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AND THE

INTERNATIONAL DEVELOPMENT ASSOCIATION

AND THE

INTERNATIONAL FINANCE CORPORATION

COUNTRY ASSISTANCE STRATEGY

FOR

THE ISLAMIC REPUBLIC OF PAKISTAN

FOR THE PERIOD FY06-09

April 4, 2006

The last Country Assistance Strategy for Pakistan (Report No. 24114-PAK) was discussed on June 11, 2002 and a Country Assistance Strategy Progress Report (Report No. 28262-PAK) was discussed on April 20, 2004

CURRENCY AND EQUIVALENTS

Currency Unit = Pakistan Rupee
US\$1 = PKR 59.40

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ABBREVIATIONS AND ACRONYMS

AAA	Analytical and Advisory Activities	IDI	Long Distance and International
ADB	Asian Development Bank	LL	Local Loop
ADR	Alternative Dispute Resolution	MDG	Millennium Development Goals
AIDS	Acquired Immunodeficiency Syndrome	MIGA	Multilateral Investment Guarantee Agency
AJK	Azad Jammu Kashmir	MTBF	Medium Term Budget Framework
BMOs	Business Membership Organizations	MTDF	Medium Term Development Framework
CAE	Country Assistance Evaluation	NBP	National Bank of Pakistan
CAS	Country Assistance Strategy	NEPRA	The National Electric Power Regulatory Authority
CAS-PR	Country Assistance Strategy Progress Report	NEAS	National Education Assessment System
CBR	Central Board of Revenue	NGOs	Non-Governmental Organizations
CFAA	Country Financial Accountability Assessment	NWFP	North West Frontier Province
CGA	Controller General of Accounts	PDF	Pakistan Development Forum
CWIQ	Core Welfare Indicators Questionnaire	PEP-MENA	Private Enterprise Partnership for Middle East and North Africa
DCC	Donor Coordination Cell	PFM	Initial Public Offering
DFID	Department for International Development (UK)	PIFRA	Project to Improve Financial Reporting and Auditing
DPL	Development Policy Loan	PIHS	Pakistan Integrated Household Survey
EAD	Economic Affairs Division	PPAF	Pakistan Poverty Alleviation Fund
EBP	Enterprise Benchmarking Program	PPPS	Public-Private Partnerships
ERRA	The Earthquake Reconstruction and Rehabilitation Authority	PRSC	Poverty Reduction Support Credit
FSAP	Financial Sector Assessment Program	PRSP	Poverty Reduction Strategy Paper
GDP	Gross Domestic Product	PSCB	Public Sector Capacity Building
GEF	Global Environment Facility	PTCL	Pakistan Telecommunications Limited
GoP	Government of Pakistan	PSLSM	Pakistan Social and Living Standards Measurement Survey
GTZ	German Agency for Technical Cooperation	QAG	Quality Assurance Group
HIES	Household Income and Expenditure Survey	SAC	Structural Adjustment Credit
HIV	Human Immunodeficiency Virus	SME	Small and Medium Enterprise
IBRD	International Bank for Reconstruction and Development	TATF	Technical Assistance and Trust Funds
ICR	Implementation Completion Report	TMA	Tehsil Municipal Authorities
IDA	International Development Association	USAID	United States Agency for Int'l Development
IEG	Independent Evaluation Group	WAPDA	Water and Power Development Authority
IFC	International Finance Corporation	WEF	World Economic Forum
IMF	International Monetary Fund	WHO	World Health Organization
IPO	Initial Public Offering	WTO	World Trade Organization
IPP	Independent Power Producer	WSS	Water Supply and Sanitation
JBIC	Japan bank for International Cooperation		

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EXECUTIVE SUMMARY

i. The FY06-09 Country Assistance Strategy (CAS) has been prepared at a time of great opportunity for Pakistan. Since the beginning of the new millennium, Pakistan has managed a remarkable turnaround. During the 1990's Pakistan's progress in reducing poverty and improving the welfare of its people was not very encouraging as economic growth slowed and progress in improving social indicators stagnated. Beginning in 2000, the Government initiated a wide-ranging and ambitious reform program resulting in a dramatic turnaround. The FY03-05 CAS period witnessed the consolidation and acceleration of this turnaround with sustained implementation of a program of stabilization and wide-ranging structural reforms. Yet Pakistan's development challenges remain formidable. While provisional poverty estimates suggest that poverty declined between 2001 and 2005, the proportion of the population below the poverty line remains high. And despite recent indications of improvement, social and living standards remain well below countries with similar incomes and growth rates.

Development Challenges

ii. The key challenge for Pakistan is now to sustain its recent growth performance in order to generate significant poverty reduction. Sustained growth will require continued sound macroeconomic management along with further improvements in the investment climate. Pakistan's infrastructure platform needs significant investment in order to support Pakistan's growth and service delivery goals. For the poor to participate in and benefit from growth Pakistan needs to accelerate human development. While Pakistan is making progress, analysis suggests that it will be challenging to achieve the MDGs for infant mortality, child malnutrition, primary completion, and elimination of the gender gap in primary enrolment. Looking beyond the MDG's, enhancing competitiveness in an increasingly globalized and technology driven world economy will require a growing pool of workers with leading edge skills pointing to the need for increases in the level and quality of secondary, vocational and higher education. Thus, continued concerted efforts to address poor human development outcomes are important not only to improve equity but also as an integral part of achieving Pakistan's growth objectives.

Pakistan's Poverty Reduction Strategy

iii. Pakistan's poverty reduction strategy paper (PRSP) sets forth a broad-based strategy for addressing poverty in its various dimensions including human development, governance, and vulnerability and builds on the economic program first articulated in the fall of 1999 and further elaborated in the I-PRSP of 2001. The PRSP emphasizes policies to sustain rapid growth as the main vehicle for poverty reduction and is grounded on four pillars: (i) achieving and sustaining a high growth rate while maintaining macroeconomic stability, translating this higher growth into lower poverty, and bridging the social gap; (ii) improving governance and consolidating devolution, both as a means of delivering better development results and ensuring social and economic justice; (iii) investing in human capital, with a renewed emphasis on effective delivery of basic social services; and (iv) targeting the poor and vulnerable to bring marginalized sections of the population and backward regions into the mainstream of development, and to make marked progress in reducing existing inequalities. The PRSP's targets are fully aligned with the MDGs.

Bank Group Assistance Strategy

iv. In line with Pakistan's recent performance and the Government's request for increased Bank Group support, this CAS proposes a substantial increase in the volume of lending to Pakistan during the next four years.¹ The immediate priority will be to assist in addressing the impact of the October 2005 earthquake – up to US\$1 billion in IBRD/IDA commitments will be used to support reconstruction and recovery (US\$840 million in new commitments have already been approved). In addition, based on the

¹ In this report, the "Bank Group" refers to IBRD, IDA, IFC, and MIGA while the "Bank" refers to IBRD/IDA.

Government's priorities for sustaining growth and accelerating poverty reduction, the CAS envisions an expansion in lending in **infrastructure** (primarily energy, water, and transport) and **human development**. Bank Group program priorities will retain considerable continuity with the FY03-05 CAS, focusing on the areas which are most critical for poverty reduction. The three inter-linked and mutually reinforcing pillars of the CAS correspond to the strategic priorities of the PRSP: (i) sustaining growth and improving competitiveness; (ii) improving government effectiveness and service delivery; and (iii) improving lives and protecting the vulnerable.

Pillar I: Sustained Growth and Improved Competitiveness

v. The focus of this pillar of the CAS will be to support the investments and reforms needed sustain rapid, private sector-led growth. To help maintain the hard-won benefits of macroeconomic stability the Bank will provide support to help the Government strengthen economic management through improving the composition and effectiveness of public expenditures and supporting tax reforms. In agriculture, the focus of the Bank's work will initially be to support the preparation of a rural strategy, integrating issues related to agriculture, natural resource management, the rural non-farm economy, infrastructure, rural finance and the need for targeted interventions. In irrigation the Bank will support a combination of institutional reforms and investments throughout the system including major investments in rehabilitation of critical assets and reforms to improve the quality, efficiency, and accountability with which irrigation services are delivered. Recognizing that sustaining the current high rates of economic growth requires globally competitive production in an increasingly demanding world market, the Bank Group will also support reforms to improve the business environment.

vi. Infrastructure bottlenecks pose a significant threat to Pakistan's ability to sustain rapid growth. In the power sector the Bank Group will support further strengthening of sector governance to improve performance and attract private investment while at the same time helping to address a significant backlog in investment, particularly to address technical losses. In telecommunications the Bank will support adoption of measures to strengthen the policy and regulatory environment and possible investment support for accelerating the provision of rural telecommunication infrastructure. In transport, the Bank and the government will adopt a strategic approach focusing first on the National Trade Corridor linking Pakistan's major ports in the south with its major cities and trade corridors to the North. The key outcome sought would be significant reductions in the time and cost of moving goods through the Indus corridor. Investment and policy-based lending for highways, trade facilitation, ports and railways will be considered, with an emphasis on increasing private sector participation in operation and management. In the financial sector, the Bank Group will support further financial sector reforms to increase access to finance (especially for microcredit borrowers) and support further reforms with the aim of increasing the availability of longer term savings instruments.

Pillar II: Strengthened Governance and Service Delivery

vii. Improving government effectiveness is a central theme of the PRSP. Priorities in this area will be to support further reforms and investment to increase efficiency, transparency and accountability in the use of public resources. In public financial management, full implementation of the Project for Improved Financial Reporting and Auditing (PIFRA) will be the focus along with analytical support to assist in defining the agenda for further reforms in financial management at the federal and provincial levels. The Bank will also support the achievement of transparent and efficient public procurement through development policy lending, policy dialogue and capacity building. Working across sectors, the Bank Group will continue to support cross-cutting reforms to increase capacity and accountability of those responsible for service delivery; empower communities and clients through enhanced access to information on finances and performance; and build the capacity of both communities and governments. Work will also include support to further civil service reform and devolution as well as a stepped-up engagement in the urban sector to improve municipal service delivery, especially in the larger cities.

Pillar III: Improved Lives and Protection of the Vulnerable

viii. The PRSP recognizes that increased investment in human capital leading to significant improvements in education and health will be necessary to build the skilled, healthy work force necessary to sustain recent growth performance. The Bank strategy in education will continue to be focused on the provinces, using development policy credits to support policy and systemic changes as well as the other areas linked to education reform including decentralization and governance reforms. In health, at the national level, the Bank will concentrate on encouraging the Government to focus on public health functions (such as surveillance, quality control, monitoring and evaluation, and public information) while supporting the development and implementation of program and management reforms in the Lady Health Worker program as a way of expanding access to primary health care and family planning. The Bank Group will also support the piloting and evaluation of new approaches for service delivery and demand side interventions. Recognizing that a major focus of efforts in health must be at the provincial and local level, we will support major system reforms through planned provincial Development Policy Credits, beginning in NWFP.

ix. The PRSP recognizes that protection for the poor and vulnerable is a cornerstone of any poverty reduction program. The Bank's assistance for social protection will include support for safety nets that help the chronic poor cope with and, where possible, escape poverty, and help families and individuals cope with seasonal shocks and natural disasters. The Bank will also provide support for social security via improving formal sector pensions and consider innovative approaches to micro-insurance to address life cycle risks. Pakistan's PRSP recognizes that while rapid growth will be the main driver of poverty reduction, targeted interventions and community-based approaches to rural development are also required to address the immediate needs of the poor and vulnerable, especially in drought prone and flood stricken areas, and help them share in economic growth. The Bank will continue to support implementation of the Community Investment Programs in NWFP and AJK and look for possible expansion and replication opportunities. The Bank will also support the Government's newly announced program for rural poverty alleviation through social mobilization.

Delivering the World Bank Group Program

x. ***IBRD/IDA Lending.*** Pakistan's demand for World Bank financial support has grown to meet the needs of its growth and poverty reduction strategy and to address the impact of the October earthquake. To meet this demand a flexible IBRD/IDA lending program of up to US\$6.5 billion (approximately US\$3.1 billion IDA and US\$3.4 billion IBRD) is proposed in order to support implementation of the PRSP. Pakistan's IDA allocation has been increased under IDA 14, with the three-year envelope set at SDR 1.5 billion (equivalent to about US\$725 million per year). In addition Pakistan will have access to additional IDA on hard terms estimated at SDR 130 million. The scale of IBRD financial support will be determined by the strength of the GoP's policy performance and macroeconomic management. The upper bound of the proposed IBRD lending range for FY06-09 is \$3.4 billion of which up to \$1.3 billion could take the form of development policy loans. Annual lending could increase to as much as \$1 billion per year with up to \$500 million in DPLs within this envelope.

xi. ***The IFC and MIGA Programs.*** In the upcoming CAS period, IFC will be increasing its investment with the target range of US\$500-600 million for the period. IFC will also explore opportunities in pre-privatization investment. It furthermore plans to make more equity investment and intends to be a catalyst for and mobilize private equity in the country. IFC activity will focus on three main sectors: financial, SME and infrastructure. With the recent creation of Private Enterprise Partnership for Middle East and North Africa region (PEP-MENA), IFC has initiated a substantial TA program in Pakistan to build capacity and address constraints of the SME, infrastructure and financial sectors. MIGA's outstanding portfolio in Pakistan consists of 10 contracts of guarantee with a total gross exposure of US\$136.8 million and a net exposure of US\$106.8 million. An application seeking coverage for a US\$20.8 million equity investment in a hydropower project in Pakistan is currently pending.

xii. **Partnerships and Harmonization.** The Bank Group's work in Pakistan is coordinated with and reinforced by the efforts of other donors in a wide variety of areas. The international response to the October earthquake has also served as an opportunity to substantially deepen donor harmonization and coordination. The Government leads coordination of policy dialogue and donor support within the framework of the PRSP, using the Pakistan Development Forum (PDF), held annually in Islamabad, as the principal forum for discussion with and among donors. A Donor Coordination Cell (DCC) has been created in the Economic Affairs Division (EAD). Formal donor group meetings are also held, at least two to three times a year, to discuss implementation of the government's PRSP. Under the leadership of the Government of Pakistan, the Bank Group is increasing efforts to strengthen partnerships and improve harmonization of activities among donors in line with the Paris Declaration on Aid Effectiveness. During the next four years we expect an increasing share of analytical activities to be carried out jointly with partners.

Managing Risks

xiii. The proposed CAS program poses a number of risks, the greatest of which is that of possible **policy reversal** due to shifting priorities or political changes. There are also **implementation risks** relating to both the Bank and Pakistan. The Bank will seek to pro-actively manage these risks by actively addressing capacity constraints while seeking to build and sustain support for further reforms. We will continue to rely on the self-regulating nature of the programmatic approach wherein the volume and pace of lending will match the pace of reforms.

Issues for Board Discussion

xiv. The following issues are suggested for Board discussion:

- a) Does the proposed program adequately support Pakistan's strategy for poverty reduction and achievement of MDGs?
- b) Is the planned increase in the scale of World Bank Group support for Pakistan appropriate?
- c) Is mix of instruments and activities consistent with the focus of the strategy?