ECONOMIC AND FINANCIAL ANALYSIS

A. The National Economy

1. **Macroeconomic trends**. Pakistan experienced strong economic growth, with a compound annual growth rate of 5.1% during 2001–2007; growth fell to 3.8% during 2008–2015 because of a challenging investment climate, political instability, weak (but recently improving) fiscal discipline and public sector governance, and an unresolved energy crisis. A comparison of South Asian countries conducted by the World Economic Forum confirms that Pakistan's economic environment is inferior to its regional peers,[1] as a result of high political and policy instability, poor infrastructure (especially an unstable power supply), corruption, and government inefficiency. Pakistan's business climate is hampered by political instability, corruption, and poor private access to bank finance. Despite having a modern banking system, Pakistan's financial intermediation remains low and is deteriorating compared to that of its regional peers. The ratio of domestic credit to the private sector to gross domestic product (GDP) was just 15% in 2015, down from 28% in 2007. As a result, a massive surge of public sector borrowing undermines private access to affordable credit. Financial inclusion remains very low and access to credit is worsening; only 3% of adults have loan accounts, and 30% have deposit accounts.[2]

2. **Structure of the economy.** The economy is driven by a resilient services sector, representing 56% of GDP. The sector grew by 5.6% during 2001–2007, and 4.6% during 2007–2015. Industrial output represents only 19.0% of GDP, and the sector is impacted by power supply and connectivity issues. Industrial sector growth was 7.2% during 2001–2007, but declined to 3.1% during 2007–2015. Agriculture's share of GDP remained stable (26% of GDP in 2000 and 25% in 2015), with stable growth of 2.9% during 2001–2007 and 2.8% during 2007–2015. Pakistan draws particular strength from the resilience of its informal economy, including subsistence farming. Remittances have been a significant source of foreign exchange and income, amounting to about 6% of GDP.

3. Gross fixed investment from the public and private sectors is a key determinant of growth. Gross fixed investment in the public sector was 3.8% of GDP in FY2016 (about $10.8 billion), up slightly from 3.5% in FY2014. Over the same period, GDP growth averaged 4%, or about 3% less than growth needed to absorb the increasing labor force.[3] Pakistan's population grew by 35 million from 2000–2012, reaching 179 million in 2012; the urban population in large cities has grown by 3.0% annually, while the urban population in cities of less than 1 million has grown at 2.2%. Poverty remains widespread; official estimates indicate 44% of the population lives below the poverty line in Pakistan, while 46% of the urban population lives in slums.

4. Microeconomic surveys of the investment climate provide insights on the extent to which infrastructure deficiencies constitute barriers to business. The World Bank Enterprise Surveys indicate that a large proportion of respondents view electricity, telecommunications, and transport as a major or severe obstacle to doing business.[4] Electricity is considered a major

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[1] World Economic Forum. 2015. *Global Competitiveness Report 2015–2016*. Geneva (September).

[2] International Monetary Fund. Access to Finance Database. http://www.imf.org (accessed on 27 August 2013).

[3] Government of Pakistan, Planning Commission. 2011. *Pakistan: Framework for Economic Growth* Islamabad., indicates Pakistan's economy must grow by 7%–8% annually to maintain the current level of unemployment and underemployment. Studies have shown that the elasticity of employment with respect to GDP growth is about 0.5; thus a 1 percentage point increase in the GDP growth rate produces a .5 percentage point increase in employment.

[4] World Bank. 2015. Enterprise Surveys: Pakistan (2013).

constraint by 75% of firms,[5] and the lack of electricity and other utilities hampers existing business and dampens investment. A survey of 650 small and medium-sized manufacturing enterprises in Pakistan also concluded that almost 80% were discouraged from making investments due to the uncertainty and unreliability of electricity services.[6] A similar effect also applies to other infrastructure bottlenecks, with increased investment in infrastructure needed to facilitate higher growth.

B. The Punjab Economy

5. Punjab has a population of 110 million people (over 53% of the country's total); about 68% of the population is under 30 years of age, and many of are entering labor force, which has been increasing by over 3% annually. In 2014–2015, total labor force participation was 48.6% (34.5% of men and 14.1% of women), and 45.6% of the population was employed (32.6% of men and 12.9% of women).[7] The unemployed population was 2.32 million (1.49 million men and 0.83 million women).

6. Annual investment requirements for infrastructure in Punjab are about $3.6 billion to $5.0 billion, which must be partly financed by the private sector, which has been investing in energy, telecom and other sectors.

7. The government can finance infrastructure shortfalls in several ways. It could implement tax and other reforms to increase revenues to finance public investments, or support state-owned enterprises to borrow by considering manageable debt levels. It can also expand private-sector investment by developing a PPP framework, which would also improve bankability and feasibility of infrastructure projects and overall investment.[8] To facilitate this, Pakistan has amended PPP policies to streamline procurement and bidding processes,[9] and the Punjab government has also developed a PPP Cell to show its commitment to engaging the private sector in the provision of infrastructure. To provide an enabling framework, the Punjab government has adopted a PPP law, issued a PPP policy, and prepared detailed guidelines for the main phases in the lifecycle of PPP projects.[10]

8. According to the PPP guidelines,[11] selection of a project under the PPP framework will be done through three interlinked economic analyses: (i) least-cost analysis, which serves to demonstrate that the project is the least-cost solution for meeting the incremental demand; (ii) economic internal rate of return, which is to guarantee that the project is economically feasible in accordance with ADB guidelines on financial management and analysis of projects; and (iii) value for money, which shows the savings (in net present value terms) from undertaking the

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[5] S. Straub and A. Terada-Hagiwara. 2010. Infrastructure and Growth in Developing Asia. *Asian Development Bank Economics Working Paper Series* No. 231. Manila. ADB.

[6] Asian Development Bank. 2012. *Infrastructure for Supporting Inclusive Growth and Poverty Reduction in Asia.* Manila.

[7] Ministry of Finance. *Pakistan Economic Survey 2015-16*.

[8] Nikkei Asian Review. 2017. ADB Economist looks To PPP for Infrastructure Needs. (1 April).

[9] Asian Development Bank. 2017. Meeting Asia's Infrastructure Needs. Manila.

[10] *Punjab Public-Private Partnership for Infrastructure Act, 2010, Policy for Public-Private Partnerships in Infrastructure*, approved by the Provincial Cabinet of Punjab on 19 August 2009, through Notification SO (CAB-II)1-6/2009, Services and General Administration Department (Cabinet Wing), Government of the Punjab. *Project Inception Guidelines for Public-Private Partnerships in Infrastructure*; *Project Preparation Guidelines for Public-Private Partnerships in Infrastructure*; *Transaction Execution Guidelines for Public-Private Partnerships in Infrastructure*; and *Punjab Public Private Partnership Act in 2014;* all approved by PPP Steering Committee on 12-04-2011

[11] http://ppp.punjab.gov.pk/sites/ppp.pitb.gov.pk/files/Project%20Preparation%20Guidelines_0.pdf

PPP framework. Adoption of a PPP framework brings additional benefits, such as (i) competitive procurement of the private party, (ii) strong performance incentives inherent in the structure of PPP projects, (iii) faster and more efficient construction of the project, (iv) reduced overall project costs by implementing a whole-of-life costing approach over the term of PPP agreements, (v) optimum allocation of project risks, and (vi) superior management and other skills of the private sector. These benefits will be further augmented by (i) supporting projects within and outside the PPP framework, (ii) additional private sector resources of various types generated as a result of the PPP adoption, (iii) more comprehensive cross-assessments by different institutions involved in the PPP business process, (iv) building of best practices of the institutions involved, and (v) development of overall institutional and human capacity.

9. The proposed project in Punjab will increase the financial resources of the provincial government to develop more PPP projects, and also attract much-needed capital from the private sector for infrastructure development. The $100 million in ADB support to augment Punjab VGF resources has the potential to attract additional funding of $200 million to $300 million for infrastructure development through PPPs over the project implementation period.[12] The leveraging impact of ADB support will further assist in bridging Punjab's infrastructure development financing gap.

C. Finance Sector and Infrastructure Financing

10. Pakistan's finance sector consists of 41 banks, which held PRs14.1 trillion of finance sector assets in 2015.[13] The asset base of nonbank financial institutions is relatively small (PRs78 billion), while other major finance sector participants include the National Savings Scheme (with a portfolio of PRs3.1 trillion), mutual funds (with net assets of PRs443 billion), insurance companies (with total premiums of PRs192 billion), and microfinance institutions (with loans of PRs93 billion). The State Bank of Pakistan regulates banks, development finance institutions, and microfinance institutions, while the Securities and Exchange Commission of Pakistan is the regulator for insurance companies, other nonbank financial institutions, and private pension funds. The Pakistan Mercantile Exchange is the country's futures commodity exchange. Pakistan has a single exchange system following the merger of the exchanges in Karachi, Lahore, and Islamabad in January 2016 into the Pakistan Stock Exchange. The exchange has generated positive momentum, and was included in the emerging market index (reclassified from frontier market) by MSCI in June 2017.[14] There were eight new equity listings and two new debt instruments listed in 2015. The corporate bond market is very small and slowly developing.

11. Banks are very liquid, with stable retail deposit funding that is reinforced by incoming overseas remittances. Banking deposits totaled PRs10.4 trillion at the end of 2015. However, banks traditionally provide limited benefits to the economy, because funding of the federal budget deficit through the purchase of government securities and loans absorbs a large part of bank funding, as reflected by the extremely low loan–deposit ratio, which averaged 48% in 2013–2015.

12. Banks are currently the major providers of commercial infrastructure financing. However, funding from banks has increased only moderately, from PRs276 billion in 2009 to PRs444

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[12] On the basis that average gearing offered by commercial banks for a PPP project may range from 60% to 70%.

[13] State Bank of Pakistan. 2016. Quarterly Performance Review of the Banking Sector (October–December, 2015).

[14] MSCI Emerging Markets Index is an index created by Morgan Stanley Capital International (MSCI) designed to measure equity market performance in global emerging markets. MSCI. Market Classification.

billion in 2015.[15] In 2015 commercial financing was concentrated in power (62%), which has well-established legal and regulatory frameworks and standard power purchase agreements, followed by telecommunications (16%), petroleum, and roads.

13. Financing of infrastructure projects through the capital market is not developed. Infrastructure financing is far below its potential because of (i) significant risks that the execution of agreements will be undermined by the prevailing unresolved circular debt in the energy sector; (ii) the traditional approach of banks, with a preference for asset-backed corporate loans rather than cash-flow-based project financing; and (iii) significant construction risks and uncertainty about the ability of projects to generate sufficient revenues to service their debt.[16]

14. To help address this gap, the State Bank of Pakistan (i) issued guidelines on infrastructure project financing,[17] and (ii) developed the structure for a special-purpose vehicle for infrastructure financing to enable the issuing of long-term bonds as well as *Shariah*-compliant *sukuk* bonds in the local market.[18] However, such structures have not fully penetrated the long-term financing market, and there have been very limited infrastructure bond issuances and placements in the past.

[15] State Bank of Pakistan. 2015. Quarterly Infrastructure Finance Review: Oct–Dec 2015.
[16] Circular debt represents the cash flow shortfall incurred by the Central Power Purchasing Agency, which limits its ability to service its debt to power suppliers, representing a high credit risk for commercial financiers.
[17] State Bank of Pakistan. Infrastructure Finance Review 2008-2012.
[18] *Sukuk* is an Islamic financial certificate, similar to a bond in conventional finance, which complies with *Sharia* or Islamic religious law.