21. The higher taxes collected on imported items were due to a combination of higher global prices, and a larger volume of imports.[36] The three largest contributors to growth in revenues in H1 FY22 were sales tax on goods, direct taxes, and taxes on international trade/customs duties. Of the revenues collected by the Federal Board of Revenue (FBR), 52.1 percent are related to imports. More specifically, 70 percent of the sales tax on goods, 13.7 percent of direct taxes and 8.5 percent of the federal excise duty collected were based on imports.[37,38]

Non-tax revenues recovered in H1 FY22

After declining by 23.2 percent in H1 FY21, non-tax revenues increased by 12.6 percent in H1 FY22, largely due to higher inflows from the Pakistan Telecommunication Authority at the federal level, and higher hydropower profits of KP at the provincial level. Barring mark-up payments from Public Sector Enterprises, all other sources of non-tax revenues also recorded an increase in H1 FY22.

Federal Government current spending rose sharply in H1 FY22, in part due to vaccine procurement

In H1 FY22, current expenditures increased by 16.0 percent y-o-y, up from the 8.3-percent growth in H1 FY21. Development expenditures and net lending also rose by 24.8 percent, after declining by 3.3 percent in H1 FY21. The highest contribution to growth in current expenditure came from grants and subsidies. This was in part due to procurement of COVID-19 vaccines by the Federal Government – an expense recorded under grants – and settlement of outstanding power sector arrears, recorded under subsidies.[39] As part of reforms to increase domestic revenues, the Government approved a Supplementary Finance Bill in January 2022, withdrawing two-thirds of tax exemptions on GST (Box 2.2).

[36] With the rise in global prices, taxes collected on imported items such as petroleum products, vehicles, edible oils, and machinery grew significantly, whereas, for cotton and fertilizer, higher demand bolstered tax revenues as the quantum of imported items increased in H1 FY22. Bi-Annual Review. Jul-Dec 2021-22. Federal Board of Revenue

[37] The revenue generated by the FBR is 88.6 percent of the total tax revenue and includes direct taxes, sales tax on goods, federal excise duty, and customs duty on imports. Historically, the share of taxes generated through imports has been lower than domestically sourced taxes (44.3 percent at end-FY21). Ibid

[38] Revenue from direct taxes rose by 22.7 percent in H1 FY22 – the highest half-year growth since FY12 – as revenue from withholding taxes on imports grew 45.5 percent. Ibid.

[39] In H1 FY22, the Federal Government settled PKR135 billion in debt owed to Independent Power Producers (IPPs) and spent PKR196.3 billion on COVID-19-related spending under grants. See: Ministry of Finance: Monthly Economic Update & Outlook: February 2022.

Box 2.2: Finance (Supplementary) Act 2022

The Finance (Supplementary) Act 2022, passed by the National Assembly on January 13, 2022, was introduced to enhance revenue mobilization, and streamline expenditure in line with the fiscal framework agreed upon in the Sixth Review of the IMF-Extended Fund Facility (EFF). As per the IMF, the supplementary bill targeted an underlying primary balance (excluding grants) of 0 percent of GDP in FY22 and a provincial consolidated surplus at 0.5 percent of GDP in FY22.

Expenditure: The Supplementary Bill aimed to reduce non-priority current spending and poorly targeted subsidies, while making provisions for higher spending on the procurement of COVID-19 vaccines and clearance of power sector arrears. It also budgeted for an increase in development expenditure and social spending, mainly through 1) expansion of the Benazir Income Support Program by 50 percent (excluding COVID-19 related one-off spending); 2) increase in health and education spending by 27 percent; and 3) spending on the Kamyab Pakistan Program and food subsidy program (estimated at 0.2 percent of GDP).

Revenue: The revised fiscal program focused on eliminating two-thirds of tax expenditures on GST while broadening the tax base and improving tax administration. The Supplementary Bill also budgeted for a gradual increase in the PDL until it reached a maximum of PKR30/liter. However, with the fuel price reduction package announced in February, past increases in the PDL were most likely partially or wholly reversed and further increases were temporarily paused.[40] The table below summarizes the main legislative amendments made as part of the supplementary bill.

General Sales Tax: Amendments to Sales Tax Act 1990	
Streamlining of tax rates	**Fifth schedule**: Zero-rating withdrawn on several items including duty-free shops; local supply of plant and machinery to export processing zones and exports, covered under the Export Facilitation Scheme; and the supply, repair, or maintenance of ships and related equipment and machinery. In contrast, zero-rating was introduced on drugs at the import stage and reinstated for crude oil.
	Eighth schedule: Several goods with reduced rates of tax have been brought under the standard GST regime, including branded food items; agricultural machinery and other inputs, such as poultry and cattle feed; plant and machinery not manufactured locally and having no compatible local substitutes; internet and TV broadcast equipment; and silver, gold, and precious metal jewelry.
Eliminating exemptions	**Sixth schedule**: Exemptions were withdrawn on the following imported and branded items (Table 1 of Sixth Schedule): 1) live animals and poultry, 2) meat and uncooked poultry, 3) eggs, 4) cereals and milling industry products except for rice, wheat, and wheat and meslin flour, 5) sugar cane, 6) food for infants, 7) seeds and various types of agriculture equipment, and 8) plant and machinery of greenfield industries. However, exemptions were retained on imported fruits and vegetables from Afghanistan; exemptions were withdrawn for local supplies of raw cotton, whey, sausages (sold without retail packaging), bread and related items sold in tier-1 retailers, and matchboxes, among other items (Table 2 of the sixth schedule).
Increasing tax rates	**Ninth schedule**: 17 percent ad valorem tax was introduced on imported mobile devices exceeding US$200 in value.
Lowering of threshold	The sales tax threshold for the cottage industry was reduced from PKR10 million in annual turnover to PKR8 million, to broaden the tax base.
Federal Excise Duty: Amendments to Federal Excise Act 2005	
Increasing tax rates	FED was increased on imported and locally manufactured vehicles.

	Previous FED	**Current FED**
Imported motor cars	Range (2.5–30 percent)	Range (2.5–40 percent)
Locally manufactured or assembled cards	Range (0–5 percent)	Range (2.5–10 percent)
Imported double-cabin pick-up vehicles	25 percent	30 percent
Locally manufactured double-cabin pick-up vehicles	7.5 percent	10 percent

Customs Duty: Amendments to Customs Act 1969	
Administrative reforms	Under the Finance Supplementary Act 2022, the role of Collector of Customs in determining the customs value of imported or exported goods was eliminated, and the power to determine customs value now rests solely with the Director of Customs Valuation. Previously, both the Collector of Customs and the Director Valuation were authorized to determine the customs value of imported or exported goods. (Section 25A of the Customs Act).
Income Tax: Amendments to Income Tax Ordinance, 2001	

[40] In February 2022, the Government announced an energy price reduction package to be implemented from March through June 2022 that included a reduction of PKR10/liter on end-consumer petrol and diesel prices, a temporary price cap on fuel prices, and a PKR5/unit subsidy on the base electricity rate for almost 85 percent of domestic consumers and 40 percent of commercial consumers.

Introducing advance taxes	Advance tax rate was introduced on foreign TV serials and advertisements. Dividends received by the Real Estate Investment Trust (REIT) from a special purpose vehicle will be taxed at the rate of zero percent, and dividends paid to non-REIT investors will be taxed at 35 percent.

Source: (i) The primary balance target is excluding grants, one-off transactions, COVID-19 spending, and IPPs related arrears clearance in FY22. IMF Country Report No. 22/27, (ii) Finance (Supplementary) Act 2022, (iii) The Sales Tax Act, 1990: As amended up to 15th January 2022, (iv) FBR Circular No. 01 of 2022, (v) FBR Circular No. 06 of 2022, (vi) FBR Circular No. 12 of 2022.

The fiscal deficit was largely financed from external sources

External financing inflows more than doubled in H1 FY22, whereas domestic financing inflows contracted by around half. The growth in net external inflows largely stemmed from other loans and project aid. Overall, external financing flows constituted 74.8 percent of total budgetary financing in H1 FY22, increasing exchange rate risks on external debt (Figure 2.8).

Public debt increased in H1 FY22

Public and publicly guaranteed debt stood at PKR45.3 trillion at end-December 2021, an increase of PKR3.1 trillion since end-June 2021. Of the total public debt at end-H1 FY22, the share of external debt was 37.5 percent, whereas short-term debt was 13.0 percent. Pakistan's total debt level is in breach of the Fiscal Responsibility and Debt Limitation Act (FRDLA) 2005 (amended in 2017) that stipulated a reduction of total public debt to 60 percent of GDP by end-FY18. Moreover, the growing arrears of the power sector and liabilities emanating from commodity operations pose further risks to debt sustainability.

f. Medium-Term Outlook

GDP growth is projected to slow in FY22–FY23 before strengthening over the medium term

On the back of recent monetary tightening, high base effects, and stronger inflation, real GDP growth is expected to moderate to 4.3 percent in FY22 and then further to 4.0 percent in FY23 as the Government undertakes fiscal tightening measures to manage growing demand pressures and contain external and fiscal imbalances. Economic growth is then projected to recover slightly to 4.2 percent in FY24 (Table 2.1), supported by the implementation of structural reforms to support macroeconomic stability and fiscal sustainability.

Domestic demand growth is expected to slow in the near-term

Growth in private consumption and private investment is projected to decline in FY22-F23, partly due to higher borrowing costs and erosion in real incomes due to elevated inflation before strengthening thereafter. Total investment growth is also expected to pick up then as the business environment improves. After being relatively muted in FY21 due to fiscal restraint and rollback of pandemic-related mitigation measures, government consumption growth is expected to increase in FY22 and remain high in FY23 on pre-election spending before moderating in the medium term.

Inflation is expected to average in the double-digits in FY22

Consumer price inflation is estimated to rise to an average of 10.7 percent in FY22 on strong domestic demand, higher global commodity prices and a weaker exchange rate. Price pressures are then expected to gradually ease over the forecast horizon as energy prices moderate from recent highs and world inflation pressures dissipate.

The CAD is expected to widen sharply in FY22, heightening external sustainability risks

Largely reflecting the surge in imports, the CAD is expected to widen to 4.4 percent of GDP in FY22. With monetary tightening to curtail macroeconomic risks emanating from the large external imbalance, imports are projected to decline next year before recovering again in FY24. As export competitiveness reforms gain traction, particularly those aimed at reducing import tariffs on relevant intermediates for the export sector, and increased allocations for export refinance schemes, exports are projected to begin recovering in FY24, the CAD is consequently expected to narrow to 3.0 percent of GDP. In addition, the growth of official remittance inflows is expected to moderate after benefiting from a COVID-19-induced transition to formal channels in FY21.

The fiscal deficit is projected to widen in FY22

The fiscal deficit (excluding grants) is projected to increase to 6.3 percent of GDP in FY22, on the back of higher spending on COVID-19 vaccine procurement, settlement of energy sector arrears, development spending, and the recently announced food and fuel price reduction packages. As the Government rolls back the relief measures and resumes fiscal consolidation efforts, the fiscal deficit is projected to narrow slightly to 6.1 percent of GDP in FY23. With the implementation of structural reforms to increase domestic revenue mobilization, particularly harmonization of the GST regime and Personal Income Tax (PIT) reform, the fiscal deficit is projected to improve further to 5.3 percent of GDP in FY24. Public debt as a share of GDP is projected to remain high, but gradually decline over the medium term, supported by higher GDP growth and declining primary deficits. However, Pakistan's vulnerability to debt-related shocks will remain elevated as will the country's external financing requirements. To meet these, Pakistan will need the continued support of its multilateral and bilateral partners and access to international capital markets. The macroeconomic outlook is predicated on the IMF–EFF program remaining on track.

Table 2.1: Pakistan Macroeconomic Outlook (FY22-24)[1]
(Annual percent change unless indicated otherwise)

	2018/19	2019/20	2020/21	2021/22e	2022/23f	2023/24f
Real GDP Growth, at constant factor prices	3.1	-1.0	5.6	4.3	4.0	4.2
Agriculture	0.9	3.9	3.5	3.6	3.2	3.3
Industry	0.2	-5.8	7.8	4.0	3.3	3.8
Services	5.0	-1.3	5.7	4.7	4.5	4.7
Real GDP Growth, at constant market prices[2]	2.5	-1.3	6.0	4.3	4.0	4.2
Private Consumption	5.6	-3.1	6.3	5.5	3.0	3.9
Government Consumption	-1.6	8.4	3.1	6.9	6.0	3.8
Gross Fixed Capital Formation	-11.1	-5.5	6.8	4.4	2.5	4.4
Exports, Goods, and Services	13.2	1.5	4.8	7.1	1.8	2.8
Imports, Goods, and Services	7.6	-5.1	5.5	12.1	-0.7	2.1
Inflation (Consumer Price Index)	6.8	10.7	8.9	10.7	9.0	7.5
Current Account Balance	-4.2	-1.5	-0.6	-4.4	-3.1	-3.0
Financial and Capital Account Balance, (% of GDP)	3.7	3.2	2.4	5.7	2.9	3.1
Fiscal Balance (excluding grants, % of GDP)	-7.9	-7.1	-6.1	-6.3	-6.1	-5.3
Debt (% of GDP)	78.0	81.1	76.0	76.0	74.4	72.5
Primary Balance (excluding grants, % of GDP)	-3.1	-1.6	-1.2	-1.5	-1.1	-0.4

Sources: Pakistan Bureau of Statistics, State Bank of Pakistan, World Bank staff estimates.

Note: [1] This macroeconomic outlook uses the re-based national accounts data at 2015-16 prices. It was prepared by World Bank staff and differs from that of the Government. [2]World Bank estimates for FY21. The Pakistan Bureau of Statistics has not published expenditure/demand-side data on the re-based national accounts for FY21.

g. Risks and Priorities

Multiple external factors pose downside risks to the outlook

Tighter global financing conditions, potential further increases in world energy and food prices due to the Ukraine–Russia conflict, and slower global growth due to rising inflation, pose substantial risks for Pakistan's economic outlook. A conducive external environment is particularly pertinent for narrowing the large current account deficit and meeting elevated external financing requirements, which requires continued access to international capital markets with manageable yields (Box 2.3).

Protracted domestic political uncertainty can lead to delays in urgently needed adjustment measures

Given the current significant imbalances in the external sector and low external buffers, macroeconomic adjustment, specifically fiscal consolidation to complement ongoing monetary tightening, is urgently needed. Heightened domestic political uncertainty over the past few months has slowed the implementation of key reforms to improve overall fiscal and debt sustainability. Going forward, further policy reform slippages and delays in adjustment measures are likely to exacerbate the already widening macroeconomic imbalances.

Structural reforms are critical to sustain growth

Historically low levels of capital accumulation and productivity growth limit Pakistan's growth prospects and lead to frequent macroeconomic crises. As such, the current record-high trade deficit due to elevated aggregate demand pressures is symptomatic of the long-standing structural issues associated with low potential growth. To achieve higher and sustained growth, critical reforms needed include those aimed at sustaining macroeconomic stability, increasing domestic revenue mobilization, supporting private sector investment, raising export competitiveness, and improving the financial viability of the energy sector. In the absence of these measures, the fiscal deficit and external accounts could come under further pressure, exacerbating current imbalances. With low fiscal and external buffers, it is also important that Pakistan successfully complete the ongoing IMF–EFF program.

Box 2.3: Moderating global growth in a higher inflation, tighter financial conditions, and uncertain environment

Global growth rebounded to 5.5 percent in calendar year 2021—its strongest post-recession pace in 80 years—following the pandemic-induced collapse of 2020. Global growth expanded through much of 2021 as policy stimulus and relaxation of pandemic-related lockdown measures boosted demand. The global purchasing managers' index (PMI) peaked in May 2021 at 58.5 (a reading over 50 indicates expansion) but slowed in the second half of the year and reached an 18-month low of 51.1 in January 2022. Global inflation also rose rapidly during the year – from 3 percent at the start of 2021 to 7.8 percent at the end of the year, levels not seen in decades (Figure 2.9). In Emerging Markets and Development Economies (EMDEs), increases in inflation have been broad-based across countries and components: four-fifths of EMDEs experienced an uptick in inflation in 2021, with increases in food, energy, and core components. Global trade rebounded in tandem with global activity but has been uneven across goods and services. Although goods trade recovered swiftly and was 6 percent above its pre-pandemic-high in December 2021, services trade is still lagging and was 4 percent below its pre-pandemic-high in November 2021.

The global economy is expected to slow sharply in 2022, on the back of rising inflation, strong base-effects, ongoing supply bottlenecks, waning policy support, and the war in Ukraine. Global growth momentum was already slowing at the start of 2022. In global trade, the global PMI manufacturing new export orders index in January 2022 signaled its first contraction in goods trade since mid-2020. The pace of the slowdown is expected to hasten with the war in Ukraine. Disruptions to sea and air logistics due to the conflict may further worsen supply bottlenecks, adding to prolonged delivery times and high production costs. Commodity prices have already spiked in response to the war, with Brent crude oil price peaking at $130/bbl. in early March 2022. Agricultural prices have also increased by 21 percent in the first three months of 2022, the increase was particularly acute for wheat, of which Russia and Ukraine are major producers. Moreover, the war in Ukraine has led to a rapid deterioration in investor sentiment and increased financial market volatility.

Risks to global growth remain to the downside and have magnified on recent developments. Expectations of stronger U.S. policy tightening have increased rapidly. Risk assets have also deteriorated with the EMBI global diversified sovereign spread rising by 155 basis points in mid-March, compared to a year ago, and emerging market exchange rates have depreciated by 10 percent (Figure 2.10). The impact of heightened geopolitical and financial risks in an environment of high debt and inflation may force EMDE central banks to rapidly withdraw monetary stimulus and undermine recoveries. Further inflation pressures may de-anchor inflation expectations and erode real incomes. The COVID-19 pandemic can still damage economic activity going forward, overwhelming health systems and requiring new mobility restrictions.

Figure 2.9: Consumer price inflation
(Percent, year-on-year)

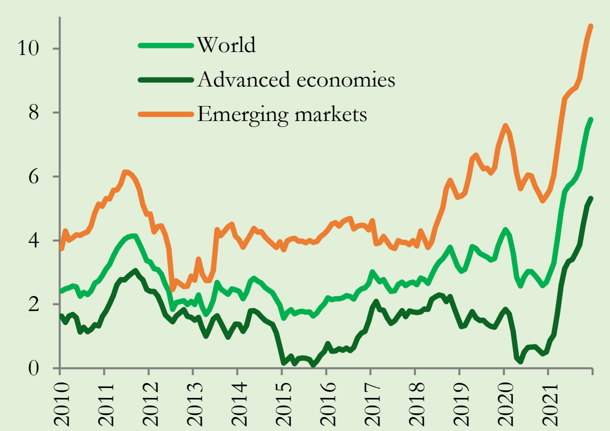
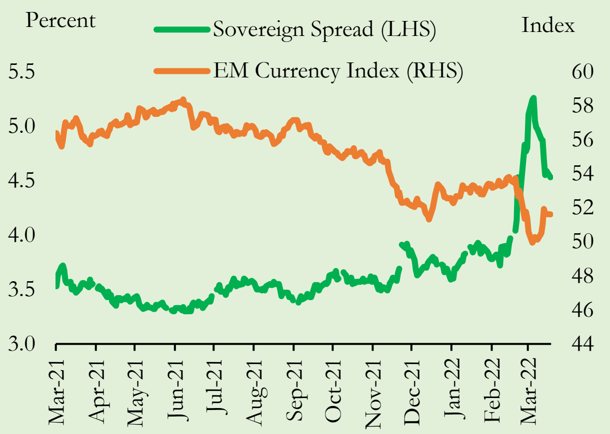


Figure 2.10: Sovereign spread
(Percent)



Sources: Haver Analytics; J.P. Morgan.
Notes: Figure 2.14: GDP-weighted average, Figure 2.15: EMBI global diversified sovereign spread and JP Morgan EM Currency Index (as of March 08, 2022).

3. Special Focus – Financing the Real Economy

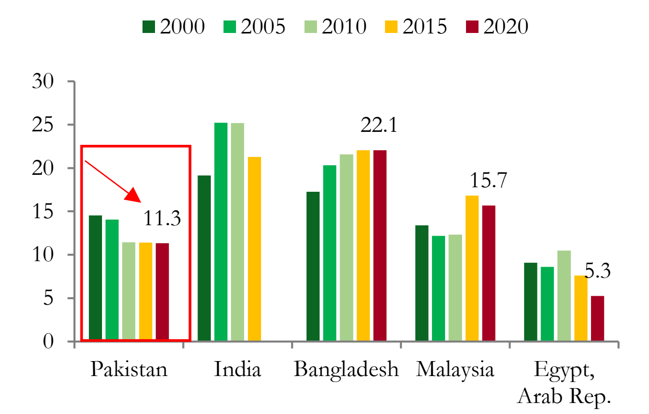
Pakistan's financial sector remains underdeveloped and is failing to effectively deliver on its role as an intermediary of capital. Credit to the private sector as a percent of GDP is low in comparison to peers and has also trended downward over the past decade and a half. Credit is also concentrated in the corporate segment, leaving other critical segments and sectors such as SMEs underserved. While there are bright spots, such as the microfinance sector, these sub-sectors remain smaller than the dominant banking sector, despite significant potential for growth and financing the real economy in the immediate term. There are several structural impediments preventing the greater flow of financing to the real economy, in particular to the underserved segments. These include: 1) extensive government borrowing from the financial sector; 2) growing but still limited financial inclusion and low domestic saving that limits the resources available to be intermediated to the private sector; 3) market failures in the form of inadequate financial infrastructure leading to informational asymmetries; 4) a weak insolvency and creditor-rights regime; 5) underdeveloped capital markets; 6) high informality and low financial literacy; and 7) high cost of finance and an emphasis on traditional forms of collateral. Enhancing the flow of financing to the real economy requires both the resolution of structural problems and leveraging emerging growth areas, which comprise: a) microfinance; b) digital finance; c) risk capital; d) development finance; and e) capital markets.

a. Importance of Finance and the Financial Sector

Pakistan needs higher investment to unlock sustainable, sustained, and equitable growth

Figure 3.1: Private investment, selected years

Percent of GDP



Source: World Development Indicators (WDI)

Pakistan has been unable to achieve sustained economic growth and has repeatedly faced macroeconomic crises in recent decades. This is partly because growth cycles have tended to be consumption-driven, with investment and exports not contributing substantively to growth.[41] There is a need to pivot growth away from consumption towards investment and exports. The importance of investment for growth is highlighted by the fact that the current levels of private investment and productivity limit Pakistan's growth potential to 2.5–3 percent per year.[42] Despite the importance of investment for growth, both public and private investment remain low in Pakistan. Private investment stood at 11.3 percent of GDP in 2020, half of the South Asian average of 21.2 percent, and lower than all peer comparators except Egypt (Figure 3.1).[43]

A deep, inclusive, and innovative financial sector is foundational for economic growth anchored in investment

Although investment levels are dependent on several factors, a critical one is a well-functioning financial sector that can allocate capital to its most productive use, shift risks to those who can best bear them and exert corporate governance.[44] The financial sector facilitates investment by intermediating capital between savers and borrowers. In this process, not only does it stimulate capital formation, but as research has shown, a deep and inclusive financial sector also supports productivity growth, formalization of the economy, and greater export orientation.[45] The financial sector also facilitates economic growth by catalyzing the process of structural transformation by enabling greater flow of

[41] World Bank. 2020. Islamic Republic of Pakistan: Leveling the Playing Field. Systematic Country Diagnostic; World Bank, Washington, DC. © World Bank.
[42] Ibid.
[43] For the purposes of this note, regional peer(s) refers to India and Bangladesh, structural peer to Egypt, and aspirational peer to Malaysia.
[44] International Finance Corporation. 2021. Country Private Sector Diagnostic – Creating Markets in Pakistan: Bolstering the Private Sector.
[45] See for instance: Butler, Alexander W. and Cornaggia, Jess, Does Access to External Finance Improve Productivity? Evidence from a Natural Experiment (March 4, 2009). Journal of Financial Economics (JFE), Vol. 99, No. 1, 2011.

credit to finance-constrained segments, markets, and sectors. Enhanced credit to sectors such as agriculture also has the potential to reinvigorate poverty reduction initiatives.[46]

The importance of the financial sector for facilitating inclusive growth has become more prominent with the COVID-19 pandemic

In response to the COVID-19 pandemic, countries launched comprehensive stimulus packages consisting of monetary, fiscal, and regulatory measures to mitigate the deleterious economic effects of the crisis. Central banks put in place payment holiday programs and refinance facilities, eased their monetary policy, and through the financial sector, provided direct support to firms to help them "keep the lights on" and to prevent liquidity issues from evolving into solvency challenges. However, the impact of this package of support was shaped to a significant extent by the respective country's level of financial development and firms' access to credit. Smaller firms, informal businesses, and those with more limited access to the formal credit market were harder hit by income losses stemming from the pandemic.[47] The same trends were witnessed in Pakistan. Larger firms with greater access to finance were able to escape the crisis relatively unscathed unlike smaller, more informal, and financially excluded firms.[48]

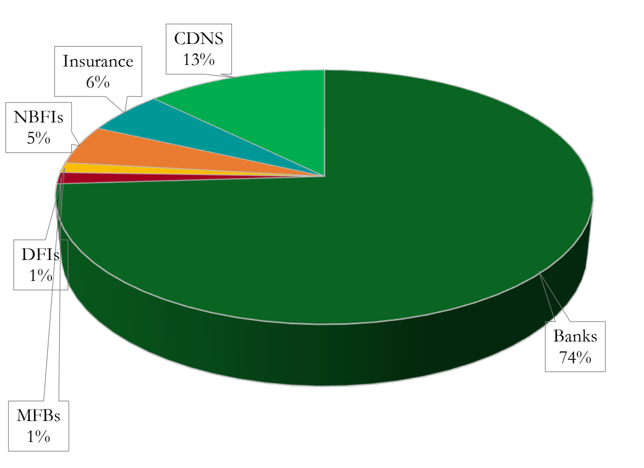
b. Structure of Pakistan's Financial Sector

Pakistan's 's financial sector is heavily bank-centric, much like most developing economies

The financial sector is heterogeneous and comprises distinct entities that are interlinked. The sector can be bifurcated into financial institutions and financial (capital) markets. The financial institutions landscape, in turn, comprises commercial banks, development finance institutions (DFIs), microfinance banks (MFBs), insurance companies, non-bank financial institutions (NBFIs), and the Central Directorate for National Savings (CDNS). The NBFI sector consists mostly of mutual funds, leasing companies, micro-finance companies, and pension funds (Figure 3.3). Overall, the sector is dominated by banks, which account for 74.1 percent of the financial sector's total assets (Figure 3.2).[49]This is even though non-bank subsectors within the broader financial sector (e.g. capital markets) offer significant growth potential and can potentially account for a greater percentage of the financial sector's asset base.

Figure 3.2: Distribution of financial sector assets, December 2020

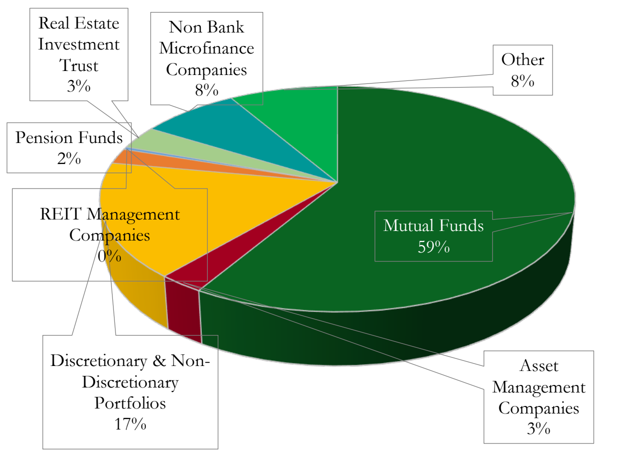
Percentage share



Source: State Bank of Pakistan (SBP) and Securities and Exchange Commission of Pakistan (SECP)

Figure 3.3: Distribution of non-bank financial institutions assets, November 2020

Percentage share



Source: Securities and Exchange Commission of Pakistan (SECP)

[46] Levine and Zervos (1998) suggest that a developed financial sector, indicated by a high proportion of credit to the private sector (as percent of GDP), is a robust predictor of long-run economic growth
[47] World Bank. 2022. World Development Report 2022: Finance for an Equitable Recovery. Washington, DC: World Bank. © World Bank.
[48] World Bank. 2020. Quantifying the Impact of COVID-19 on the Private Sector in Pakistan. World Bank, Washington, DC. © World Bank.
[49] As of June 2021, public sector commercial banks, local private banks, and foreign banks account respectively for 19.6 percent, 76.6 percent, and 2.6 percent of the total assets of commercial banks in Pakistan, while specialized banks account for 0.96 percent of the total assets..

The structure of the financial sector is evolving with digital finance starting to play an increasingly important role in intermediation, especially in payments

The combination of a more conducive regulatory environment, increased mobile and internet penetration, and changing consumer behavior due to COVID-19 has created a scenario where digital finance has started playing an ever-greater role in the financial sector. The State Bank of Pakistan (SBP) has led the charge by supporting branchless banking, *Asaan* (easy) mobile wallets, payment systems reform, and e-commerce. These reforms have supported the supply side of the digital finance ecosystem. Mushrooming cellular use has also driven the growth of mobile phone and internet bank transactions to 14 percent of e-banking value and 27 percent of e-banking transactions.[50] Furthermore, the number of active mobile wallets has doubled over the period 2019–21to 41 million, leading to a 91 percent growth in branchless banking transactions and a 98 percent growth in the value of transactions over the same period.

Growth in the risk capital space, both venture capital (VC) and private equity (PE), has coincided with growth in the digital finance sector, supported by regulatory reform

In 2021, over 80 VC funds/institutional/corporate investors invested more than US$300 million in Pakistani startups. Over the last three years, the VC market has tripled in volume, while the value of deals increased by eight-fold. The growth of risk capital has been enabled by the key sectoral regulators, the SECP—primarily involved with fund establishment and governance—and SBP—the regulator for foreign repatriation of funds. In 2008, the SECP approved the regulatory framework for registration and regulation of both PE and VC Funds. In 2015, the SECP promulgated the first Private Fund Regulations. Recently, the SECP has made amendments to the Companies Act, 2017 to enable companies to raise capital through services and immovable property and issue shares for non-cash considerations, empowering funds, and entrepreneurs to structure deals in non-traditional ways that are more suited for risk capital. SBP has also strengthened the Foreign Exchange Manual to enhance investments into Pakistani startups by foreign PE and VCs and enable easier repatriation of funds.

While the sector has grown and evolved in recent years, it remains concentrated

Pakistan's financial sector has undergone considerable structural shifts since the privatization of several large nationalized commercial banks in the 1990s. The privatization of these banks was complemented by a wave of deregulation. The NBFI sector in particular has seen significant innovation in the past decade with the advent of real estate investment trusts (REITs), private equity companies, venture capital funds, and, more recently, FinTechs. Digital finance is also disrupting the status quo. Although this evolution is helping to improve access to finance to those traditionally excluded, the sector remains concentrated. The 5 biggest banks out of the 32 operating in the country account for close to 50 percent of the total assets and deposits in the banking system. This trend permeates across the sector. A single pension fund accounts for 34.4 percent of the total assets of the pension funds sector.[51] The three largest microfinance providers, all microfinance banks, account for 43.4 percent of the gross loan portfolio in the microfinance sector.[52]

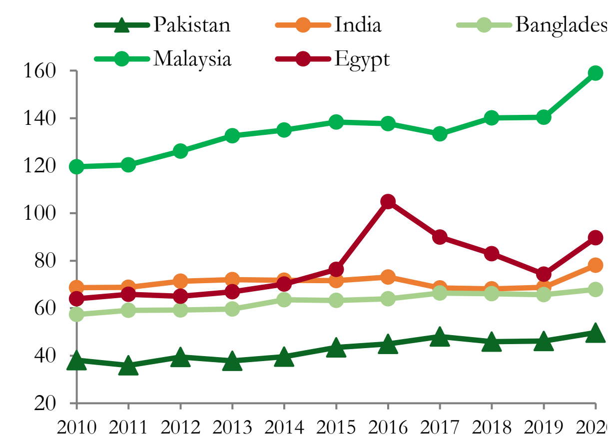
[50] This is a marked increase over the last two years—in 2019, mobile phone and internet bank transactions constituted 5% of e-banking value and 3% of e-banking transactions. State Bank of Pakistan. Statistical Bulletin, January 2022.
[51] A total of 21 pension funds were operational in Pakistan as of December 2021. State Bank of Pakistan. Financial Stability Review (2020).
[52] Pakistan Microfinance Network: a total 47 Microfinance Providers were operational in Pakistan as of December 2021.

c. The Untapped Potential of the Financial Sector

Pakistan's financial sector is relatively small and is not effectively delivering on its role as an intermediary of capital and facilitator of investment and growth

Pakistan's domestic credit to GDP ratio, an indicator of the development and depth of the financial sector and consequently it's potential to finance growth, stood at 58 percent in 2018, lower than regional comparators such as India (72 percent) and aspirational comparator economies such as Malaysia (142 percent).[53] This relatively small size is also reflected in the assets of deposit-taking financial institutions, which include commercial banks. Assets of deposit-taking institutions, while having grown from 30 percent to 50 percent of GDP over the period 2000–20, are relatively low compared to regional peers such as India (78 percent) and Bangladesh (68 percent) (Figure 3.4).[54]

Figure 3.4: Deposit Money Banks' Assets
Percentage of GDP

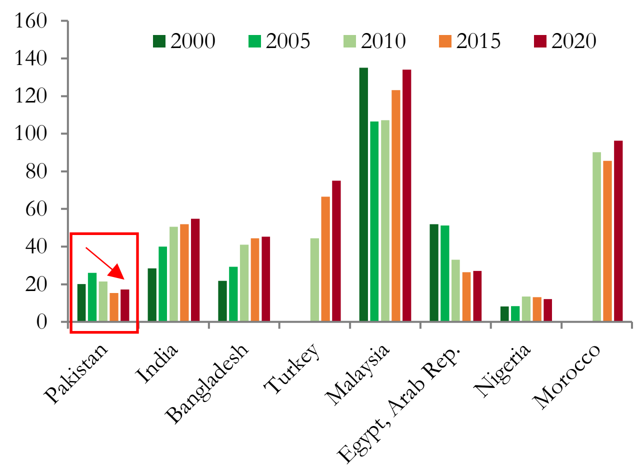


Source: International Financial Statistics (IFS)

Credit to the private sector surged in the early-mid 2000s on the back of privatization and deregulation…

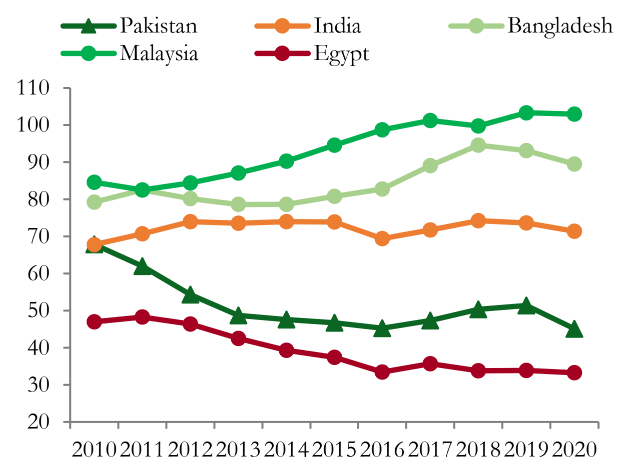
Credit to the private sector surged as banks ventured into new segments in the early 2000s, diversified their portfolios, and started offering new products. Growth in the financing of nontraditional sectors, however, was not strategically anchored in sound risk management, loan origination, and underwriting practices. With ample liquidity, an accommodating monetary policy stance, and limited government appetite for borrowing due to sizable foreign inflows and aid, banks significantly expanded their loan books. This trend, however, did not last and reversed course with the onset of the political, security, and energy crisis in 2008. Non-performing loans (NPLs) surged, and the sector underwent a significant de-risking process, moving away from private sector financing and channeling resources to financing the government. This trend is yet to change almost a decade and a half later: The financial sector is currently predominantly in the business of financing the government rather than financing the private sector.

Figure 3.5: Credit to Private Sector
Percentage of GDP



Source: World Development Indicators (WDI)

Figure 3.6: Advances to Deposits ratios
Percentage share



Source: World Development Indicators (WDI)

[53] Domestic credit to GDP includes credit to both the public and private sectors.
[54] Assets include cash, government securities, and interest-earning loans (e.g., mortgages, letters of credit, and inter-bank loans).

…however, the momentum could not be sustained

Credit to the private sector increased by 20 percent over calendar year 2021, a significant feat amid the pandemic.[55] However, as a share of GDP, private sector credit has dropped from a high of 29 percent in 2008 to 17 percent in 2020 (Figure 3.5). The trends witnessed in recent years are also reflected in the average advances-to-deposit ratio (ADR) of banks. Despite fiscal incentives put in place by the government, at 46.6 percent, the banking ADR in Pakistan is the second lowest among peer comparators (Figure 3.6).[56]

The dearth of finance flowing to the private sector in Pakistan is also evident at the firm level

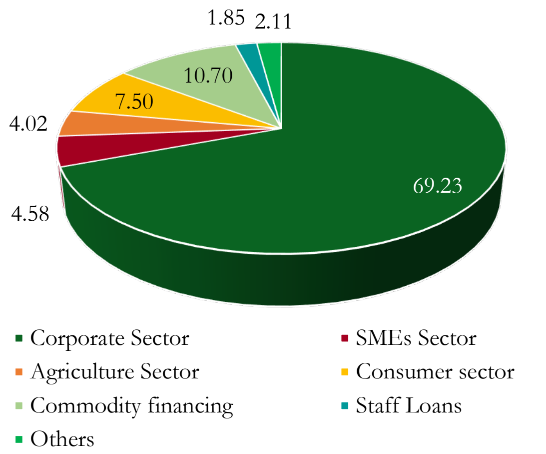
Ongoing consultations with firms in the private sector have revealed that access to finance remains low. The last enterprise survey, administered to a representative sample of private firms in 2013, showed that only 6.7 percent of the firms surveyed had an outstanding loan/line of credit with a bank. This is lower than Pakistan's peer comparators and the regional average as 34.1 percent, 31.9 percent, and 34.8 percent of firms in Bangladesh, Malaysia, and Turkey, respectively, had an outstanding loan/line of credit. At a more aggregate regional level, 27 percent of the firms surveyed in South Asia had an outstanding loan/line of credit. Firms that managed to secure a loan in Pakistan also needed substantial collateral. The average value of collateral needed for a loan amounted to 153 percent of the value of the loan. As a result, most firms in Pakistan resort to internal finance for working capital and capital expenditure needs, with banks catering to the financing needs of just a small percentage of firms.

Most of the loans from the banking sector are primarily being intermediated to the corporate segment and industrial sector, leaving other critical segments and sectors underserved

The corporate segment accounts for close to 70 percent of the loan book of banks and this share has been trending upwards in recent years (Figure 3.7). The sector's lending is also significantly concentrated in a few large business conglomerates. Only 20 business groups in the country accounted for 30 percent of the banking sector's private sector lending portfolio in 2017.[57] Large corporates often have direct ownership linkages with banks; therefore, a considerable portion of the loan book of banks is comprised of related party loans, rather than conventional private sector lending. Credit is also concentrated within major sectors. The textiles sector, for instance, accounts for 14.7 percent of the loan book of banks.

Figure 3.7: Advances by sector, FY21

Percentage of total



Source: Authors calculations based on SBP data

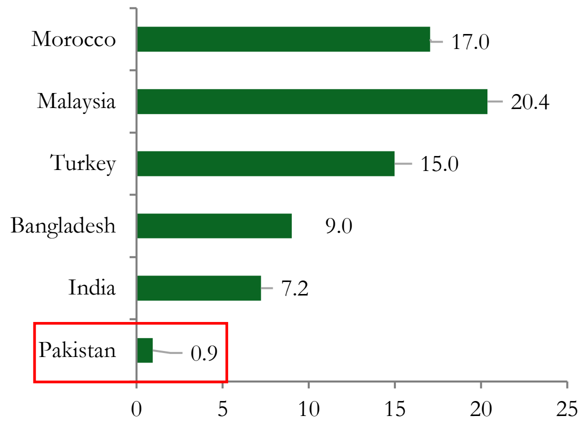
Credit to critical sectors of the economy has historically been low in Pakistan.

Credit to the SME sector accounted for approximately 6.3 percent of total private sector financing in June 2021, catering to the financing needs of only 172,893 SMEs, slightly lower than a decade earlier. According to the SME finance forum, the current quantum of financing amounts to less than 10 percent of the financing requirements of the SME sector. At less than 1 percent of GDP, SME financing also pales in comparison to Pakistan's peer comparators (Figure 3.8). Infrastructure financing is concentrated, with the power sector accounting for 63 percent of the total infrastructure financing portfolio as of 2016.[58] Agriculture financing, while having grown remarkably in recent years and achieving a major milestone of PKR1 trillion in disbursements in 2019, is currently catering to less than 25 percent of the agricultural households in the country. Outstanding agriculture finance also only accounts for approximately 4 percent of the banking sector's outstanding loan book (Figure 3.9). Housing finance, however, represents the silver lining.

[55] This number only reflects lending by commercial banks.
[56] The advances-to-deposit (ADR) ratio is a ratio between the banks total loans and total deposits. Banks may not be earning an optimal return or intermediating savings/deposits effectively if the ratio is too low. ADR is also commonly used as a measure of liquidity.
[57] State Bank of Pakistan – Bank Credit to Private Sector: A Critical Review in the Context of Financial Sector Reforms (2017)
[58] State Bank of Pakistan. Infrastructure Finance Review (2016).

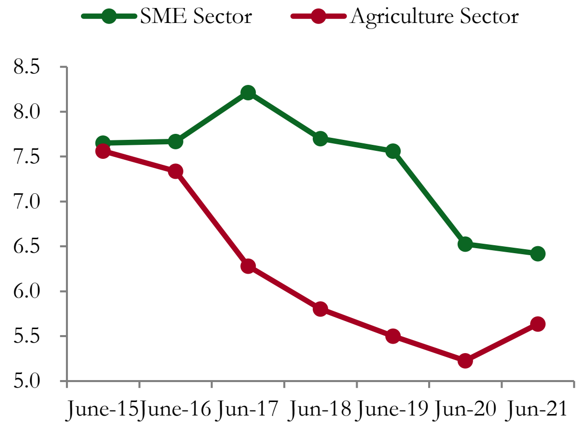
The stock of housing finance which grew by 40 percent over the 10-year period 2010-19 has over the last two years increased by 146 percent. The stock has increased from PKR70 billion in 2010 to PKR366 billion as of December 2021, on the back of sweeping fiscal and regulatory measures, including mandatory lending targets for housing and construction set forth by the SBP and the roll-out of a low-cost income housing program by the Government – Mera Pakistan Mera Ghar.

Figure 3.8: SME finance
Percent of GDP



Source: IMF Financial Access Survey

Figure 3.9: Sectoral financing as a share of private sector financing
Percentage share

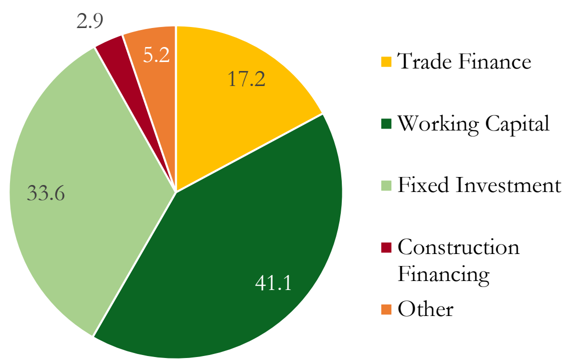


Source: Authors' calculations based on SBP data.

Most of the financing to the private sector goes toward working capital and trade finance, as opposed to fixed investment

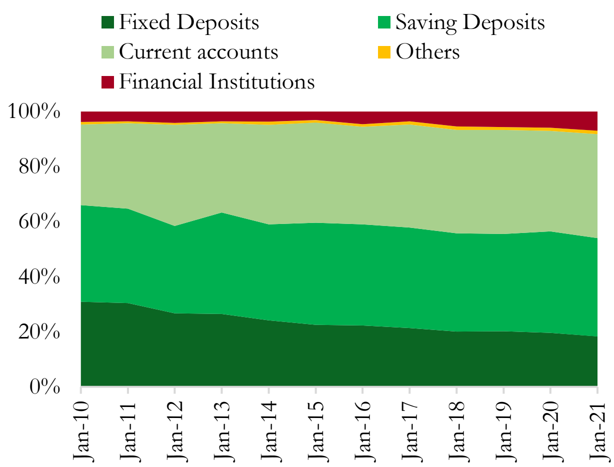
Long-term financing for investment is essential for the sustainable long-term growth of any economy. However, financing for longer-term fixed investment only accounts for 33.6 percent of the total financing extended by the banking sector in Pakistan (Figure 3.10). The dominance of working capital and trade financing that is inherently shorter tenor in the financing portfolio of banks is partly an outcome of their deposit structure, the majority of which is of shorter maturity (i.e., current and savings accounts), as opposed to longer maturity (i.e., fixed deposits). Seventy-three percent of the deposit base can be classified as current or savings, whereas fixed-term deposits only account for 18 percent of the total deposit base of banks in Pakistan (Figure 3.11). Leveraging shorter tenor-more variable deposits, such as current and savings deposits, for longer-term fixed investment financing can expose banks to asset-liability mismatches, which can lead to serious stability risks if not managed. The current deposit structure also enables the banks to earn a hefty spread by simply investing in government securities. The spread between the 3-month T-bill yield and deposit cost has averaged 4.4 percent over the past 5 years. Even higher spreads can be earned by investing in longer-duration Government bonds.

Figure 3.10: Type of financing
Percentage share



Source: SBP

Figure 3.11: Evolution of the deposit structure
Percentage share



Source: SBP

The government is both a significant source of funding for and a borrower from the banking sector

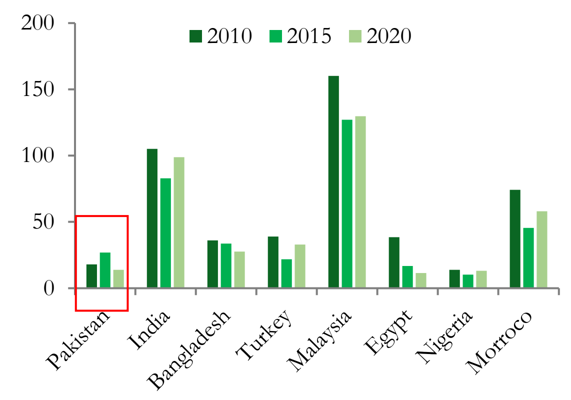
As of December 2021, public sector deposits (government and public sector enterprises) accounted for 21.3 percent (PKR4.3 trillion) of the deposits in the country's banking system, approximately the same as the deposits being held in the system by the private sector.[59] This amount was equivalent to 16.5 percent of the total government domestic debt. The banking sector, to a great degree, has been intermediating public sector funds back to the public sector at a substantial markup, risk-free. The government, on one hand, is borrowing extensively from banks at high rates and is the dominant borrower in the system, and on the other hand, is earning nominal interest on its cash balances in the banks. A back-of-the-envelope calculation, assuming that all government deposits are current deposits and are being intermediated back to the government at the average cost of domestic debt capital in FY21, reveals that the government incurred a fiscal cost of almost PKR416.5 billion (0.8 percent of GDP) on its deposits with the banking system. As of September 2021, the government has established a single treasury account for more effective cash flow management under the aegis of the ongoing IMF program.[60] Operationalization of the TSA will have a significant impact on the fiscal cost of government deposits in the commercial banking system.

Capital markets, both debt and equity, remain underdeveloped and shallow in Pakistan

The debt market is largely dominated by government securities. Total outstanding government domestic debt stood at PKR26.3 trillion at end-June 2021, while outstanding corporate debt was only a fraction of that at PKR782.9 billion. There were only 93 private issues outstanding in the debt market as of March 2021.[61] The corporate bond market is mainly used by a few large state-owned enterprises (SOEs), private corporations, and banks to meet their capital adequacy requirements. Pakistan's equity market is also relatively shallow, concentrated, and volatile. The market capitalization to GDP has decreased considerably from a high of 34 percent in FY08 to 17 percent in FY21, much below the level of Pakistan's peers' (see Figure 3.12). Moreover, the Pakistan Stock Exchange (PSX) is dominated by a few sectors, mainly financial, energy, and fertilizer, which altogether account for 48 percent of PSX's market capitalization.[62] There have been promising developments recently with several new listings and the operationalization of the Growth Enterprise Market Board. However, the market is generally subdued due to overall low listings, tax driven distortions between asset classes, and preference of raising funds through banks instead of the capital markets.

Figure 3.12: Market capitalization

Percent of GDP



Source: Nonbanking financial database, World Bank, Bloomberg, Pakistan Stock Exchange, World Federation of Exchanges, Global Stock, Markets Factbook, and supplemental S&P data, Standard & Poor's

The effectiveness of the development finance landscape in financing the real economy has fallen in recent years

Public Financial Institutions (PFIs) currently play a small role in the financial system as opposed to the 1960s–80s, for instance, when PFIs, which include DFIs, played a prominent role in the financial sector landscape and industrial development of Pakistan by financing prominent sectors such as textiles, cement, sugar, and fertilizer. The assets of bilateral DFIs account for only 1.7 percent of the assets of scheduled Banks and around 75 percent of investments are in government securities. Public Sector Commercial Banks, similarly, exhibit lending and investment behavior akin to private sector banks, despite the clearly stated development finance mandates and visions.

[59] State Bank of Pakistan

[60] International Monetary Fund. 2021. Article IV Consultation, Sixth Review under the Extended Arrangement under the Extended Fund Facility.

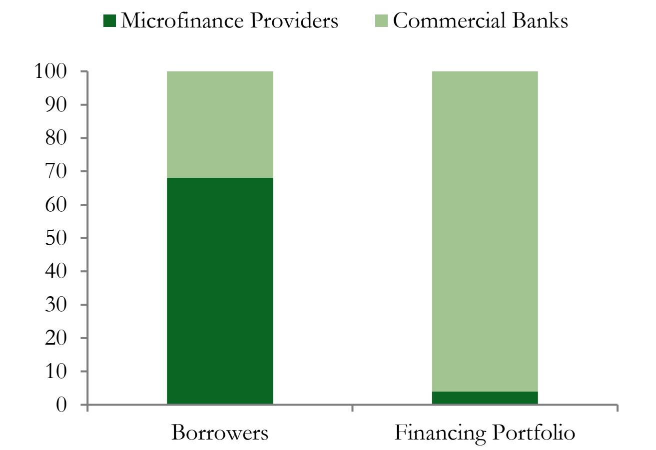
[61] Economic Survey of Pakistan 2021. Capital Markets and Corporate Sector.

[62] Using publicly available data from Pakistan Stock Exchange (PSX).

The microfinance sector, while still at a nascent stage, offers significant growth potential and has been at the center of the financial inclusion agenda in Pakistan

Although the microfinance sector has a smaller loan portfolio (Figure 3.13), at 3.9 percent of the total advances by the Scheduled Banks (PKR392 billion for MFPs vs PKR9.56 trillion for commercial banks), the sector caters to the financing needs of a significantly larger number of individuals/households and micro and small enterprises (8.1 million borrowers vs 3.8 million by banks). The microfinance sector, as such, plays a significant role in enhancing access to finance in Pakistan, both for households and small enterprises. However, a market-sizing exercise by the Pakistan Microfinance Network in 2019 showed significant potential for expansion and identified a potential microcredit market of 40.9 million borrowers and an MSE-credit market size of 5.8 million microenterprises. This implies that microfinance providers have only met 20 percent of the micro-credit demand and under 5 percent of the MSE-credit demand.[63]

Figure 3.13: MFPs as a share of borrowers and financing portfolio
Percentage share



Source: Authors calculations based on data from SBP and Pakistan Microfinance Network

d. Structural Impediments to the Financial Sector's Potential

The low level of financial intermediation is due to constraints in both the supply and demand for finance

The financial sector is not fulfilling its potential in financing the private sector, focusing instead on providing financing to the government. However, the current situation is driven by impediments in not only the supply but also the demand for finance. It is equally important to note that the factors constraining greater intermediation extend beyond the structural factors mentioned in this section. These factors include more specific sub-sector-level impediments, as opposed to the cross-cutting impediments delineated in this section.

Supply Side

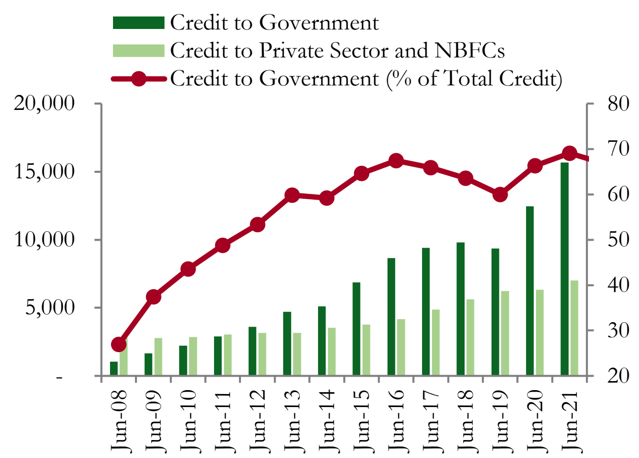
Extensive government borrowing from the financial sector has deterred greater intermediation of resources to the private sector in Pakistan

Credit to the government, which includes investments in government securities, direct lending for commodity operations, and lending to SOEs, has increased drastically in recent years, both in levels and as a percentage of total credit extended by the banking sector. The Government is the dominant borrower in the system. Compared to the 131-percent increase in credit to the private sector over the period FY11–21, credit extended by the banking sector to the government surged by 442 percent over the same period. This has led to credit to the public sector accounting for 66.8 percent of all the credit extended by the banking sector at end-December 2021 (Figure 3.14). These trends are not limited to the Banking sector but permeate across the financial sector. DFIs and NBFIs such as pension funds, mutual funds, and insurance companies, and even the capital markets are in the business of financing the government. In this respect, Pakistan also stands out among peer comparators. As of 2019, credit by domestic money banks to the government and SOEs as a share of GDP in Pakistan was the 11th highest among the 156 countries for which data is available (Figure 3.15).

[63] Pakistan Microfinance Network. Estimating the Potential Market for Microfinance in Pakistan including Credit, Savings, Payments, and Insurance.

Figure 3.14: Government Borrowing from Banks, FY11–21

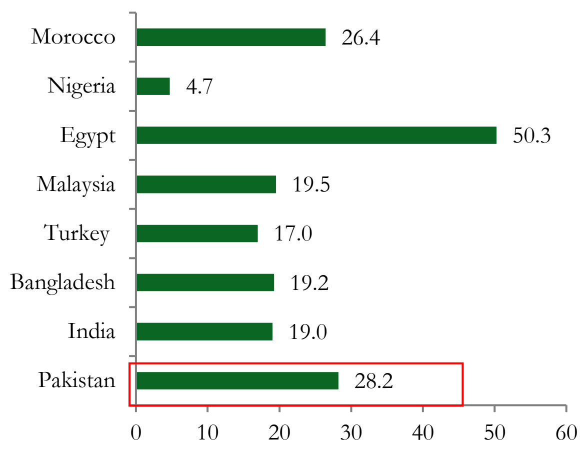
PKR billion/ Share of total



Source: Author's calculations based on SBP data.

Figure 3.15: Credit to Government and state-owned enterprises, 2019

Percentage of GDP



Source: International Financial Statistics

Treasury operations, as opposed to lending operations, have become the mainstay of the financial sector

The financial sector has pivoted an ever-greater percentage of its asset base towards the Government in recent years. This is due to several reasons: 1) government exposure offers assumed risk-free yield; 2) it does not entail any capital charges stemming from the fact that it is risk-free; 3) it is liquid and can be offloaded in the secondary market, unlike private lending, which is not marketable; 4) government securities are readily accepted within the system as collateral; and 5) investment in government paper is cheap and only requires a treasury desk, as opposed to lending, which entails complex procedures and requires significant human resources. Increasing exposure to the Government, however, has come at a cost, the most important one being crowding out credit to the private sector. Bouis (2019) finds that higher bank holdings of government debt in emerging market and developing economies is associated with a lower credit growth to the private sector and with a higher return on assets of the banking sector.[64] Research indicates that in Pakistan, a 1-percentage point growth in government borrowing leads to crowding out of private sector credit by 8 basis points in 4 months.[65]

Excessive dependence on lending to the government is stifling innovation in the financial sector

In the presence of a dominant borrower with no to low risk, the financial system has few incentives to design innovative financial products and institute robust risk management practices to extend finance to underserved sectors. The impact of the "dominant borrower syndrome" on deepening and efficiency in Pakistan is indicated by the fact that alternative financing models such as value chain financing, warehouse receipt financing, and factoring are still at a nascent stage in Pakistan.

Refinance facilities have been employed to mitigate some of the distortionary impact of government borrowing, but with limited results

Refinance facilities operated by the SBP, such as Export Financing Scheme (EFS) and Temporary Economic Refinance Facility (TERF), accounted for 17 percent of the outstanding credit to the private sector by banks in June 2021.[66] The refinance facilities offer concessional financing to Banks, which is subsequently on-lent to firms in the private sector at below-market rates. Although these facilities have been operationalized to spur investment and boost exports, in addition to the broader objective of enhancing the flow of financing to the private sector, they can have a distortionary impact. Refinance facilities can impede the development of capital markets by offering concessional financing at long tenors, competing directly with the instruments and products offered in the capital markets. These refinance facilities are also often not available to smaller firms. Most importantly, however, refinance facilities usurp market discipline and the organic functioning of the market.

[64] Banks' Holdings of Government Securities and Credit to the Private Sector in Emerging Market and Developing Economies. 2019. Bouis, Romain. IMF Working Paper.
[65] Does Government Borrowing Crowd Out Private Sector Credit in Pakistan. 2017. Zaheer, Sajjad; Khaliq, Fatima; Rafiq, Muhammad. SBP Working Paper Series.
[66] Author's calculations based on SBP data.

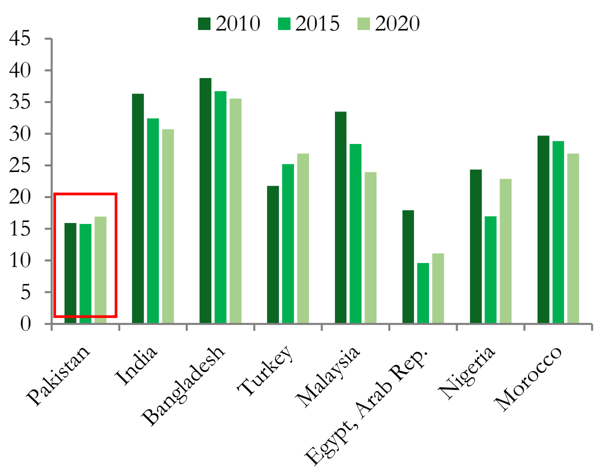
Low domestic savings limit the pool of resources available that can be intermediated onward…

The financial sector finances investments through the intermediation of national savings. Empirical findings suggest that increasing the fraction of domestic savings in the financing of domestic capital (i.e., a rise in self-financing ratios) contributes to the economic growth performance of countries.[67] Despite the importance of savings for growth, gross savings in Pakistan are the lowest among peer comparators at 16.9 percent of GDP as of 2020, barring Egypt (Figure 3.16).

…and this limited pool of savings is also not making its way into the financial sector

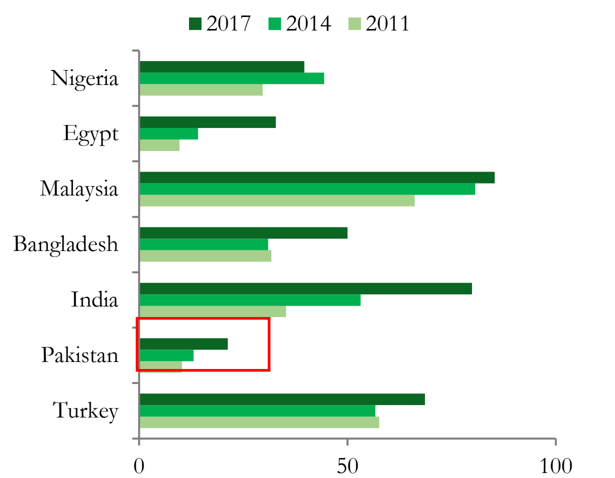
The savings challenge has only been exacerbated by the low level of financial inclusion in the country, where even those who save are not saving with the financial system, and as such savings are not being fully leveraged to support capital formation. Only 21 percent of the population has access to an account and only 18 percent of the population uses digital payments (Figure 3.17).[68] There are also large gaps in financial inclusion, with vulnerable segments having limited access at high prices. In terms of access to accounts, 7 percent of adult women have access compared to 35 percent of adult men, and 15 percent of young adults (ages 15–24) have access compared to 25 percent of older adults. It should be highlighted, however, that Pakistan has made notable gains on the financial inclusion agenda in recent years, supported by policy reforms and holistic strategies such as the National Financial Inclusion Strategy (see box 3.1 on SBPs efforts to reduce the gender gap in financial inclusion). However, despite the progress made, Pakistan underperforms on key metrics of financial inclusion in comparison to its peer comparators. Estimates suggest that less than 50 percent of domestic savings find their way to the financial sector, with the rest used in real estate, being intermediated through informal channels, or are soaked up directly by the government through National Savings.[69] The incentive system is skewed such that savings flow outside of the financial sector. The large quantum of currency in circulation (CiC) in the economy is also indicative of this trend. The CiC/M2 ratio, which averaged 22 percent till June 2015 has increased to over 28 percent as of June 2021. The increase in CiC/M2 ratio translates into excess CiC of PKR1.4 trillion. These are resources that could have been intermediated for productive uses by the financial sector but are currently outside the sector.

Figure 3.16: Gross Savings
Percent of GDP



Source: WDI

Figure 3.17: Account ownership at a financial institution or with a mobile-money-service provider
Percent of population ages, 15+



Source: Findex

[67] Aytul Ganioglu & Cihan Yalcin, 2013. "Domestic Savings-Investment Gap and Growth : A Cross-Country Panel Study," Working Papers 1346, Research and Monetary Policy Department, Central Bank of the Republic of Turkey.
[68] World Bank Findex 2017. State Bank of Pakistan SME Finance Quarterly Reviews.
[69] Ali, A – Saving and Investment in Pakistan, State Bank of Pakistan, 2016.

Box 3.1: SBP's Banking on Equality Policy: Reducing the Gender Gap in Financial Inclusion

The State Bank of Pakistan (SBP) launched the Banking on Equality policy in September 2021 to narrow the gender gap in financial inclusion by introducing women-friendly business practices in the financial sector. To promote gender equality, the financial institutions (FIs) within the regulatory ambit of SBP have been instructed to implement specific measures across cross-cutting areas.

Measurable targets and actions have been assigned under key pillars of the policy intended to improve gender diversity within financial institutions, development of women-centric financial products and services, marketing and increased outreach toward women, financing to women entrepreneurs under the priority sectors, and collection of gender-disaggregated data to inform better decision making. By 2024, FIs will be required to increase the ratio of women bank staff to 20 percent from the current 12 percent, decrease the share of women branchless banking agents to 10 percent from 2 percent, outreach of women centric products and financing to women entrepreneurs to reach 20 million unique active digital accounts by 2023, and place Women Champions at 75 percent of bank touch points. The policy initiative is a significant shift away from the previous gender-neutral approach to the one that actively seeks to address long standing barriers to women's access and usage of finance. Financial institutions will now be compelled to formulate policies and practices to increase women's workforce participation and design and market their offerings in line with women's demographics and life cycle needs within the local cultural and social context.

A significant increase in private sector lending would also require a potentially significant strengthening of bank capital

Banks in Pakistan are well-capitalized, with a capital adequacy ratio (CAR) of 16.7 percent at end-December 2021, well above the regulatory minimum of 11.5 percent.[70] As noted, however, banks' portfolios are heavily skewed towards lending to the sovereign, that is, carrying a risk weight that is close to zero. In practice, this means that banks can increase lending to the sovereign with no or minimal increases in total risk-weighted assets, and without lowering their CAR. By contrast, positive risk weights are applied to private sector loans, with residential mortgages and retail and corporate lending subject to risk weights of 35, 75, and 100 percent respectively. While capital levels are currently adequate given the preponderance of government lending in banks' portfolios, a significant expansion of banks' private sector lending portfolio would push up total risk-weighted assets and lower the CAR. Data collected for a sample of the largest fifteen banks indicate that total risk-weighted assets amounted to PKR8,714 billion as of end-2020 with a total capital of PKR1,624 billion.[71] Assuming all else equal, a simple doubling of the corporate, retail, and residential mortgage portfolios would lower the CAR to slightly below 13 percent.[72]

Informed risk-taking is impeded by market failures in the form of missing credit infrastructure leading to informational asymmetries

Financial institutions in Pakistan find it difficult to assess the repayment capacity and credit worthiness of potential borrowers in the presence of significant informational asymmetries owing to limited and underdeveloped credit infrastructure. Knowledge gaps in the existing system create uncertainty and heighten the risk of loan default, leading to risk aversion, credit rationing, and a surge in risk premia, rendering loans unaffordable. MSMEs and low-income borrowers from the informal sector are particularly affected by informational asymmetries as they do not have adequate collateral or credit history to fulfill stringent lending requirements. Although progress has been made in recent years, the market for credit information remains small and fragmented. The Credit Bureaus Act for the regulation and issuance of licenses to credit bureaus, which collect credit information and sell it to creditors for a fee so they can make informed credit decisions, was introduced only in 2015. Currently, only 2 credit bureaus are operational in Pakistan, in addition to SBP's electronic Credit Information Bureau (eCIB). However, these bureaus are constrained by multiple legal, policy, and institutional hurdles. To address this gap, the SECP has established an electronic Secured Transactions Registry (STR) in line with the Secured Transaction Act 2016. The registry helps SMEs and small farmers obtain financing from banks/DFIs against a registered charge on their movable assets.

[70] The CAR is a measure of how much capital a bank has available, reported as a percentage of the sum of a bank's risk-weighted credit exposures. The purpose is to establish that banks have enough capital on reserve to handle a certain number of losses, before being at risk for becoming insolvent. Since different types of assets have different risk profiles, banks are allowed to discount for lower-risk assets.
[71] For this sample of banks, the CAR thus amounts to 18.6 percent (PKR1,624 billion/PKR8,714 billion).
[72] In this simplified example, it is assumed that the credit risk weighted assets for corporate, retail, and residential mortgage lending is doubled. In practice, the decrease in the CAR could be more pronounced as the expansion in the private sector lending portfolio would also increase operational risk weighted assets (which is expressed as a fixed percentage of gross income).

A weak insolvency and creditor rights regime only exacerbates the sector's risk aversion

A transparent, predictable, and judicious insolvency and credit rights regime is critical in lowering the cost of credit, expanding access to finance, and fostering entrepreneurship. Pakistan's insolvency and creditor rights regime, however, has not been conducive to the meaningful intermediation of funds for productive investment to a more diversified borrower pool. Pakistan has a gross NPL ratio of 8.9 percent and a recovery rate of 41 cents/dollar. For high-income OECD countries, this metric is 70 cents/dollar. The stock of NPLs in Pakistan stood at PKR860 billion (approximately USD5 billion) as of December 2021. A significant percentage of these NPLs, however, are not new and can instead be classified as legacy NPLs. This is captured by the fact that NPLs that are overdue by more than 365 days (classified as "loss") have accounted for over 80 percent of the total stock of NPLs over the past decade. Due to the legal impediments to writing-off long overdue loans and lengthy litigation process, banks are reluctant to shed off bad loans from their books. A meaningful resolution of these NPLs would not only unlock significant liquidity that can be used for productive lending but would also give financial institutions the impetus they need to extend financing to marginalized segments.

Capital markets remain underdeveloped and under-tapped

On the investor side, the base of institutional investors that can invest at scale in the markets, although growing, is still very low and there is limited awareness of capital market products among retail investors. Institutional investors, like the vast majority of the financial system, also channel their resources towards financing the government. On the issuance side, there are several constraints as well. First, a large informal sector (as discussed below) implies that the pool of businesses that are ready and willing to embrace the transparency and governance requirements for market access is limited. Second, fees related to first-time or repeated issuance of capital and debt instruments are also high and processing time for supervisory approval of documents regularly extends beyond 2–3 months. As a result, capital market options are rarely competitive vis-a-vis bank loans, which are usually cheaper and simpler for issuers. Third, Government debt issuances have not played a catalytic role in the development of the private debt capital market in Pakistan either. While the average time to maturity has increased in recent years (i.e., from less than 2 years in 2013 to ~3.8 years in 2021) government securities are mostly of shorter tenors, which has hindered the development of a long-term yield curve, essential for the pricing of corporate securities. However, while the capital market is underutilized, authorities, in particular the SECP, are engaged in an ambitious reform program to address several of the preconditions required for capital market development. [73]

Demand Side

A large informal sector significantly impedes the demand for finance and financial services

Most businesses in Pakistan operate in the informal sector. Informality is also high as a share of total employment. The share of formal workers (i.e., wage workers with a written contract) of the total wage workers in Pakistan was 27 percent as of 2017.[74] A large informal and undocumented sector precludes a sizable percentage of the firms and households from accessing the financial system. While households and businesses may be able to open personal accounts, access to finance is predicated on cumbersome documentation, which can only be fulfilled if a business is operating in the formal economy, or an individual has a written employment contract. Informal income assessment models are being developed by the financial sector to circumvent the informality challenge and this reform agenda has gained momentum with the rise of the FinTech sector.

The demand for finance has also remained subdued

Limited financial literacy has exacerbated the informality challenge in Pakistan. According to the Standard & Poor's Ratings Services Global Financial Literacy Survey 2015 (S&P Global FinLit Survey), only 26 percent of the adults in Pakistan are financially literate. While this number is largely in line with the financial literacy numbers in the rest of South

[73] The SECP corporatized and demutualized the stock exchanges in Pakistan in 2012. The Securities Act was also promulgated in 2015 aimed at effective regulation and enhanced protection of investors and public in general. In 2016, the three stock exchanges were integrated into PSX. The tax regime for non-residents investing in debt securities has also been simplified, which should facilitate their participation in the domestic capital markets.

[74] Cho, Yoonyoung; Majoka, Zaineb. 2020. Pakistan Jobs Diagnostic: Promoting Access to Quality Jobs for All. Jobs Series; No. 20. World Bank, Washington, DC. © World Bank.

due to a lack of financial literacy

Asia, low financial literacy has had a bearing on demand for finance, especially in an environment where the financial sector landscape grows increasingly complex. According to the SBP-Gallup Pakistan, Access to Finance Survey 2015, 52 percent of unbanked respondents identified a lack of knowledge about banks and bank accounts as the key obstacle to account ownership. Similarly, more than 30 percent of the respondents cited a lack of knowledge for not making domestic person-to-person transfers using banks, mobile money, and post office. Although the average adult in Pakistan might still be familiar with the utility of banks, this may not hold for the larger financial sector landscape, which includes mobile money, FinTechs, and NBFIs. To address this challenge, the SBP has launched the National Financial Literacy Program (NFLP) which is focused on imparting basic financial education to the unbanked and underserved segments of the population, especially the women & youth. As of June 2021, more than 1.6 million individuals had benefited from this program.[75]

Preference for Shariah based financing instruments deters businesses from tapping into traditional instruments…

Pakistan ranks 7th out of 123 countries in terms of percent of respondents who do not have an account with a financial institution due to religious reasons, according to the global Findex database 2017. The growth of Islamic finance in recent years is also indicative of the role played by religion in the financial decisions made by businesses and households. Assets of Islamic Banking institutions as a percentage of assets of conventional banks have increased from 12 percent in 2015 to 20.4 percent in 2020. Deposits as a percentage of deposits of conventional banks, similarly, have also increased from 15.2 percent to 22.3 percent.

...while those who are not deterred by the type of financing are often deterred by the cost of finance and lack of traditional collateral

Demand has also remained subdued due to the cost of finance. While the cost of finance, or the average lending rate, has come down over the past decade, from a high of 14 percent in 2010 to 10.75 percent in 2020, it remains elevated. The interest rate spread (difference between lending and deposit rates), similarly, while having declined over the past decade, remains high at 3.2 percent in 2020, against 2.2 percent in Bangladesh and 2.0 percent in Malaysia. The cost of finance is also a significant impediment to the growth of microfinance. Interest rates for some products offered by MFPs can be as high as 50 percent.[76] The lack of collateral remains another significant challenge. Demand for finance, even when economic agents are financially literate and are not deterred by religious or cost-related reasons, has remained subdued due to the lack of collateral required by most institutions in the financial sector.

e. Enhancing the Flow of Financing to the Real Economy

Enhancing the flow of financing to the real economy requires resolving structural problems as well as leveraging emerging growth areas

The structural impediments to the enhanced flow of finance to the private sector require concerted efforts by the government, regulators, and stakeholders to resolve in the medium to long term. The solutions to many of these challenges are complex and necessitate a whole-of-system approach. Reducing the Government's dependence on borrowing from the financial sector to free up resources for the private sector, for instance, requires a reduction in the fiscal deficit. This in turn requires greater resource mobilization and expenditure consolidation measures. In addition to resolving these structural challenges, five growth areas offer significant potential to unlock greater flows of financing to the real economy in the short-medium term. These are: a) digital finance; b) risk capital; c) microfinance; d) development finance; and e) capital markets.

The table below summarizes key recommendations for addressing some of the challenges currently preventing greater flow of financing to the private sector in Pakistan.

[75] State Bank of Pakistan. Annual Performance Review 2020-21.
[76] The How & the Why of Microfinance Lending Rates. 2019. Pakistan Microfinance Network.

Area	Policy Recommendation	Implementation Timeframe	Responsible Agencies
Structural	Reduce government's usage of the domestic markets' financial resources to encourage stronger flows to the private sector	Long-term	Ministry of Finance, Debt Office, SBP
	Increase outreach, investor awareness, and financial literacy to equip businesses and households with the information required to access the financial sector and the products offered by it	Medium-term	SBP, SECP
	Pursue financial inclusion policies to tap into the informal savings of the population, particularly by leveraging newly developed digital channels	Medium-term	SBP, SECP
	Improve the business climate and incentives for entering the formal market to facilitate SME growth and usage of the formal financial sector, including by automating the process of business registration and consolidation of multiple registration processes into a digital one stop shop	Medium-term	Board of Investment and relevant government departments
	Address legal, policy, and institutional hurdles that currently limit the development of the market for credit information (including data sharing, data privacy, integration of platforms etc.)	Medium-term	SBP, SECP
	Enhance the effectiveness of the court system with competence on insolvency proceedings and introduce novel means to address micro and small enterprises' insolvency including by building judicial specialization on insolvency cases, strengthening the framework for the rehabilitation of viable firms, and improving the taxation regime around distressed assets)	Medium-term	Judiciary, SBP
	Strengthen banks' capital base to provide space for enhanced lending to riskier segments	Medium-term	SBP
Capital Markets	Provide time-bound incentives for strategic sectors and large corporates to enter the bond market to help develop the market, particularly by promoting listing of large corporates with significant debt requirements	Short-term	SECP, SBP
	Develop and diversify the investor base by equipping institutional investors with appropriate investment capacity and skills to invest in capital markets to ensure they diversify investments beyond sovereign paper and real estate	Medium-term	SECP
	Support evolution of capital markets by encouraging book-building of semi-autonomous bodies, reducing tax driven distortions between asset classes, and developing a vibrant secondary market for government securities		
Digital Finance	Optimize delivery of government social transfers (e.g., BISP), leverage and integrate the micro-payment gateway (RAAST) to facilitate outreach and inclusion	Short-term	SBP
	Digitize government payments and collection flows at the federal and provincial levels	Medium-term	SBP, Ministry of Finance
Risk Capital	Establish a central coordinating mechanism to support a holistic approach towards building an enabling environment for risk capital in Pakistan to ensure an industry driven legislative framework for risk capital	Short-term	SECP

	Improve the regulatory and taxation framework for international investors and supporter stronger incentivization for local funds	Short-term	SECP, Federal Board of Revenue
	Crowd in institutional investors such as pension funds and insurance companies that can play a catalytic role in broadening and diversifying the financing base for risk capital through a review and potential revision of the regulatory and policy regimes	Medium-term	SECP
Microfinance	Support product innovation and outreach to grow the MSE portfolio through more rigorous client centric product development and customer outreach	Short term	PMN, SECP, SBP
	Digitize all facets of microfinance business models including internal processes and client interfaces	Medium-term	PMN, SECP, SBP
Development Finance (DF)	Establish a coordinating unit that can serve as a depository for DF initiatives such as Kamyab Pakistan Program, both federal and provincial, in addition to supporting the monitoring and evaluation of the DF interventions to limit their distortionary impact	Short-term	MoF, SBP
	Consolidate and harmonize existing instruments and institutions that characterize the development finance landscape, after an effectiveness review based on a clear mandate, governance, and rules of engagement	Medium-term	MoF, SBP

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Statistical Annex

Annex Table 1: Key Macroeconomic indicators (annual)

	FY17	FY18	FY19	FY20	FY21
Real GDP growth, at constant market prices	**4.4**	**6.2**	**2.5**	**-1.3**	**6.0**
Private consumption	6.9	7.2	5.6	-3.1	6.3
Government consumption	4.5	5.5	-1.6	8.4	3.1
Gross Fixed Capital Investment	7.7	10.3	-11.1	-5.5	6.8
Exports, Goods and Services	2.5	10.0	13.2	1.5	4.8
Imports, Goods and Services	19.0	15.7	7.6	-5.1	5.5
Real GDP growth, at constant factor prices	**4.6**	**6.1**	**3.1**	**-1.0**	**5.6**
Agriculture	2.2	3.9	0.9	3.9	3.5
Industry	4.6	9.2	0.2	-5.8	7.8
Services	5.6	6.0	5.0	-1.3	5.7
Inflation (Consumer Price Index, period average)	**4.8**	**4.7**	**6.8**	**10.7**	**8.9**
Current Account Balance (% of GDP)	**-3.6**	**-5.4**	**-4.2**	**-1.5**	**-0.6**
Fiscal Balance, excluding grants (% of GDP)	**-5.2**	**-5.8**	**-7.9**	**-7.1**	**-6.1**
General Govt. and Govt. Guaranteed Debt (incl. IMF obligations) (% of GDP)	**63.2**	**67.1**	**78.0**	**81.1**	**76.0**
Primary Balance, excluding grants (% of GDP)	**-1.4**	**-1.9**	**-3.1**	**-1.6**	**-1.2**

Sources: (i) Pakistan Bureau of Statistics, (ii) Fiscal Operations, Ministry of Finance, (iii) State Bank of Pakistan, and (iv) World Bank staff estimates
Note: The Pakistan Bureau of Statistics rebased national accounts from 2005/06 prices to 2015/16 prices in January 2022. PBS has not published demand-side data on the re-based national accounts for FY21. The above table reports World Bank estimates for FY21 expenditure accounts to conform to the production accounts' new base year data.

Annex Table 2: Balance of payments summary[1]

US$ million unless mentioned otherwise

	FY20	FY21	H1-FY20	H1-FY21	H1-FY22
i. Current account (A+B+C+D)	**-4,449**	**-1,916**	**-3,447**	**1,247**	**-9,023**
A. Good trade balance	**-21,109**	**-28,188**	**-10,906**	**-11,386**	**-21,187**
Goods Exports	22,536	25,630	12,408	11,815	15,235
Goods Imports	43,645	53,818	23,314	23,201	36,422
B. Services Trade Balance	**-3,316**	**-1,957**	**-2,070**	**-944**	**-1,823**
Services Exports	5,437	5,882	2,924	2,840	3,424
Services Imports	8,753	7,839	4,994	3,784	5,247
Trade Balance	**-24,425**	**-30,145**	**-12,976**	**-12,330**	**-23,010**
C. Balance on primary income[2]	**-5,459**	**-4,613**	**-3,063**	**-2,673**	**-2,481**
D. Balance on secondary income[2]	**25,435**	**32,842**	**12,592**	**16,250**	**16,468**
of which, remittances	23,131	29,370	11,371	14,203	15,808
ii. Capital account	**285**	**235**	**198**	**132**	**119**
1. Balance from current and capital accounts (i+ii)[3]	**-4,164**	**-1,681**	**-3,249**	**1,379**	**-8,904**
2. Financial accounts[4]	**-9,313**	**-8,225**	**-7,145**	**-309**	**-10,052**
of which:					
Direct investment	-2,652	-1,786	-1,408	-827	-976
Portfolio investment	409	-2,770	-584	443	374
Financial derivatives/employee stock options	-8	0	-4	2	-1
Net acquisition of financial assets	-127	471	187	1,573	415
Net incurrence of financial liabilities	6,935	4,140	5,336	1,500	9,864
3. Errors and omissions	**150**	**-991**	**458**	**-406**	**-360**
Overall balance (-1+2-3)	**-5,299**	**-5,553**	**-4,354**	**-1,282**	**-788**
Gross SBP reserves (incl. CRR, SCRR)[5]	13,724	18,716	13,278	14,886	19,058

Memorandum items					
Current account balance (percent of GDP)	*-1.5*	*-0.6*	-	-	-
Trade Balance (percent of GDP)	*-8.1*	*-8.7*	-	-	-
Export growth (percent, y-o-y)	*-7.4*	*12.7*	*3.0*	*-4.4*	*27.3*
Import growth (percent, y-o-y)	*-16.6*	*17.7*	*-14.6*	*-4.7*	*54.4*
Remittance growth (percent, y-o-y)	*6.4*	*27.0*	*3.5*	*24.9*	*11.3*
Financial account (percent of GDP)	*3.1*	*2.4*	-	-	-
Overall Balance (percent of GDP)	*-1.8*	*-1.6*	-	-	-

Source: State Bank of Pakistan, World Bank Staff calculations
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.
[5]CRR: Cash Reserve Requirement, SCRR: Special Cash Reserve Requirement.

Annex Table 3: Summary of Pakistan's Fiscal Operations

PKR billion (unless mentioned otherwise)

	FY20	FY21	H1 FY20	H1 FY21	H1 FY22	H1 FY21 Growth y-o-y (%)	H1 FY22 Growth y-o-y (%)
Fiscal Balance	**-3,376**	**-3,403**	**-995**	**-1,138**	**-1,372**	**14.4**	**20.6**
Primary Balance	**-757**	**-654**	**286**	**337**	**81**	**17.7**	**-76.0**
Total Revenue	**6,272**	**6,903**	**3,232**	**3,351**	**3,956**	**3.7**	**18.0**
Tax Revenue[1]	4,751	5,760	2,467	2,764	3,294	12.0	19.2
Federal	4,337	5,251	2,252	2,518	3,023	11.8	20.1
Provincial	414	508	214	246	271	14.7	10.3
Non-Tax	1,521	1,144	765	587	662	-23.2	12.6
Federal	1,419	993	705	540	594	-23.4	10.0
Provincial	102	150	60	47	68	-21.2	43.1
Expenditures	**9,648**	**10,307**	**4,227**	**4,489**	**5,328**	**6.2**	**18.7**
Current *of which*:	8,532	9,084	3,721	4,029	4,676	8.3	16.0
Interest	2,620	2,750	1,281	1,475	1,453	15.1	-1.5
Defense	1,213	1,316	530	487	520	-8.1	7.0
Development Expenditure and net lending, of which	1,204	1,316	473	458	571	-3.3	24.8
Total PSDP[2]	1,090	1,211	457	403	565	-11.8	40.2
Other development	65	27	8	11	0	35.4	-100.0
Net lending	49	77	8	44	6	424.9	-86.1
Statistical Discrepancy	-87	-93	32	2	81	-94.1	4147.4

Source: Ministry of Finance, World Bank staff calculations
Notes: [1]For FY21, the Ministry of Finance switched Gas Infrastructure Development Cess, Natural Gas Development Surcharge, and Petroleum Levy from tax to non-tax revenues. For consistency of analysis across years, these taxes have been included in tax revenues.
[2]Public Sector Development Programme.