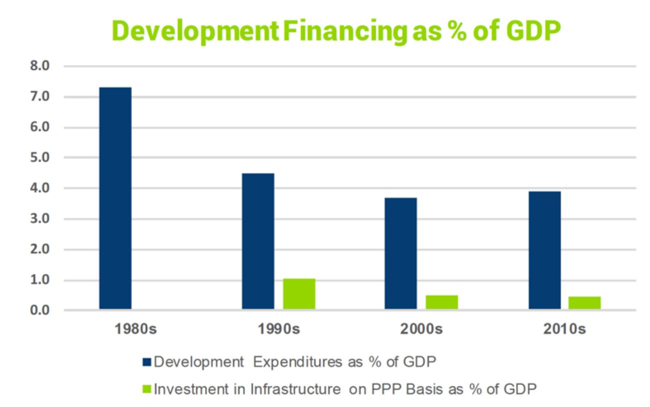
INFRAZAMIN PAKISTAN

INFRA ZAAVIYA

Podcasts Newsletter

Infra Zaaviya provides insights into the areas in which InfraZamin operates. Through those insights we are aiming to address the need for blended finance to support private investment at the scale required to meet the SDGs and develop local capital markets across Africa and Asia through blended finance long-term local currency credit solutions.

In Pakistan, most of the public sector infrastructure related development projects are financed through development expenditures of the three-tiered government system (Federal, Provincial and Local). The portion of the budget allocated for development spending, the Public Sector Development Program (PDSP), is controlled by a centralized Planning Commission, which assesses the feasibility of proposed infrastructure projects. The Planning Commission also approves provincial development projects for which the federal government allocates grants to the provinces.



There has been a general long-term trend of declining public sector expenditure on development projects. The deterioration of the fiscal balance has led to less public sector capital being allocated for development expenditure. Pakistan has one of the lowest tax-to-GDP ratios in the world and as a result, it has less revenue to spare on discretionary spending. To exacerbate the problem, it also has a high level of debt burden which increases debt servicing costs. The public sector interest payments amounted to 40.1% of revenue in 2020 while debt servicing cost reached 57.5% of the total revenue, in the same year. Thus, an increasing portion of the low revenue is spent on debt servicing which leaves a reduced share to be allocated for development expenditure

The pronounced decline in public sector expenditure on development projects has not been adequately substituted by the private sector. In fact, private investment on infrastructure, as a % of GDP, has contracted over time as well. Market failures such as non-existent and non-consistent policies in infrastructure disincentivise and impede private capital to flow into development financing. As a result, Pakistan has the lowest private sector gross fixed capital formation, as a % of GDP, amongst the regional players. The share of private sector investment in GDP growth has also persistently remained low.

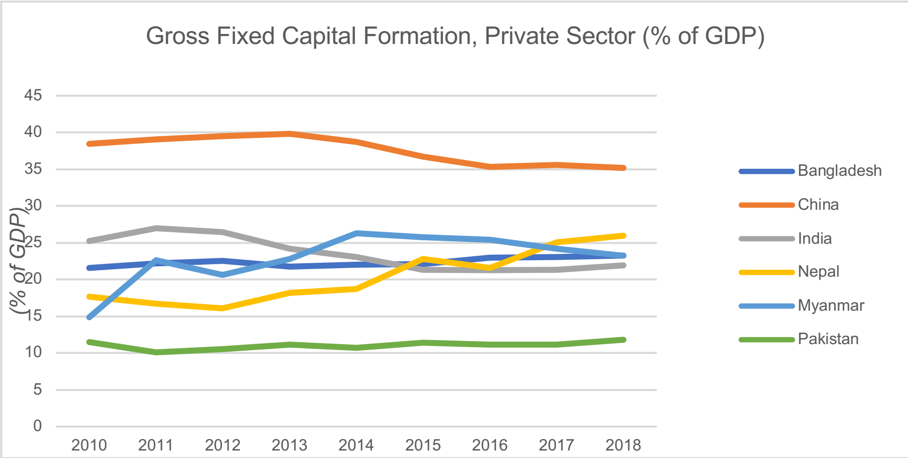


Figure 2. Source: The World Bank

Pakistan's banking landscape is highly skewed towards providing credit to the top corporate borrowers. In Pakistan, 64% of banks' balance sheet assets are commercial loans, however the top 20 corporate borrowers represent an overwhelming 30% of total lending in Pakistan (i.e., nearly 50% of total corporate lending). A further 26% of banking assets are loans to federal or state governments. This leaves only 9% of banks' balance sheets for lending to non-corporates and non-governmental entities (i.e., non-recourse project finance, consumer lending etc.), demonstrating severe financial exclusion in nearly all sectors.

The banking system also finances persistent government deficits and circular debt that crowds out private investment. Financed by increased borrowing, the fiscal deficits raise interest rates that in turn reduce private borrowing and spending. Thus, credit to private sector has stayed low, even below the global average, and so has private investment's share in GDP growth. The banking sector is highly liquid but is driven by traditional way of doing business and gravitating towards government and corporate guaranteed or 'safe' balance sheet-based lending, thereby further obstructing financial inclusion.

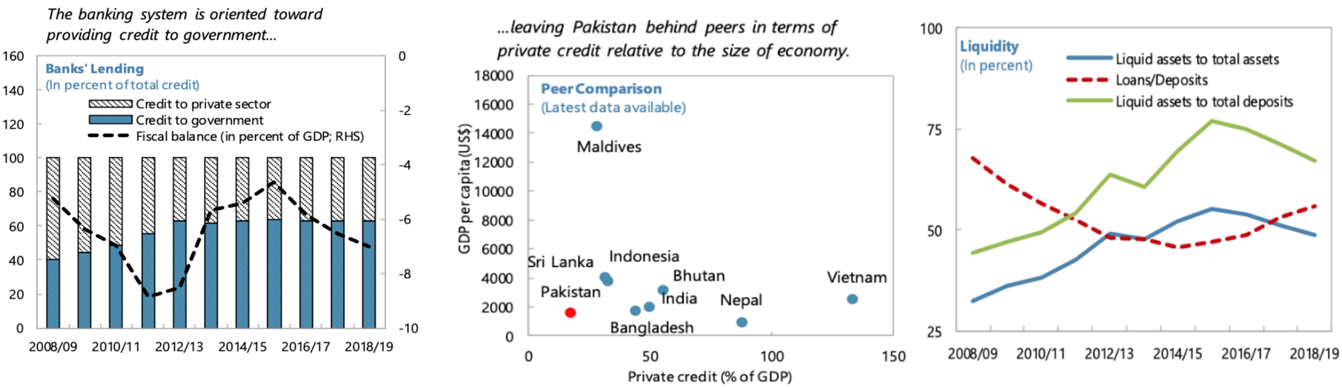


Figure 1: Source: IMF

Pakistan also relies heavily on external financing for its infrastructure needs, with financing coming from MLAs, IFIs and more recently Chinese development banks as part of China Pakistan Economic Corridor (CPEC). Majority of the present outstanding external borrowing belongs to "program loans". However, due to its external account vulnerability, Pakistan cannot sustainably rely on external financing for its infrastructure projects. The country has gone through repeated Balance of Payments crisis which puts a halt to its infrastructure spending, that relies on foreign currency borrowing. The external account, although in a gradual recovery, is still vulnerable and volatile.

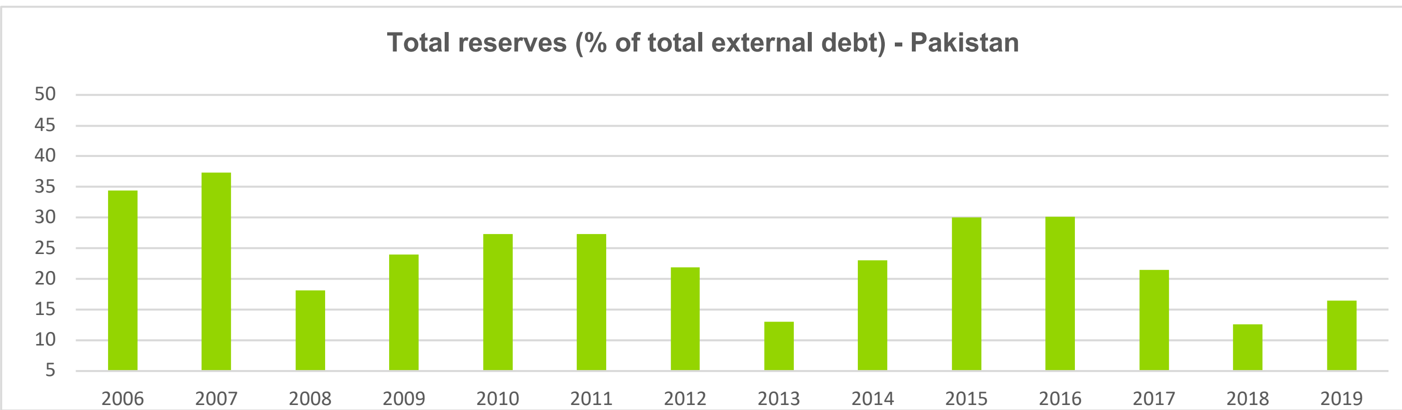


Figure 2 Source: The World Bank

This persistent underinvestment, by public and private sector, has led to a structural infrastructure gap. Oxford Economics estimates a gap of US$ 125 Billion between investment needs and the current trend from 2016 to 2040, across 7 sectors. According to the State Bank of Pakistan, the persistent infrastructure deficit contributes to a loss of 4-6% of GDP and increases cost of production by about 30%. As a result, Pakistan was ranked as 105th out of 141 countries, in physical infrastructure, by the World Economic Forum in its Global Competitiveness Report, in 2019.

Given these challenges, creating an investment environment that mitigates these risks and encourages investment for infrastructure projects, should be high on the priority list. Credit enhancements could serve this purpose. A credit enhancement facility can be very potent in promoting greater financial inclusion through its assumption of partial credit risk, thus making such projects bankable and investable as the case may be for its target financiers (banks, DFIs, AMCs, pension funds, corporates etc).

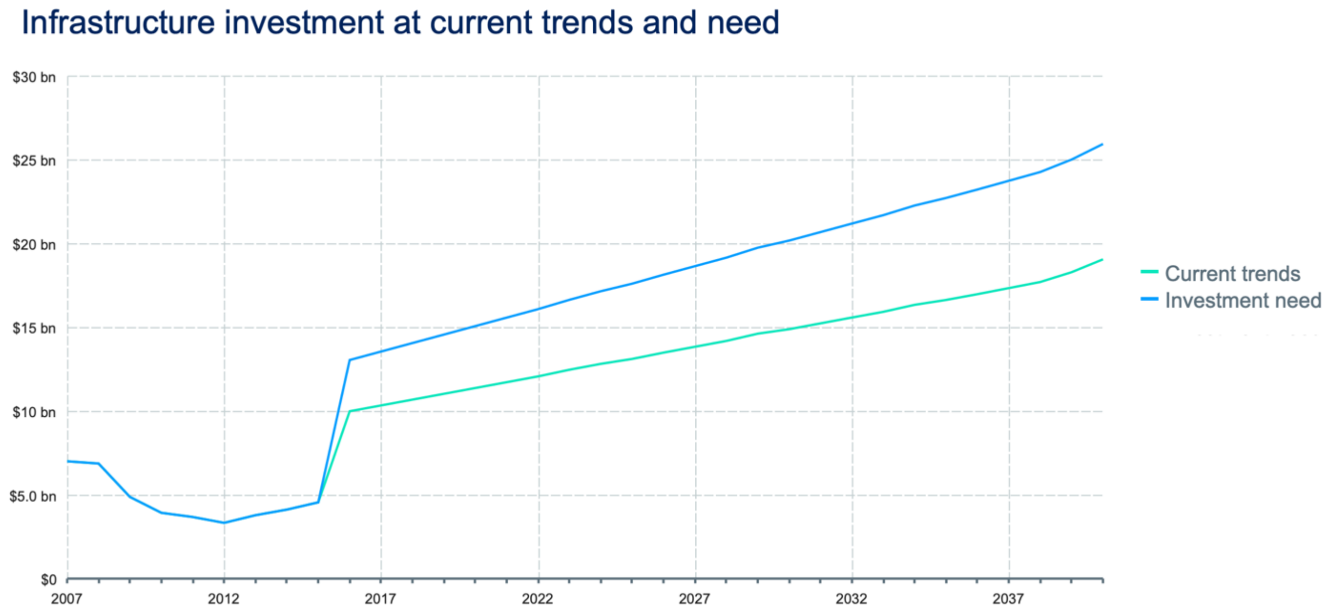


Figure 3. Soruce : Global Infrastructure Hub

Banks are looking to diversify their portfolio away from sovereign debt to securities with high interest rates and similarly low risk. Life insurance companies are seeking to add longer term assets in their portfolio, while state owned pension funds are looking to investment alternatives to government securities. A credit enhancement facility can assist this diversification by reducing risk and rendering the resultant debt instruments more creditworthy institutional and retail investors. By reducing the risk of private sector debt, credit enhancement can make it more attractive to a broader class of investors, thus facilitating the deployment of untapped pockets of liquidity into productive investments.

INVESTMENT NEED
US$ 480 BN

CURRENT INVESTMENT TRENDS
- US$ 355 BN

GAP
US $125 BN

A credit enhancement facility can also ease pressure on the external account by catalysing local currency capital for infrastructure financing. Pakistan has a persistent gap between its saving and investment rate, which means it imports capital to finance the S-I gap. The current account mirrors this S-I gap and thus due to persistent external deficits, the country repeatedly goes through sharp Balance of Payment crises. Credit enhancement can crowd in banks and other lending institutions into funding infrastructure locally. Local currency financing, especially with longer tenors, will reduce external volatility associated with a depreciating currency. Thus, credit enhancement can also help reduce reliance on external financing for infrastructure projects.