ADB

Concept Paper

Project Number: 52049-001
September 2018

Proposed Programmatic Approach and Policy-Based Loan for Subprogram 1 Islamic Republic of Pakistan: Trade and Competitiveness Program

Asian Development Bank

CURRENCY EQUIVALENTS
(as of 1 July 2018)

Currency unit	–	Pakistan rupee/s (PRe/PRs)
PRs1.00	=	$0.00823
$1.00	=	PRs121.55

ABBREVIATIONS

ADB	–	Asian Development Bank
GDP	–	gross domestic product
IMF	–	International Monetary Fund

NOTES

(i) The fiscal year (FY) of the Government of Pakistan ends on 30 June. “FY” before a calendar year denotes the years in which the fiscal year ends, e.g., FY2017 ends on 30 June 2017.

(ii) In this report, "$" refers to United States dollars.

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PROGRAM AT A GLANCE

1. Basic Data			**Project Number:** 52049-001
Project Name	Trade and Competitiveness Program (Subprogram 1)	**Department/Division**	CWRD/CWPF
Country	Pakistan	**Executing Agency**	Ministry of Finance
Borrower	Government of Pakistan		

2. Sector	**Subsector(s)**	**ADB Financing ($ million)**
✓ **Public sector management**	Economic affairs management	400.00
	Total	**400.00**

3. Strategic Agenda	**Subcomponents**	**Climate Change Information**	
Inclusive economic growth (IEG)	Pillar 1: Economic opportunities, including jobs, created and expanded	Climate Change impact on the Project	Low
Regional integration (RCI)	Pillar 2: Trade and investment		

4. Drivers of Change	**Components**	**Gender Equity and Mainstreaming**	
Governance and capacity development (GCD)	Institutional development	Some gender elements (SGE)	✓
Partnerships (PAR)	Implementation International finance institutions (IFI)		
Private sector development (PSD)	Conducive policy and institutional environment		

5. Poverty and SDG Targeting		**Location Impact**	
Geographic Targeting	No	Nation-wide	High
Household Targeting	No		
SDG Targeting	Yes		
SDG Goals	SDG8		

6. Risk Categorization: Complex

7. Safeguard Categorization **Environment:** C **Involuntary Resettlement:** C **Indigenous Peoples:** C

8. Financing

Modality and Sources	**Amount ($ million)**
ADB	**400.00**
Sovereign Program (Concessional Loan): Ordinary capital resources	400.00
Cofinancing	**0.00**
None	0.00
Counterpart	**0.00**
None	0.00
Total	**400.00**

I. THE PROPOSAL

1. To aid the recovery of the current account deficit and promote macroeconomic stability and sustained high growth, the proposed Trade and Competitiveness Program aims to encourage trade, increase exports, and improve the competitiveness of domestic industries in Pakistan. Macroeconomic stability, in turn, implies stronger resilience to adverse economic shocks. This is of critical importance in Pakistan as the country pursues increased global competitiveness and prosperity to become one of the top 10 largest economies by 2047 as part of Vision 2025.[1] The program will (i) introduce important tariff and tax policy reforms to support Pakistan's exporting industries and improve their competitiveness internationally; and (ii) strengthen key institutions involved in facilitating trade, including accreditation bodies and operationalization of the EXIM Bank of Pakistan and the National Single Window. The program is consistent with the Asian Development Bank (ADB) country partnership strategy for Pakistan, 2015–2019 and is included in the country operations business plan, 2018–2020.[2] The programmatic approach will finance two subprograms to be implemented during 2018–2019, enabling a degree of flexibility in aligning policy actions with the updated macroeconomic situation.[3] Transaction technical assistance will be provided for program preparation and implementation (accessible from the list of linked documents in appendix 3).

II. PROGRAM AND RATIONALE

A. Background and Development Constraints

2. Economic growth has continued to strengthen in Pakistan but will be difficult to sustain given current macroeconomic challenges. Growth has increased from 5.3% in FY2017 to 5.6% in FY2018 (the highest since the global financial crisis in 2008–2009), although growth remains relatively low when compared regionally.[4] Growth has been supported by lower oil prices, investments related to the China–Pakistan Economic Corridor, strong credit growth, and consumption. The growth outlook is positive at 5.1% in FY2019; however, macroeconomic stability is at risk from the rapidly increasing current account deficit and depleting foreign exchange reserves. Imports are highly correlated with growth because of the lack of production inputs, oil, and consumer goods in the country. Furthermore, current exchange rate and fiscal policies are constricting the competitiveness of domestic industries and worsening the trade balance. The budget deficit widened to 5.8% of gross domestic product (GDP) in FY2017 from 4.6% in FY2016 because of greater development expenditure and tax revenue shortfalls, contributing to increased domestic demand (including for imports).

3. The current account deficit has widened as imports surged and exports declined, putting pressure on the balance of payments. Pakistan's current account deficit expanded to a new high of $18.0 billion in FY2018 (6% of GDP), a more than threefold increase from FY2016 (Table 1). The trade deficit has increased rapidly because of increasing imports from investments and consumer goods related to the China–Pakistan Economic Corridor, slowing international remittance growth, weak demand for exports, and long-term decline in Pakistan's export competitiveness. By maintaining a mostly fixed nominal exchange rate against the US dollar, the

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[1] Government of Pakistan; Ministry of Planning, Development and Reform. 2014. *Pakistan 2025: One Nation–One Vision*. Islamabad.
[2] ADB. 2015. *Country Partnership Strategy: Pakistan, 2015–2019.* Manila; and ADB. 2017. *Country Operations Business Plan: Pakistan, 2018–2020.* Manila.
[3] An initial draft of the design and monitoring framework is in Appendix 1.
[4] ADB. 2018. *Asian Development Outlook 2018*. Manila.

Pakistan rupee was estimated 10%–18% overvalued in July 2017, which has increased demand for imports and reduced the price competitiveness of exports.[5] Pakistan's export–GDP ratio of 8.2% in 2017 is far below the regional average of 17.7%.[6]

4. Pakistan's gross reserves fell from $19.4 billion at the end of FY2016 to $11.4 billion at the end of FY2018 (Table 1)—2 months of import cover. Reserves have declined because of increasing current account deficit, intervention to maintain the overvalued exchange rate, and increasing debt service on borrowed reserves. Rebuilding of reserves is essential to strengthen buffers against external shocks. The Pakistan rupee–US dollar exchange rate was devalued by 10% in the first half of 2018 but has had limited effect on the decline of reserves.

Table 1: External Sector Indicators ($ million)

Item	FY11	FY12	FY13	FY14	FY15	FY16	FY17	FY18
Current account balance	214	(4,658)	(2,496)	(3,130)	(2,795)	(4,867)	(12,621)	(17,994)
Balance on trade in goods	(10,427)	(15,652)	(15,355)	(16,590)	(17,267)	(19,283)	(26,680)	(31,074)
Exports of goods	25,369	24,718	24,802	25,078	24,090	21,972	22,003	24,772
Imports of goods	35,796	40,370	40,157	41,668	41,357	41,255	48,683	55,846
Balance on trade in services	(2,029)	(3,305)	(1,564)	(2,650)	(2,970)	(3,406)	(4,339)	(5,171)
SBP gross reserves	16,614	11,905	7,198	10,509	14,836	19,446	17,550	11,364
Average exchange rate (Pakistan rupee−US dollar)	85.50	89.24	97.24	102.86	101.29	104.24	104.69	109.84

( ) = negative, SBP = State Bank of Pakistan.
Note: Exports and imports of goods are free-on-board values.
Source: State Bank of Pakistan database (http://www.sbp.org.pk/ecodata/index2.asp).

5. Low competitiveness of domestic industries is a core problem and is constraining trade and investment. To reduce import demand and counteract the widening trade deficit, the government has increased import tariffs and duties on intermediate, machinery, consumer, and luxury goods. For example, the government has (i) increased customs duty from 0% to 3%–5% on machinery since 2013, and (ii) doubled the regulatory duty on iron and steel imports to 30% in 2016. Average tariffs remain high and the tariff structure has become more complex, reversing the progress of previous tariff simplification efforts.[7] These trade tax policies increase costs to producers and have a negative impact on the competitiveness of domestic industries that depend on imported intermediary goods and machinery to produce more sophisticated products for export. Domestic taxes have been set at high rates to raise additional revenue to mitigate fiscal expansion but are lowering competitiveness. Corporate tax rates are high at 34% and goods and services tax rates are 17%, resulting in a high tax burden and cost of doing business and a high price of export goods. Diesel fuel (a key source of energy for industry in Pakistan) is levied with 34.5% sales tax and duties, and firms face high electricity tariffs, eroding the economic competitiveness of industry, transport, and agriculture.

6. The long-term decline in Pakistan's share of global trade has been driven by poor trade facilitation, infrastructure gaps, poor investment climate, and lack of trade openness, reducing its prospects of regaining momentum in export growth. Pakistan ranks 115 out of 137 in the Global Competitiveness Index 2017–2018,[8] below its South Asian neighbors.[9] Foreign direct investment

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[5] International Monetary Fund. 2017. Pakistan: Article IV Consultation. *Country Report.* No. 17/212. Washington, DC.
[6] World Bank. World Development Indicators (accessed July 2018).
[7] The trade regime was significantly liberalized during 1997–2003 with simplification of and steep cuts in import tariffs. These policies were reversed in 2008 as the external current account worsened during the global financial crisis. Maximum tariff rates were raised, the number of tariff slabs was increased from four to nine, and ad hoc exemptions were provided. Government of Pakistan, Planning Commission. 2011. *Framework for Economic Growth*. Islamabad.
[8] World Economic Forum. 2017. *The Global Competitiveness Report 2017–2018.* Geneva.
[9] India ranks 39, followed by Sri Lanka (71), Bhutan (97,) Nepal (98), and Bangladesh (106).

has remained relatively low at 0.92% of GDP in 2017 despite increased government infrastructure spending, and manufacturing output as a share of GDP has declined from 14.5% in 2012 to 12.0% in 2017 (footnote 6). Private investment has not picked up because of the uncompetitive economic environment and high cost of doing business. The narrow tax base for direct taxes and expanding budget deficit have given incentive to increase taxes on international trade and indirect regressive taxes.

7. Pakistan is losing competitiveness in exports because of a growing concentration in goods with low sophistication and low value added. Pakistan has a complexity index value of –1.07, ranking 74 out of 89 countries, which indicates it has the lowest level of export sophistication and diversity among its competitors.[10] Pakistan is competing with lower-income countries exporting low-tech products at more competitive wage rates, and its share of high-tech products is less than 2% of total exports. Textiles comprised 55% of Pakistan's goods exports in FY2018; however, these are largely low-value products (e.g., cotton yarn, cotton cloth, knitwear).[11] High tariffs and restrictions on the import of synthetic fibers and products are restricting Pakistan manufacturers from producing synthetic textiles (e.g., including finished garments), which are higher up the value chain and growing in global demand.

8. The institutions and bodies established to provide essential trade-related services to exporters have inherent weaknesses, which is negatively affecting trade facilitation and Pakistan's competitiveness. Institutions responsible for metrology and product testing, certification services for export product quality, accreditation services for testing bodies, intellectual property rights enforcement, and establishment of special economic zones play a critical role in trade facilitation and competitiveness. Exports of many agricultural commodities suffer because of poor testing and certification facilities. Inadequate trade finance services can be improved by establishing a stronger legal and regulatory framework and increasing the availability of finance (e.g., through operationalizing the EXIM Bank of Pakistan).

B. Policy Reforms and ADB's Value Addition

9. The proposed reform areas are as follows: (i) tariffs and taxes rationalized;[12] and (ii) institutions strengthened. The reforms are linked to the government's proposed strategic trade policy framework, 2018–2023.[13] The new government is expected to endorse the framework by October 2018. Given extensive experience in designing and implementing policy-based loans in Pakistan and the region in similar policy areas, ADB is well prepared to design and implement the program, incorporating lessons from previous experiences and results from detailed diagnostic studies.[14] The structural reforms should take a phased approach to be implemented effectively, e.g., the introduction of tariff and tax policy reforms requires sufficient preparatory and implementation time. Thus, it is critical that reforms are properly identified and sequenced. A programmatic approach is ideal for chronologically sequencing the reforms in a multiyear program. This also enables a degree of flexibility in aligning policy actions with the updated macroeconomic situation and exogenous shocks.

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[10] The economic complexity index analyzes the mix of products a country can produce (The Observatory of Economic Complexity. Pakistan.)

[11] State Bank of Pakistan. Economic Data.

[12] The tariff and tax rationalization exercise will avoid putting excessive burden on government finances and will not encourage unproductive and non-targeted subsidies. However, some loss of revenue in the short run is inevitable.

[13] Dialogue is ongoing between the ADB team and the government to finalize detailed reform areas and policy actions.

[14] ADB has approved 19 policy-based loans for Pakistan during 2008–2017.

10. The ADB program team has been coordinating with development partners in Pakistan to identify key structural reform areas that are important to accelerate and sustain medium-term growth, including reforms for improving trade and competitiveness.[15] The International Monetary Fund (IMF) completed the extended fund facility program in September 2016.[16] The World Bank is currently processing a loan to support the implementation of actions under the strategic trade policy framework 2018–2023.

C. Impacts of the Reform

11. The overarching development priorities of the country as articulated in Vision 2025 include enhancing economic benefits from trade. The effect of the reform program will be improved competitiveness and increased exports. Reforms will be allocated to subprograms 1 and 2 based on the most efficient sequencing of reforms to achieve the desired effect of the program.

D. Development Financing Needs and Budget Support

12. To support the government's growing development financing needs from an increasing budget deficit and to effectively support the cost of implementing the reforms over 2018–2019, $700 million equivalent will be allocated to the program ($400 million for subprogram 1 and $300 million for subprogram 2). The government will incur significant adjustment costs from the reforms, including (i) loss of revenue in the short run because of rationalization of tariffs and taxes; (ii) costs associated with implementing and operating the National Single Window system for exporters and importers; and (iii) financing of EXIM Bank of Pakistan capital and the National Interest Account.[17] The loan will be provided through ADB's concessional ordinary capital resources. Given the high fiscal deficit it would be extremely difficult for GOP to incur additional reform related costs unless important discretionary developmental expenditures are cut from the budget. Therefore, ADB's program support for enabling the proposed reforms is critical.

E. Implementation Arrangements

13. The Economic Reforms Unit of the Ministry of Finance will be the executing agency. The Ministry of Finance, the Federal Board of Revenue, and the Ministry of Commerce and Textiles will be the implementing agencies. The proceeds of the policy-based loan will be withdrawn in accordance with ADB's *Loan Disbursement Handbook* (2017, as amended from time to time).

III. DUE DILIGENCE REQUIRED

14. Due diligence to be carried out during the program preparatory work is summarized as follows:

(i) **Safeguards.** The direct and indirect impacts of the proposed policy actions on the environment, involuntary resettlement, and indigenous peoples, if any, will be assessed.

(ii) **Economic.** The economic viability and sustainability of the program will be assessed, and the economic benefits and reform costs will be evaluated.

(iii) **Governance.** Public financial management, procurement, anticorruption, and capacity issues and mechanisms will be agreed with the government as part of the

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[15] Development partners include ADB, Department for International Development (of the United Kingdom), International Monetary Fund, United States Agency for International Development, and the World Bank.

[16] The IMF has expressed concerns over rapidly depleting reserves. IMF. 2018. Pakistan: First Post-Program Monitoring Discussions. *Country Report.* No. 18/78. Washington, DC.

[17] The establishment and funding of the National interest account will backstop EXIM Bank's underwriting abilities.

program design.

(iv) **Poverty and social.** No poverty or social issues requiring specific attention were identified. The program impact will benefit the poor from improved employment opportunities in the supported sectors. To promote gender inclusiveness, gender impacts will be examined carefully.

IV. PROCESSING PLAN

A. Risk Categorization

15. Both subprograms are categorized *complex* since each loan exceeds the $50 million threshold.

B. Resource Requirements

16. ADB staff (8 person-months) with expertise in the public management and finance sectors will process the program. The program will require a staff consultant (6 person-months) to support diagnostic analysis and implementation of some policy actions under subprogram 1. A technical assistance grant of $750,000 from ADB's Technical Assistance Special Fund (TASF-6) will support effective preparation and implementation of subprogram 2 policy actions, including technical support and capacity building.[18]

C. Processing Schedule

17. Table 2 lists the major milestones.

Table 2: Proposed Processing Schedule

Milestone	Expected Completion Date
Fact-finding mission	September 2018
Management review meeting	October 2018
Loan negotiations	November 2018
Board consideration	December 2018
Loan signing	December 2018
Loan effectiveness	December 2018

V. KEY ISSUES

18. The key issues are as follows: (i) the government will need extensive capacity development support to implement the proposed policy actions (especially those in the second subprogram), making the technical assistance very important; (ii) the government will need to comply with all subprogram 1 policy actions before the report and recommendation of the President is circulated to the Board; and (iii) ADB will need to ensure effective development partner coordination, especially with the IMF.

[18] Technical Assistance for Program Preparation (accessible from the list of linked documents in Appendix 3).

DESIGN AND MONITORING FRAMEWORK

(Initial Draft)

Country's Overarching Development Objectives Economic benefits from trade enhanced (Vision 2025)[a]			
Results Chain	**Performance Indicators with Targets and Baselines**	**Data Sources and Reporting**	**Risks**
Effect of the Reform Improved competitiveness and increased exports	To be accomplished by 2020: a. Pakistan Global Competitiveness Index goods market efficiency pillar score improved by at least 0.2 points (2018 baseline: 4.0) b. Total annual goods export value increases by 20% (FY2018 baseline: $24.77 billion)	a. World Economic Forum Global Competitiveness Index b. State Bank of Pakistan data	Global or regional economic slowdown leads to lower export demand.
Reform Areas 1. Tariffs and taxes are rationalized	**Indicative Policy Actions** By 2019: 1.1 Regulation approved by MOF reducing tariffs, regulatory duties, and taxes on machinery and raw material imports (2018 baseline: not approved) 1.2 Regulation approved by MOF (i) reducing the 34.5% goods and services tax on diesel and (ii) reducing the cumulative corporate tax rate (2018 baseline: not approved) 1.3 Regulation approved by the government to rationalize electricity tariffs for industrial use (2018 baseline: not approved)	1.1 State Bank of Pakistan data 1.2–1.3 National budget documents	Unexpected external factors or urgent domestic issues cause delays in implementing critical reforms.
2. Institutions strengthened	2.1 Government approved Pakistan National Accreditation Act, 2017 to (1) reconstitute the Board of Directors of PNAC to (i) include professionals, having sector expertise and scientific knowledge; (ii) restricting the Ex-officio Board Members to 1/3rd of total Board members; (iii) ensure at least one female Board member; and (iv) Fix the term for each member to three years (other than ex-officio members); and (2) empower the Board of Governors to recommend three candidates to the Federal Government for appointment of one of them as the Director General / Chief	2.1–2.5 Annual reports of MOF, PNAC, Ministry of Trade, and EXIM Bank of Pakistan.	

Results Chain	Performance Indicators with Targets and Baselines	Data Sources and Reporting	Risks
	Executive Officer of PNAC (2018 baseline: not implemented) 2.2 Government approved long-term plans, policies and schemes of PNAC as required under the Section 8 of the Pakistan National Accreditation Act, 2017 (2018 baseline: not implemented) 2.3 Government approved the legal framework for the National Single Window (2018 baseline: not implemented) 2.4 Government submitted the draft EXIM Bank Act for legislation (2018 baseline: not implemented) 2.5 Government approved EXIM Bank's (i) governance structure; (ii) business plan; and (iii) establishment and capitalization of the National Interest Account provisioning for GOP's full faith and credit support to EXIM Bank (2018 baseline: not implemented)		

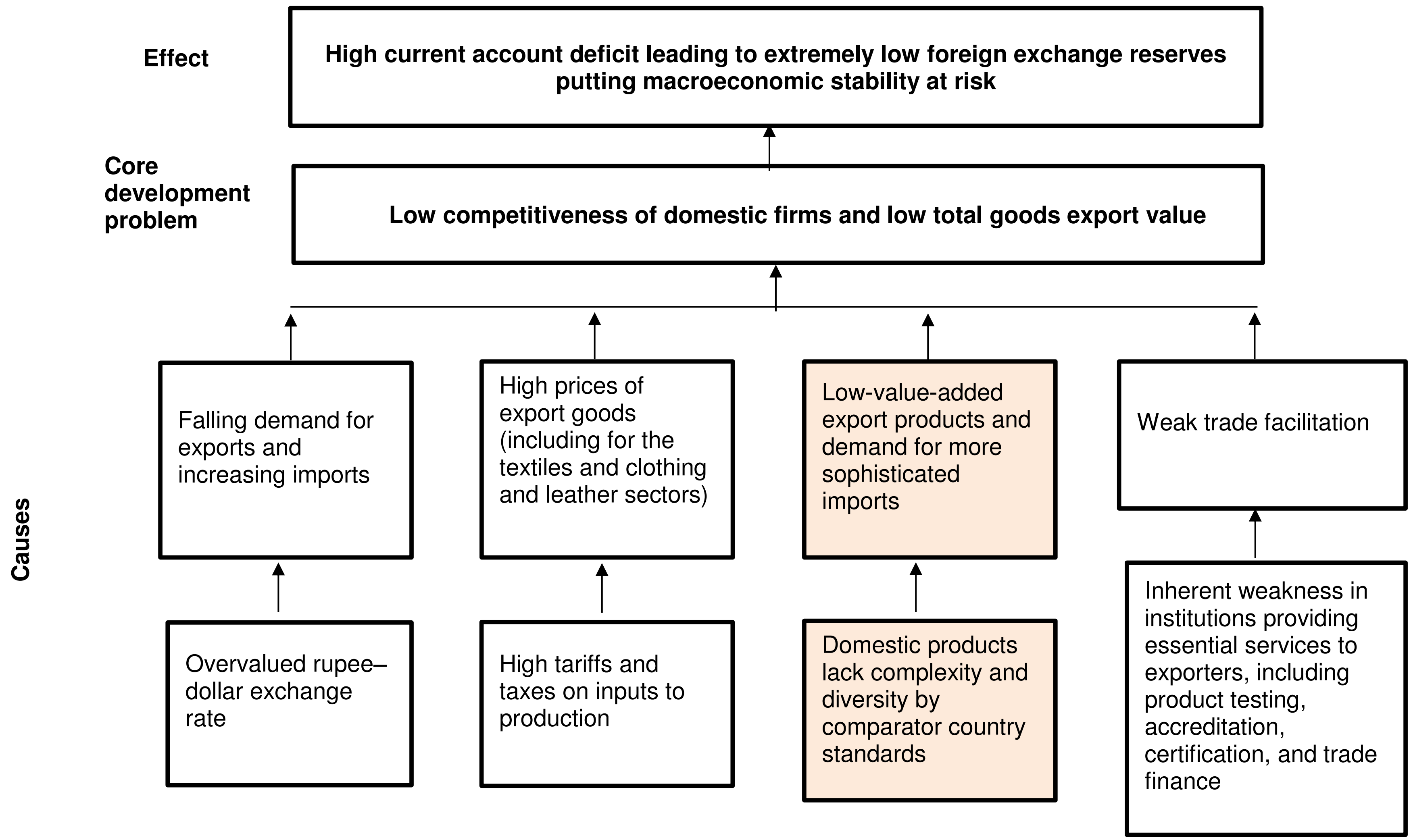
Budget Support ADB: $700 million (concessional ordinary capital resources loan) and $750,000 (technical assistance)

ADB = Asian Development Bank, FY = fiscal year, GOP = Government of Pakistan, MOF = Ministry of Finance, PNAC = Pakistan National Accreditation Council.

[a] Government of Pakistan; Ministry of Planning, Development and Reform. 2014. *Pakistan 2025: One Nation–One Vision*. Islamabad

Source: Asian Development Bank.

PROBLEM TREE



Note: Cause in shaded box will not be directly addressed by the program but will be supported indirectly through tariff rationalization by reducing the cost of intermediate goods used in the production of higher-value products.

LIST OF LINKED DOCUMENTS

http://www.adb.org/Documents/LinkedDocs/?id=52049-001-ConceptPaper

1. Initial Poverty and Social Analysis
2. Technical Assistance for Program Preparation