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Financial Architecture

STABILISATION WITHOUT TRANSFORMATION

Pakistan's Capital Misallocation Trap

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EXECUTIVE SUMMARY

Pakistan enters FY2026 with its strongest stabilisation indicators in a decade: a current account surplus, single-digit inflation, and record workers' remittances of US$38.3 billion. Yet total investment stands at just 13.8 percent of GDP — less than half the level sustained by India, Vietnam, or Bangladesh — and private sector credit has collapsed from 29 percent of GDP in 2008 to under 14 percent. The binding constraint on growth is no longer macroeconomic management; it is the financial architecture through which capital flows. Three structural failures have converged: a sovereign crowding-out that has pushed government securities to roughly 62 percent of banking assets; a speculative asset bias that channels national savings into land rather than enterprise; and an intermediation failure that leaves small and medium enterprises with barely five percent of private credit while diaspora capital sits unconverted. This brief diagnoses these three gaps and proposes five reforms — spanning bank incentive redesign, development finance, real-estate taxation, diaspora investment channels, and SME risk-sharing — to convert stabilisation into transformation. Stabilisation can restart growth; only architecture can sustain it.

Key Terms: *Capital Misallocation · Financial Architecture · Crowding-Out · Financial Intermediation · Development Finance · Speculative Asset Bias*

AT A GLANCE: CAPITAL ALLOCATION INDICATORS

Indicator	Value	Source (APA)
Total investment	13.8% of GDP (FY2024-25)	Ministry of Finance (2025)
Government securities, share of bank assets	~62% (CY2025)	SBP (2026a)
Advances-to-deposit ratio	38.1% (June 2025)	SBP (2025b)
Private sector credit	13.8% of GDP (2022); 29% in 2008	World Bank (2023a)
SME share of private sector credit	~5%	World Bank (2023a)
Workers' remittances	US$38.3 billion (FY2024-25), record	SBP (2025a)

01 | THE PROBLEM: STABILISATION THAT NEVER BECOMES TRANSFORMATION

Pakistan has become one of the world's most experienced practitioners of macroeconomic stabilisation. Since its first arrangement in 1958, the country has entered more than two dozen lending arrangements with the International Monetary Fund (IMF, 2026), spending 34 of the subsequent 65 years inside a Fund programme (PIDE, 2024). Each cycle follows a familiar arc: foreign exchange reserves decline, the currency comes under pressure, emergency measures restore balance, and confidence briefly returns. The machinery of stabilisation works. What never follows is transformation.

Fiscal year 2024-25 displays this paradox in its purest form. The economy posted its strongest stabilisation indicators in years: average inflation fell from 26.0 percent to 4.7 percent, the current account recorded its highest surplus in more than two decades, and workers' remittances reached a record US$38.3 billion, up 26.6 percent in a single year (SBP, 2025a). Yet total investment stood at only 13.8 percent of GDP, with fixed investment at 12.0 percent and private investment at just 9.1 percent (Ministry of Finance, 2025). Gross fixed capital formation of Rs 13,814.7 billion, though 15.0 percent higher than the previous year, remains structurally inadequate for an economy of nearly 250 million people.

The contrast with Asian peers is stark. India invested 29.6 percent of GDP in fixed capital in 2024, and Vietnam and Bangladesh have sustained comparable rates near or above 30 percent for over a decade (World Bank, 2026). These investment differentials have compounded into divergent growth paths: over the past decade India and Vietnam grew at well above six percent annually while Pakistan averaged closer to four — a gap that, compounded, now separates economies that transform from one that merely stabilises. Pakistan does not suffer from an absence of financial inflows; it suffers from an inability to convert them into productive capital.

The question this record poses is therefore not why capital is scarce, but why available capital so consistently fails to reach production. The economy generates very large financial flows — record remittances, rapidly expanding bank deposits, recurring official inflows — yet channels them overwhelmingly into sovereign paper, land, and consumption. That outcome is not a failure of policy calibration. It is a property of the architecture: the institutional and incentive structure through which savings, credit, and foreign inflows are allocated. Policies operate within systems, and a well-designed policy will underperform inside a system engineered to reward the unproductive. Until the architecture itself is redesigned, each stabilisation will remain what every previous one has been — a pause between crises rather than a platform for growth.

02 | STRUCTURAL FAILURES: THREE CONVERGING GAPS

Three distinct structural failures have converged to transform capital misallocation into a systemic growth vulnerability. Each operates through a different channel — the banking system, the savings incentive structure, and the intermediation chain — but all three route capital away from productive enterprise.

Gap 1 — Sovereign Crowding-Out of Private Credit.

Pakistan's banking system has progressively ceased to function as an intermediary between savers and enterprises and now operates primarily as a financier of the fiscal deficit. By end-2025, government securities accounted for roughly 62 percent of total banking sector assets, up from 55.5 percent a year earlier, while advances to the economy declined by 6.0 percent (SBP, 2026a). At mid-year the imbalance was even more striking: the investment-to-deposit ratio exceeded 100 percent — banks had placed more than their entire deposit base in securities — while the advances-to-deposit ratio languished near 38 percent (SBP, 2025b). The logic is self-reinforcing. Sovereign lending offers risk-free, high-margin returns; the government secures financing without harder fiscal choices; and the private borrower becomes a residual claimant on whatever credit remains. The arrangement is individually rational for every participant and collectively ruinous for growth.

Gap 2 — Speculative Asset Bias in the Savings Structure.

The portion of national savings that escapes the sovereign loop gravitates toward real estate rather than enterprise. Preferential and fragmented taxation of land, recurrent amnesty schemes, and a largely undocumented plot-file market have made land appreciation persistently more attractive after tax than productive investment. Precise estimates of the capital parked in real estate vary and rest on third-party scenario estimates rather than official statistics; the directional evidence, however, is embedded in the financial system itself. Lending remains anchored in collateral — overwhelmingly urban property titles — so credit flows systematically toward those who hold land rather than those who create value, and firms whose principal assets are receivables, inventory, and talent are defined out of bankability (World Bank, 2023a). When land reliably outperforms factories, capital follows land.

Gap 3 — Intermediation Failure for Productive Enterprise.

The combined effect of the first two gaps is a hollowed-out intermediation chain. Credit to the private sector collapsed from 29 percent of GDP in 2008 to 13.8 percent by 2022 — below half the South Asian average — and within that shrunken envelope, small and medium enterprises receive around five percent of private credit despite constituting the vast majority of firms (World Bank, 2023a). Only 2.1 percent of Pakistani firms report having a bank loan or line of credit, against a South Asian average of 23.7 percent, and two-fifths are fully credit-constrained (World Bank, 2023b). The dismantling of development finance institutions in the 1990s removed the economy's long-term credit function without replacement. Diaspora finance illustrates the conversion failure with precision: the Roshan Digital Account has attracted US$12.74 billion in cumulative inflows since 2020, yet net investment stands at only US$1.8 billion — and equity investment at US$123 million, roughly one percent of total inflows (SBP, 2026b). Capital arrives; the architecture parks it.

TABLE 1 — Structural Gap Analysis Matrix

Gap Type	Diagnosis	Economic Consequence	Priority
Sovereign crowding-out	Banking system functions as fiscal financier; ~62% of assets in government securities	Private credit rationing; investment stagnation at 13.8% of GDP	Critical
Speculative asset bias	Tax and regulatory arbitrage favours land appreciation over productive returns	Savings diverted from tradable sectors; collateral-based credit lock-in	High
Intermediation failure	SME and long-term finance channels missing; development-finance vacuum since the 1990s	SMEs at ~5% of private credit; diaspora capital unconverted to investment	High

03 | POLICY RECOMMENDATIONS: FIVE ACTIONABLE REFORMS

The evidence points not toward fatalism but toward a specific and sequenced reform agenda. Five interventions are both urgent and institutionally within reach. Each targets a distinct node of the misallocation architecture, and each rests on a verified international precedent.

1 Redesign the Incentive Structure Governing Bank Asset Allocation

The Federal Board of Revenue and the State Bank of Pakistan should replace the advances-to-deposit-ratio-linked tax — an instrument that induced year-end window dressing and a high-base distortion in advances rather than durable private lending (SBP, 2026a) — with a stable, rules-based framework that permanently narrows the post-tax return differential between sovereign securities and private credit. This should combine differential taxation of income from government paper with graduated, transparently monitored targets for productive-sector lending.

International Precedent: *Priority Sector Lending framework, Reserve Bank of India (RBI, 2025)*

2 Re-establish a National Development Finance Institution Funded by Contractual Savings

The Ministry of Finance, SBP, and the Securities and Exchange Commission of Pakistan should charter a professionally governed national development bank to supply long-tenor industrial and infrastructure credit, capitalised in part by channelling pension and insurance contractual savings into its bond programme rather than directly into government securities. Strict governance safeguards — an independent board, sunset clauses on credit lines, and performance-linked refinancing — are essential to avoid repeating the failures that justified dismantling the 1990s DFIs.

International Precedent: *Korea Development Bank's role in directed industrial credit (World Bank, 1993)*

3 Neutralise the Real-Estate Tax Arbitrage

The FBR and provincial revenue authorities should equalise the effective tax burden on land appreciation with that on productive returns — through harmonised capital gains taxation, market-value-based valuation tables, and a credible end to recurrent amnesty windows — so that holding idle land ceases to dominate enterprise investment after tax. The objective is not to punish property but to remove the artificial wedge that makes speculation the rational allocation of household savings.

International Precedent: *Republic of Korea's anti-speculation land taxation, 1967–1989 (Kim & Park, 2016)*

4 Convert Diaspora Inflows into Investment Capital

The SBP should extend the Roshan Digital Account architecture beyond sovereign certificates into diversified equity funds, venture vehicles, and project-linked diaspora bonds, with simplified onboarding and tax neutrality relative to domestic investors. The objective is to convert an annual inflow now approaching US$40 billion from consumption support and deposit accumulation into a standing investment pipeline (Ketkar & Ratha, 2009).

International Precedent: *India's Resurgent India Bonds and diaspora bond programmes (Ketkar & Ratha, 2009)*

5 Scale SME Risk-Sharing and Cash-Flow-Based Lending

The SBP and the Pakistan Credit Guarantee Company should expand partial credit guarantees and require banks to adopt cash-flow-based and movable-collateral lending standards, shifting credit assessment from urban property titles to enterprise viability. Korea's credit guarantee institution, established in 1976, demonstrates how a well-capitalised guarantee system can sustain high SME lending at national scale across decades (KODIT, 2025; OECD, 2026).

International Precedent: *Korea Credit Guarantee Fund — KODIT (OECD, 2026)*

TABLE 2 — Implementation Roadmap

Reform	Lead Institution	Int'l Precedent (APA)	Horizon
Bank incentive redesign	FBR / SBP	RBI (2025)	Near-term (0–12 months)
National development finance institution	MoF / SBP / SECP	World Bank (1993)	Long-term (3–5 years)
Real-estate tax neutrality	FBR / provincial revenue authorities	Kim & Park (2016)	Medium-term (1–3 years)
Diaspora investment channels	SBP	Ketkar & Ratha (2009)	Near-term (0–12 months)

SME risk-sharing and cash-flow lending	SBP / PCGC	OECD (2026)	Medium-term (1–3 years)

04 | CONCLUSION

Pakistan's economic problem is routinely described as instability. The record suggests otherwise. The country has demonstrated, repeatedly and at considerable social cost, that it can stabilise: inflation can be broken, the current account can be turned, reserves can be rebuilt. What it has never attempted is the redesign of the architecture that determines where capital flows once stability returns. Each stabilisation has therefore delivered the same inheritance — a banking system lending to the state, savings flowing into land, and enterprises starved of credit — and each recovery has expired on that inheritance.

The three gaps diagnosed in this brief are not separate maladies; they are one system observed from three angles. Sovereign crowding-out makes risk-free lending the banker's dominant strategy; tax arbitrage makes land the saver's dominant strategy; and the resulting intermediation vacuum makes credit rationing the enterprise's permanent condition. The five reforms proposed here — incentive redesign, development finance, tax neutrality, diaspora conversion, and SME risk-sharing — attack the system rather than its symptoms. They are the financial counterpart of the delivery architecture examined in Issue 05 of this series: institutions that decide where capital goes matter as much as institutions that execute what the state decides.

The window created by the current stabilisation will not remain open indefinitely. Record remittances, a current account surplus, and single-digit inflation constitute the most favourable conditions in a generation for architectural reform — precisely because the reforms can now be sequenced from strength rather than imposed in crisis. The choice is therefore not between stability and growth; it is between an architecture designed to avoid risk and one designed to create opportunity. An economy that lends to its state and banks on its land will stabilise forever and transform never.

ABOUT THE AUTHOR

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