PROGRAM INFORMATION DOCUMENT (PID)

CONCEPT STAGE

September 22, 2016
Report No.: 110032

Operation Name	Finance for Growth DPC
Region	SOUTH ASIA
Country	Pakistan
Sector	Finance & Markets / Financial Sector
Operation ID	P161136
Lending Instrument	Development Policy Financing
Borrower(s)	Ministry of Finance
Implementing Agency	Ministry of Finance
Date PID Prepared	22-Sep-16
Estimated Date of Appraisal	20-Jan-17
Estimated Date of Board	15-March-17
Approval	[ ]
Corporate Review Decision	[ ]
Other Decision *{Optional}*	N/A

I. Key development issues and rationale for Bank involvement

1. The Government is pursuing a comprehensive economic reform program, supported by development partners. Upon taking office in 2013, the new administration introduced a comprehensive reform program. Under this program, the government committed to adopt stabilization measures to eliminate the country's macroeconomic imbalances and initiate reforms needed for a more efficient economy. In its first three years, the government developed, and started to implement, ambitious reform agendas in a number of areas: an Energy Policy in August 2013, a privatization program in October 2013, a Tax Reform Strategy in February 2014, a 3-year plan for phasing out tax exemptions in June 2014, a plan for improving the investment climate in October 2014, a National Financial Inclusion Strategy in May 2015, a Tariff Rationalization Plan in March 2015 and the Doing Business Indictor Reform Plan 2016.

2. The Government of Pakistan (GoP) has sought to change the trajectory of growth with greater private sector development, which in turn will require much stronger financial intermediation. Raising private investment is crucial for the government's ambitions to accelerate growth. At present, investment stands at 15% of GDP in Pakistan; this is one of the lowest numbers for South Asia and also amongst other peer group countries. GoP is thus focusing on policy reforms at the federal and provincial levels to enhance the business and financial environment, including improving the legal framework and addressing constraints on

the private sector. Efforts to improve competitiveness at the provincial level are being supported by the World Bank through a number of projects, including the recently approved Punjab Growth and Competitiveness PforR, and the Bank is preparing a Financial Infrastructure and Inclusion Project (FIIP) to support Pakistan's recently adopted National Financial Inclusion Strategy.

3. Pakistan's low access to finance represents a serious impediment to inclusive growth. After years of steady growth, credit to the private sector declined markedly from 2008 to 2015, falling from 22 % of GDP in 2009 to just 15% in 2015. The decline in credit to SMEs was particularly pronounced, declining from 16% of bank lending in 2008 to just 7% in 2015. Against a backdrop of increasing non-performing loans in the past, slow demand from the private sector, and rising government borrowing, banks invested heavily in government securities, which now exceed private sector credit in banks' portfolios. As of June 30, 2016, government securities represented 47% of total bank assets, while private sector credit accounted for just 34% of total assets. The recent decline in interest rates on government securities has made this option less attractive to banks, and, this, coupled with stronger growth, has resulted in a modest increase in private sector credit in the past year.

4. The Government has shown strong commitment to pursuing a reform agenda which strengthens both the soundness and development of the financial sector. Analytical work conducted by both the Bank and the IMF in recent years have confirmed that weaknesses in basic financial sector infrastructure and in the legal and judicial framework have been amongst the factors that have discouraged lending to the private sector. The supply of credit has been depressed by, inter-alia, the absence of an appropriate insolvency framework, deficiencies in credit information, the lack of a secured transactions framework and electronic collateral registry for moveable collateral, and the inability to enforce collateral outside of the slow and unpredictable judicial system. Recent measures taken to redress these issues include amendments to the Financial Institutions (Recovery of Finance) Ordinance 2001 to improve the recovery of non-performing loans without court intervention, enactment of a new legal framework for secured transactions, passage of a new and strengthened Securities and Exchange Commission of Pakistan Act, and enhancements to the Credit Bureau Act.

5. The Bank has supported these reforms through a development policy financing engagement which has included the Fiscally Sustainable and Inclusive Growth DPC series and the Competitiveness and Growth DPF (a combination of DPC and PBG). Almost all of the financial sector legislative reforms implemented over the last 2-3 years have been Prior Actions in the Bank's policy engagement with the GoP. These reforms have strengthened the credit environment and should over time increase access to finance and reduce its costs. However, there is a need to complement these reforms with further efforts to strengthen, broaden and diversify the financial sector while improving governance and transparency.

6. The proposed Finance for Growth DPC directly supports key pillars of the Pakistan Country Partnership Strategy (FY15-19). Improved access to finance and an improved business

environment have been identified as key constraints to growth in Pakistan. The Program Development Objectives—promoting financial inclusion and improving governance and transparency of the financial sector—contribute both directly and indirectly to two pillars of the CPS—private sector development and inclusion. By reducing the obstacles to private sector growth, they also contribute to promoting shared prosperity in a sustainable manner.

II. Proposed Objective(s)

7. The proposed Finance for Growth DPC has two broad development objectives: (i) strengthen, broaden, and diversify the financial sector to promote financial inclusion; and (ii) improve governance and transparency of the financial sector.

8. The proposed operation contributes to the government’s strategy for accelerating economic growth through better access to credit and longer-term finance, improving the investment climate through a more robust Companies Act, promoting financial inclusion and increasing financial sector transparency.

III. Preliminary Description

9. The proposed Finance for Growth DPC aims to continue the aspirational trajectory of Pakistan’s economic reforms supported by the ongoing development policy financing engagement. The previous Fiscally Sustainable and Inclusive Growth DPC series and the Competitiveness and Growth DPF have contributed to broad-based macroeconomic reforms across fiscal stability, revenue mobilization, social protection, investment climate, and financial sector. The proposed Finance for Growth DPC focuses on deepening the financial sector policy reform engagement and contributing towards a robust, inclusive, and more transparent financial sector.

10. It consists of two pillars: the first pillar is to strengthen, broaden and diversify the financial sector, and the second pillar aims to improve governance and transparency in the financial sector. Both pillars are critical to create a dynamic financial sector, which can contribute to sustained and inclusive economic growth including by supporting and creating better enabling conditions for investment support operations that are being considered to enhance financial sector growth and intermediation in Pakistan. It focuses on reforms that will remove constraints to growth related to the financial sector’s role in effectively intermediating resources for investment and private sector development.

11. Under these pillars, the proposed operation will support the following specific policy areas:

i. In order to foster greater financial inclusion, (a) Approval of a Digital Transaction Accounts (DTA) scheme; (b) Initiation of a scheme of registered prize bonds; and (c) launch of a mechanism to distribute profits of National Savings Scheme (NSS) through the banking sector.

ii. Adoption of a new Companies Bill to modernize the regulatory framework
iii. Approval of the Corporate Rehabilitation Bill to improve the process of corporate rehabilitation and bankruptcy
iv. Enactment of the Deposit Protection Corporation Bill 2016
v. Approval of a National Policy on Infrastructure Finance to meet Pakistan's growing infrastructure needs, complemented by approval of the governance structure and business plan of the Pakistan Development Fund and issuance of prudential regulations for long-term finance
vi. Expansion of the export re-financing (ERF) scheme to a larger pool of borrowers including women entrepreneurs
vii. Completion of Corporate Governance Assessments of state-owned insurance companies
viii. Completion of the National Risk Assessment (NRA) for AML/CFT
ix. Approval of the Benami Transaction Bill (to prohibit unidentifiable financial transactions)
x. Creation of a unified Shariah Board for the financial sector

12. The reforms are based on solid analytical work, including (i) the National Financial Inclusion Strategy (NFIS) and its complimentary Technical Notes, and (ii) the FSAP Development Module and its 4 technical notes on Islamic Finance, Financial Sector Intermediation of Sources and Uses of Funds, Debt Capital Markets and Infrastructure Finance. Ongoing advisory and capacity building technical assistance on financial inclusion, insurance, anti-money laundering / combating financing of terrorism (AML/CFT) and state-owned enterprise reforms further informs the financial sector policy engagement under the proposed Finance for Growth DPC.

13. The Bank team continues to monitor the impact outcomes of the previous Fiscally Sustainable and Inclusive Growth DPC series and the Competitiveness and Growth DPF as it engages on the Finance for Growth DPC prior actions to ensure that they are aligned with the country's political developments, have counterpart and stakeholder support, and are feasible options for realizing the intended goals.

IV. Poverty and Social Impacts and Environment Aspects

Poverty and Social Impacts

14. The proposed operation supports sustained poverty reduction and shared prosperity. Greater financial inclusion can bring these people into the financial mainstream, with positive effects on economic growth, financial stability and social cohesion. Both theoretical and empirical studies have shown that financial exclusion inhibits human and physical capital accumulation, contributing to persistent income inequality and poverty. Building inclusive and transparent financial systems offer several welfare effects. These include increased access to financial services, lower costs, including through new technology; proportionate regulatory

framework that balances financial inclusion, integrity and stability; and focus on consumer protection and empowerment.

15. Growth, though volatile and low in some periods, has been quite pro-poor in Pakistan over the past decade and a half. The headcount poverty rate has fallen consistently over this period, from 34.7 percent in 2001/02 to 9.3 percent in 2013/2014 (using the latest survey data and the old poverty line). Using incidence curves that plot the growth rate in consumption at each percentile of the distribution, it is evident that growth has been pro-poor in Pakistan through much of this period. When growth first starts to rise, the incomes of those at the top of the distribution grow faster than the incomes at the bottom. However, this quickly reverses, with those at the bottom growing faster than the top of the distribution. Between 2001 and 2004, for example, median income grew at 4.8% while income at the bottom grew close to 3%. In the next period (2004-2008), the bottom grew at more than 5% while the median grew at only half that rate. After 2008, despite the global food price shock and the collapse of GDP growth, incomes at the bottom continued to grow faster than incomes at the top until 2010-11. In the period after that, as GDP growth began to rise once again, incomes at the top were growing faster than incomes at the bottom. Looking at the bottom 40 percent of the population—a measure of shared prosperity—we see a similar pattern.

16. Understanding the process driving inclusive growth is, however, an important and unfinished agenda. The Government's adoption of a revised methodology to measure poverty and the release of the new poverty line earlier this year, was an important move in the right direction. Using the new line, 29.5 percent of the population is considered poor and eligible for targeted poverty programs. Back casting the new poverty line, also confirms the past decline in poverty. The 2001-02 headcount rate using the new line is 64.3 percent. This has helped restore confidence in official government statistics and made it possible to design more effective anti-poverty programs. We now need to better understand the drivers behind successful poverty reduction over the last 15 years. Addressing the quality of national accounts data, will need to be a key aspect of this.

Environment Aspects

17. Actions proposed under this operation are not expected to have any negative effect on the environment.

V. Tentative financing

Source:	($m.)
Borrower/Recipient	0
International Development Association (IDA)	300
Others (specify)	
Total	300

VI. Contact point

World Bank
Contact: Gabi George Afram
Title: Program Leader
Tel: 92-51-9090221
Email: gafram@worldbank.org

Borrower
Contact: Dr. Waqar Masood
Title: Secretary Finance, Ministry of Finance
Tel: +92-51-9202373
Email: waqarmkn@yahoo.com

For more information contact:
The InfoShop
The World Bank
1818 H Street, NW
Washington, D.C. 20433
Telephone: (202) 458-4500
Fax: (202) 522-1500
Web: http://www.worldbank.org/infoshop