DEVELOPMENT ADVOCATE
PAKISTAN

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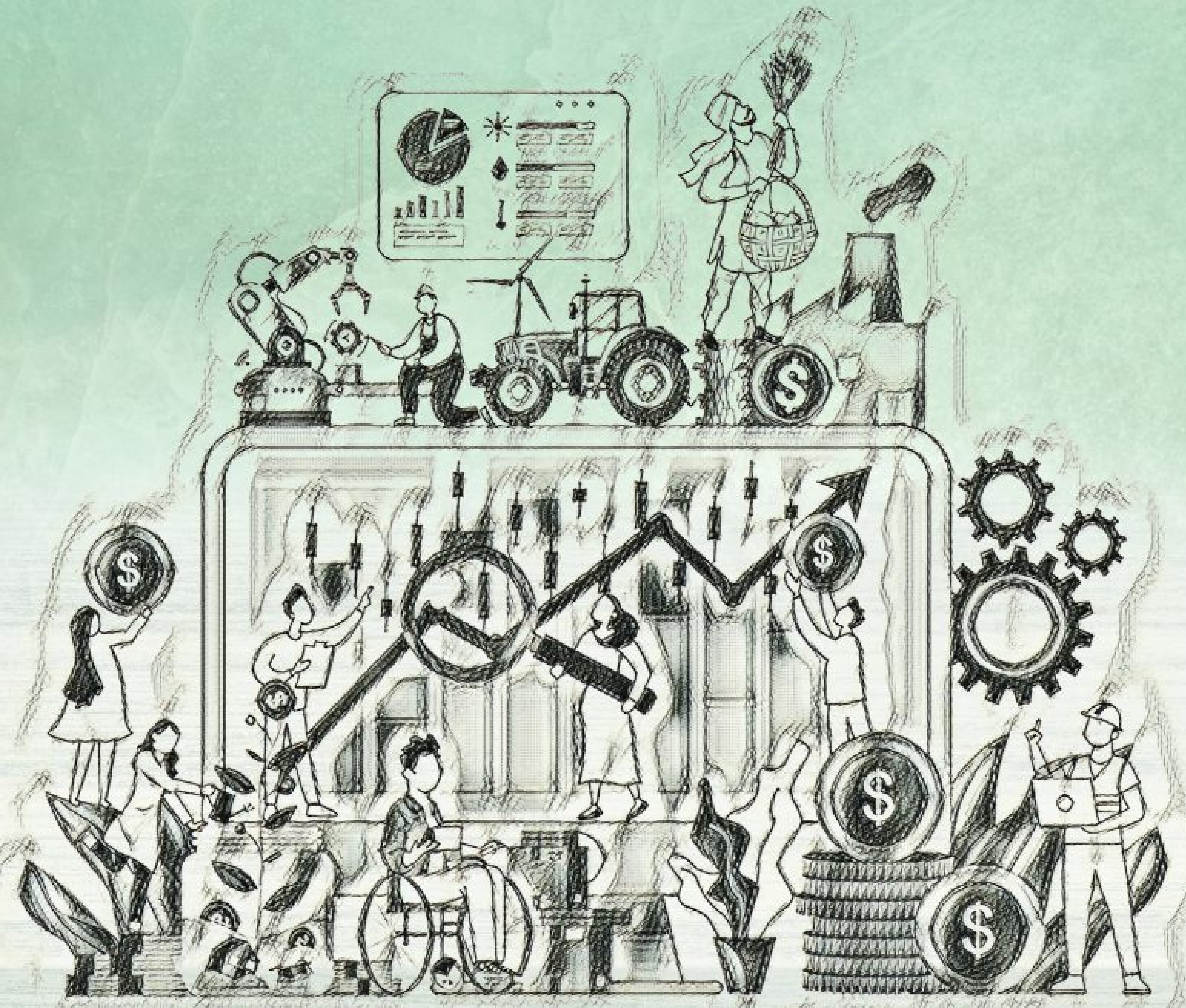
Inclusive Growth in Times of Uncertainty



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Development Advocate Pakistan provides a platform for the exchange of ideas on key development issues and challenges in Pakistan. Focusing on a specific development theme in each edition, this quarterly publication fosters public discourse and presents varying perspectives from civil society, academia, government and development partners. The publication makes an explicit effort to include the voices of women and youth in the ongoing discourse. A combination of analysis and public opinion articles promote and inform debate on development ideas while presenting up-to-date information.

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EDITORIAL

Changing Gears on Economic Policy

> Innovations in economic foresight point towards a fundamental emerging need to align economic growth with diversified development outcomes. With other vital components impacting economic progress, it is time to look beyond GDP and reposition Pakistan's economic model.

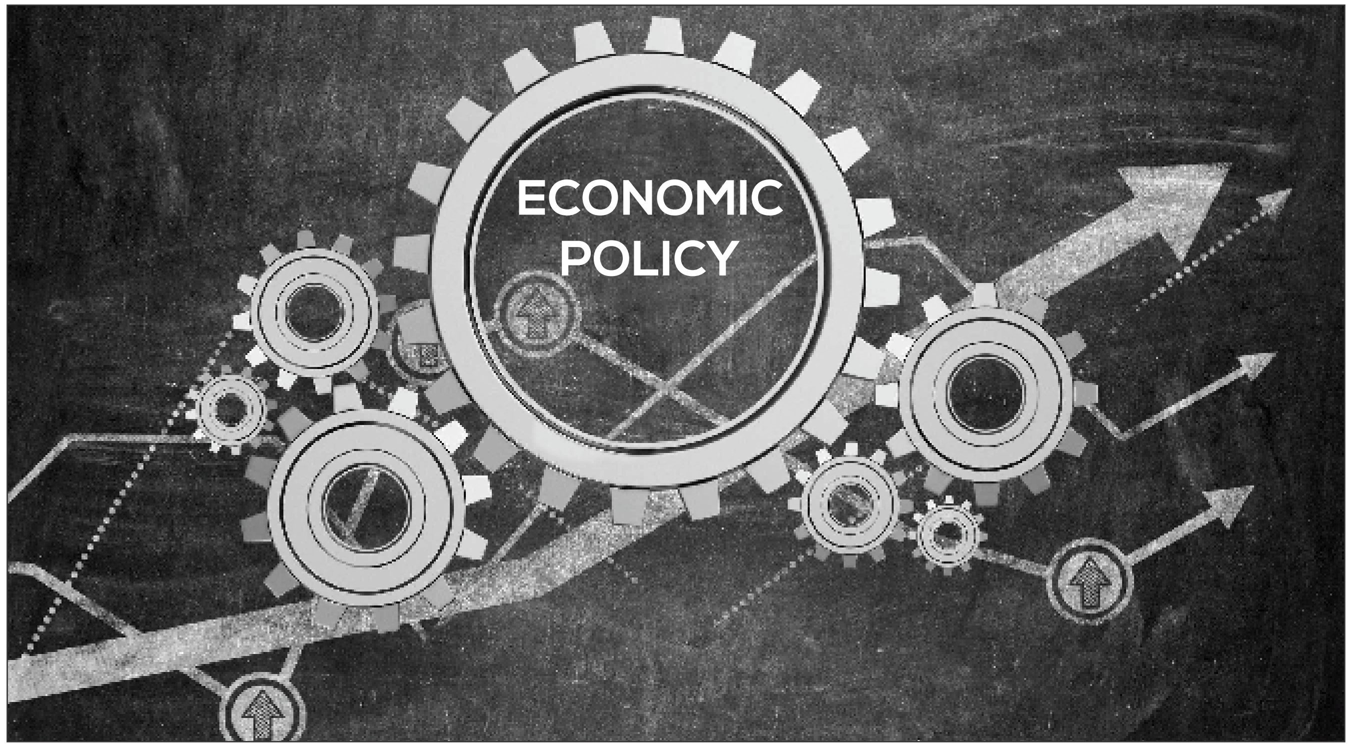
By
Aliona Niculita
Resident Representative a.i.
UNDP Pakistan

While a series of setbacks have affected the progress on global sustainable development during 2021-2022 – pandemic and lockdowns, debt crises, inflation, food insecurity and conflict – there have also been gains in health, climate change, technology, and energy, among other areas. For instance, several countries' handling of the pandemic has produced significant health breakthroughs in vaccine development and revolutionised the world into a more tech savvy space. Today, one of the biggest challenges for policy and thought leaders is to configure innovative ways for managing/overcoming multiple challenges while also leveraging the many opportunities they offer.

The domino effects of the pandemic and its concurrence with the ongoing conflict in Ukraine have created a looming global economic crisis, upending the world order as we have known it. The pandemic deepened the cracks of inequality, leading several countries down the treacherous path of borrowing to salvage economic solvency. The global scenario appears bleak, with even developed countries now reeling from its after-effects.

In the Asia-Pacific for example, countries like Sri Lanka, Afghanistan and Pakistan are facing a grave 'debt distress' and forced to make difficult decisions of budget cuts on critically needed development spending. As UNDP's recent policy analyses show, Sri Lanka's prolonged external borrowing, a deteriorating social sector, rising inflation, and indefinite negotiations with the IMF brought the country to the state of economic default. With its gross foreign exchange reserves only enough to procure less than 1.5 months of imports, and a massive debt and fiscal crisis characterised by a unique twin challenge of illiquidity and insolvency, Sri Lanka needs an extensive systematic rollout focused on mitigating the downward economic spiral as quickly as possible. Meanwhile, moderating its human development impacts is also critical. Similarly, UNDP's research on Afghanistan shows that the ongoing humanitarian and economic emergency in the country is located in deep structural and policy imbalances, that need to be corrected to preserve the gains made in the last two decades. An estimated 97 percent of Afghans could be living in poverty by mid-2022, and with commodities pricing skyrocketing globally, sustaining even basic needs such as food, healthcare, and education, have become an everyday battle for locals/people of Afghanistan.

Pakistan is currently facing similar economic challenges. While it witnessed a growth of 5.97 percent in FY2022 – the second highest in the last 14 years – it is currently faced with a debt excess of approximately USD 250 billion, rising from 57.9 percent of the GDP in 2013, to 74 percent of the GDP in 2021. It is experiencing soaring inflation (increased to 13.8 percent in May 2022 from 12.7 percent in March 2022, the highest in the last two years). The country is also facing a stubborn twin burden of Current Account Deficit (USD 13.2 billion for FY2022 as compared to USD 543 million in FY2021), and fiscal deficit is forecasted to increase to 6.3 percent of the GDP in FY22. Additionally, Pakistan faces a trade imbalance, with the trade deficit (July-April FY2022) reaching USD 32.9 billion as compared to USD 22.0 billion in FY2021, and depleting foreign exchange reserves resulting in currency devaluation. The national tax base remains very narrow, resulting in a low tax-to-GDP ratio: in FY2022 (Budget estimate) taxes formed only 12 percent of the GDP, depicting the huge revenue gap that is required to meet public expenditures.



For developing countries like Pakistan, political stability combined with good governance and a dynamic strategy for managing sovereign debt and public finance with support from development partners, is the minimalist formula required to overcome these financial and economic challenges. There is a dire need for home-grown solutions that are centred around the principle of sustainability and self-sufficiency.

UNDP's Pakistan National Human Development Report 2020 on the 'Three P's of Inequality: Power, People, and Policy' establishes the need for increasing outlays on human development and social protection, creating policies and reforms to bridge socio-economic gaps, and promoting decent work and gender equality, as essential levers to mitigate effects of inequality in promoting sustainable development. Broadening the tax-net, rationalizing government expenditure, and increasing productivity to boost exports and curtail non-essential imports are viable alternates to address the burgeoning debt crises.

Leveraging alternative financing mechanisms, including private sector investments in SDGs-aligned development projects and climate financing instruments such as green bonds, can help to decrease reliance on external borrowing and avoid the current account deficit. Provision of incentives to the private sector, with allowance for the sector to manage supply in major industries, such as electricity, and encouraging local investments from individual small-time investors is crucial to creating a sustainable investment model. Leveraging climate financing instruments and tapping green and blue economies through employment and expanding their product base, can be core pillars of a sustainable economy.

Pakistan offers multi-billion-dollar investment opportunities in transport and logistics, renewables and alternative energy, healthcare, education, technology, and communication. The country has implemented key reforms to improve ease of doing business, encouraged public-private partnerships, and hails a market size of roughly 220 million people.

With the Agenda 2030 clock ticking, Pakistan is faced with an urgency to optimise the quality and structure of its economic stabilisation and growth policies, if it aims to be one of the top ten economies of the world by 2047. It needs to move towards investment-based export-led growth powered by renewable energy. Such growth needs to be supplanted by a high productivity services sector and a flourishing agriculture sector, that may help import substitution of essential food items.

This would only be possible through investments in human capital and aligning the national economic policies to the globally accredited Financing for Development paradigm. Fully utilising youth potential, positioning women as power-agents of economic growth and prosperity, and channelling marginalised segments of society into sustainable and community-driven social safety nets, can reduce burdens on the state and accrue overall benefits for the economy.

Innovations in global economic foresight point towards a fundamental emerging need to align economic growth with diversified development outcomes. For decades, GDP has been viewed as the sole indicator of economic growth. However, now with other vital components such as environment, social sector dynamics and inclusion directly or indirectly impacting economic progress, it is time to reimagine and reposition Pakistan's economic model. This is where the transition to robust economies centred on Financing for Development comes into motion, and where social impact-led investments can power economic growth.

> “While the current economic model requires revisiting, the country has seen similar debt levels and deficits in the past - and successfully emerged out of those crises. Leveraging the youth bulge, making space for the private sector, and focusing on governance, regulation, and the social sector, are key for future sustainability.”

MAIN ANALYSIS

The Economic Journey: Muddling Through

> “Pakistan has been experiencing an economic downfall post the 1980s. With the average growth rate starting to decline continuously, the balance of payment crisis has been frequent; and today, the country is on the verge of a default-like situation for the second time in three decades.”

By

Ali Khizar

Journalist and Economist

When Pakistan came into being in 1947, it did not have any manufacturing base and had to import most food. Nevertheless, the country progressed significantly in the first four decades, with an average GDP growth rate of 5.2 percent. The industrial base developed in the 1960s, and two major dams were built simultaneously. The nationalization spree in the 1970s regressed industrial development, but growth momentum peaked in the 1980s with an average GDP growth rate of 6.4 percent. Ever since then, there has been an economic downfall. With the average growth rate starting to decline continuously, the balance of payment crisis has been frequent; and today, the country is on the verge of a default-like situation for the second time in three decades.

The country progressed on the external money flowing to support the consumption needs of a growing population, while its export base could never lift off. Earlier, it was geopolitical rent in the shape of aid and development loans that fueled growth. And in the last two decades, remittances became the prime financier of the growing import demand. In both cases, foreign capital is being deployed in consumption and unproductive assets (like real estate), while economic productivity did not grow in tandem. As a result, with the growing population and demand in absolute terms, the balance of payment crisis has frequented, and the constrained growth levels have come down to below four percent.

Financially empowering the fiscal federating units in the last decade (after the 18th amendment and 7th NFC award) has further weakened the federal fiscal position, which has resulted in the higher accumulation of debt. The responsibilities of energy and other subsidies, support of marginalized populations (through Ehsaas/BISP), defence, and debt servicing rely solely on the federal government. At the same time, the provinces get the lion's share of tax revenues without assuming any responsibility for prudence. Meanwhile, the political divide amongst provinces has exacerbated the situation.

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> Energy is a key challenge: The power sector circular debt has grown to unmanageable levels in the process, whereas gas circular debt is building on a similar trajectory, with supply increasingly being shifted towards the imported RLNG.

This is the stock of the situation at a broad level. The country has digressed towards an unsustainable economic path for the past thirty-five years. First, there is a case of institutional decay and nepotism that has derailed economic and social governance. Then, the government's footprint has increased in food and energy markets, which has created circular debts in both markets. Two out of the three recent balance of payment crises have been worsened by the respective federal government not passing on the increase in the international petroleum prices to the consumers. In reality, the politics of petroleum prices have accelerated the crises - evident in what happened in 2008, and now in 2022.

In the power sector, the government is the sole buyer and seller of grid electricity. The structure of Independent Power Producers (IPPs) is lopsided with guaranteed returns for investors, while the risk of pricing and demand is being shifted to the government. Had the government not been the sole buyer of electricity, it could have moved the risk towards the IPPs. However, that never happened. Since the government could not pay the IPPs on time due to growing gaps in costs and revenues, the risk of IPPs kept on increasing, and the return on IPPs increased with every successive power policy. The power sector circular debt has grown to unmanageable levels in the process. The story of gas circular debt is building similarly where the supply is increasingly being shifted towards the imported Re-Gasified Liquefied Natural Gas (RLNG), while buyers are not willing to pay the premium.

Another circular debt brewing is that of wheat. Again, the government is in the business of setting prices and procurement. With demand growing amid stagnating production, the indigenous supply is insufficient to feed. The gap between the cost and sale is leading to another circular debt.

The problem today is the growing debt (both above and below the line), and its servicing. The overall fiscal structure is unsustainable, where the federating units have to share the gaps in energy and food commodities.

The federal and provincial governments should move away from setting prices in energy and food markets. It will provide space for private sector companies to come in, and overall economic competitiveness can improve with private efficiencies.

Today, the economic fundamentals are weak, and the current model is not sustainable. However, the country has seen similar debt levels and deficits in the past - and has come out of these crises too. Today's situation is not much different from what was

> Growing debt and its servicing is a huge challenge. The overall fiscal structure is unsustainable, where the federating units have to share the gaps in energy and food commodities.

in the late 1990s. Change in the geopolitical situation after 9/11 created an opportunity, and the then government's privatization and deregulation policies (in telecom and banking sectors) paid dividends. Today, similar policies are required in the energy and food markets. Then, governance can improve using technology.

Pakistan is a vast and diversified market. There is immense potential due to its youth bulge. However, the country needs to bring the fiscal house to push investors to finance the current account deficit, which is necessary for a sustainable growth path. In addition, the government should focus on governance, regulation, social sectors (health, education, and environment), and tax collection. It should also let the private sector run markets and lure investment in industries where the country has a comparative and competitive edge to bring the economy back on a sustainable growth track.

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Leaving No Stone Unturned: Towards Sustainable and Inclusive Growth

> “Serious challenges of current account deficit, depleting foreign exchange reserves, massive devaluation, and high inflation require immediate short- and long-term interventions.”

By

Miftah Ismail

Federal Minister for Finance and Revenue

Pakistan has a thriving and resilient economy. Over the past several years, it encountered several challenges, of which terrorism was a major one. This severely deteriorated the economic, social, and political fabric of the country. Such consistent large-scale losses require years to recover and achieve sustained growth. While Pakistan's economy was on the path to recovery, COVID-19 struck and adversely affected the economic stability of the country. Nonetheless, Pakistan's economy has improved significantly at the macro level due to well-coordinated fiscal and monetary policies, and the resilience of the people of Pakistan. However, there is always room for improvement, especially when a country is faced with serious challenges of current account deficit, depleting foreign exchange reserves, massive devaluation, and high inflation.

Given the structural issues faced by Pakistan's economy, there is no single policy reform or easy solution that could help transform the country into economically stable and prosperous in the short term. Pakistan's economy needs both short as well as long term measures for proactively tackling the current economic impediments. Some of the major areas in which policy interventions are required include structural reforms, improving the investment climate, and facilitating universal financial inclusion.

There are a number of structural issues in the economy of Pakistan that slow down the overall growth rate. Reforms are required in different segments of the economy including the export sector, regulatory environment, privatization and de-regularization of State-Owned Enterprises (SOEs), tax administration, inclusion of the informal economy, and more focus on the digital economy. Post-pandemic era calls for prioritizing the digital economy to aid sustainable growth in the modern world. The digital economy has the ability to significantly reduce transaction cost by facilitating remote work that will not only improve efficiency and productivity, but will also reduce the demand of fuel to a significant extent. Furthermore, a technology based local network of agriculture producers and agriculture markets with the objective of reducing the 'information asymmetry', and for doing away with 'middle-men', is also imperative. On the whole, such reforms would inculcate improvement in human resource development, innovation, employment rate, foreign direct investment, and growth of the digital economy.

Priority Areas

Need for structural reforms.	Facilitating financial inclusion.
Improving the investment climate.	Prioritizing the digital economy.

> “The present government is focusing on a new economic model based on structural reforms, improving the investment climate, and financial inclusion, through collaboration with Micro-Finance Institutions, for achieving inclusive and sustainable economic growth.”

Pakistan is dealing with the challenge of high debt. Improving the investment climate through reform policies is necessary. Fiscal management reforms will ensure generation of higher tax revenues leading to an increase in tax-to-GDP ratio. Well-developed taxation infrastructure is necessary for ensuring equity, inclusivity, and sustainability. On the same lines, tax reforms should focus on shifting towards direct rather than indirect taxation, simplification of the tax management system, and broadening of tax base through use of technology, for undertaking inclusive economic growth.

Financial inclusion is essential for strengthening financial institutions, efficient allocation of capital, improved access to credit, and sound risk management. The overall goal of financial inclusion is to ensure inclusive economic growth, and improving the incomes and livelihood opportunities for the lower strata of the country. Through social empowerment, financial inclusion has the strength to enhance gender-inclusive economic empowerment. Lack of access to financial facilities also cultivate the tendency of the larger informal economy, which not only leads to lower tax revenue collection, but also negatively impacts the productivity and transparency of economic growth.

Therefore, the present government is focusing on a new economic model based on structural reforms, and improving investment climate and financial inclusion, through collaboration with Micro-Finance Institutions (MFIs), for achieving inclusive and sustainable economic growth.

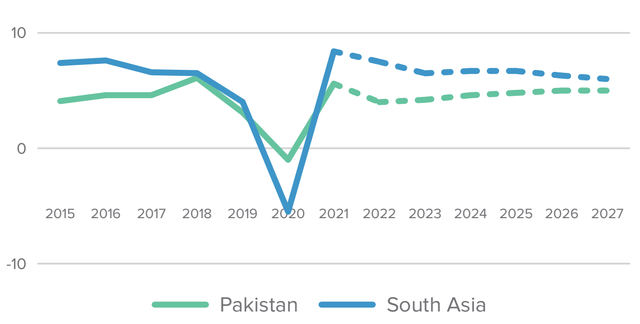
INFOGRAPHICS

Pakistan Fact Sheet

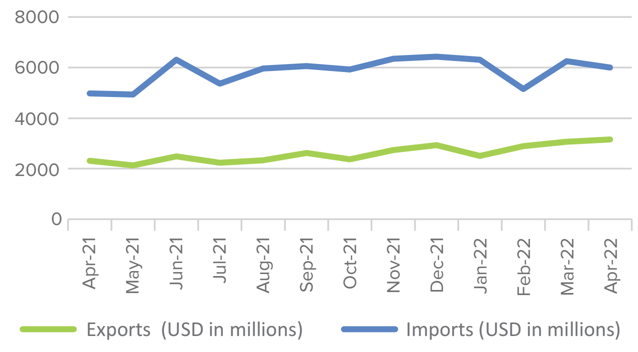
This Pakistan Fact Sheet captures the intricacies of the country's macroeconomic position and highlights the daunting challenges it faces. These include rising dependence on borrowing; narrow tax base with sluggish revenue generation; surging trade deficit; lack of investment in Pakistan; soaring inflation coupled with high-interest rates and plunging currency; elevated energy prices and subsidies denting the national exchequer; and rising food insecurity.

Time Trends and Forecast

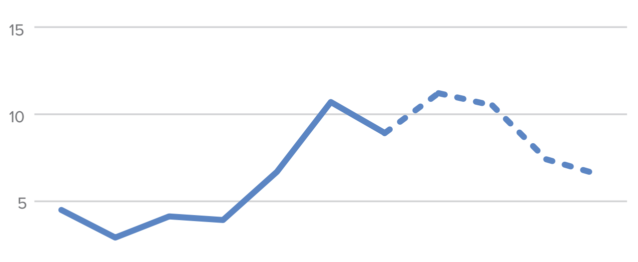
Real GDP growth recovered despite the pandemic, however another dip is expected in near future (Annual % and forecast)



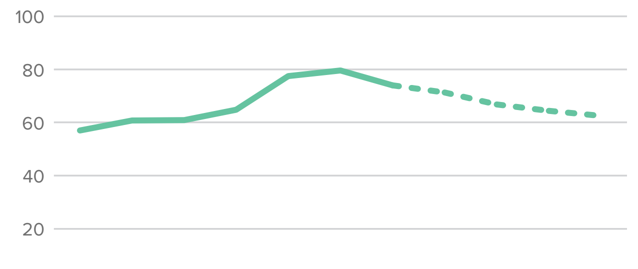
Despite sluggish growth of exports, the trade balance remains negative



Pakistan is witnessing the highest inflation rate (annual percent change)



Almost 74% of GDP is financed by general government gross debt



MACROECONOMY

GDP at Current Prices
347.74 (USD in billion) in 2022

Real GDP Growth Rate
4% in 2022

Total Debt & Liabilities
53544.3 (PKR in billions) Quarter 3-FY22

Fiscal Deficit
4% (as a % of GDP) Julu-March FY2022

FBR TAX Collection
4,375.6 (PKR in millions) Julu-March FY2022

Annual Inflation Rate
13.4% April 2022

Subsidies
459,289 (PKR in millions) 2021-22

Tax Revenue
12 (as a % of GDP) FY2022 B.E.

Forex Reserves
17,426.4 (USD in billions) March 2022

Current Account Deficit
13.2 (USD in billion) July-March FY2022

Foreign Direct Investment
2,161.9 (USD in million) July-March FY2022

Worker Remittances
2810.28 March 2022

BALANCE OF TRADE

Exports (BOP)
3154 (USD in millions) April 2022

Imports (BOP)
6001 (USD in millions) April 2022

Balance of Trade (BOP)
-2,847 (USD in millions) April 2022

INFLATION (ANNUAL %)

National	Food and Non-Alcoholic Beverages	Housing, Water, Electricity, Gas, and Other Fuels	Furnishing and Household Equipment Maintenance	Transport
13.8	17	7.1	14.7	28.3
2% Annual Compound Growth (April 2021-April 2022)	1% Annual Compound Growth (April 2021-April 2022)	-3% Annual Compound Growth (April 2021-April 2022)	4% Annual Compound Growth (April 2021-April 2022)	13% Annual Compound Growth (April 2021-April 2022)

Major Challenges

Although the economy of Pakistan achieved a GDP growth of 5.6 percent in FY2021, the fiscal situation and external sector performance are making it difficult to sustain and are impacting growth outlook. The country faces several challenges: