

ANNEX 14 – INDUSTRY AND SERVICES

A. Introduction

1. The private sector in NWFP and AJK is largely dominated by medium, small-scale and unregistered enterprises, which are often household-based. Even where the primary proprietor of the business has survived, these enterprises will have, in many cases, lost all or most of their business assets. While the monetary value of the individual losses may not be substantial, the collective impact is significant. Many of these businesses were not only suppliers of basic commodities, but also provided additional services such as pay-points for informal remittance transfers.

2. The wholesale and trade sector in NWFP and AJK contribute nearly 11.6% and 49.7% to GDP respectively, or Rs. 12.2 billion and Rs. 15.8 billion. Prior to the earthquake the sector employed 59,482 people in NWFP and 29,350 in AJK. The assessment team estimates that direct asset damage and output losses (indirect losses) in the services sector are Rs. 8,578 million and Rs. 6,076 million respectively. The employment loss for the services sector is estimated at 41,699.

3. **Consultations and site visits.** Consultations were held with institutions/individuals directly involved in the financial and private sector and with their clients. The Small and Medium Enterprise Development Authority (SMEDA), the AJK Chamber of Commerce and Hazara Chamber of Commerce, relevant census reports, representatives of district, provincial and federal level governments, and site visits to the areas all contributed to the needs assessment. With respect to the financial sector, the State Bank of Pakistan, the Khushaali Bank, Rural Support Programs (NRSP & SRSP), House Building Finance Cooperation, Central Directorate for National Savings and the Post Office were also consulted.

B. Damage Overview and Recovery Needs

4. **Methodology.** Due to the informal nature of the sector, estimating losses is difficult. To arrive at the number of shops destroyed a proxy was used based on the percentage of houses that were damaged for each of the districts with a distinction made for partially and totally destroyed. The number of commercial electricity connections served as the baseline for the number of business activities and an average value was calculated for a typical establishment both for construction material and for inventory. Since trade is an activity whose primary function is provision of services, output losses or indirect losses are referred to as the losses incurred during the interruption of business. Damage to infrastructure, loss in inventory and working capital, labor shortage and loss in purchasing power of the community for consumer goods all contribute to the indirect losses. A complete assessment of asset losses in the services sector is yet to be completed.

5. **Trade Related Impact.** All eight affected districts saw impacts to retail, restaurants and wholesale warehousing. Mansehra District in NWFP, which contains the tourist towns of Kaghan, Naran and Balakot, had significant damage to its tourism infrastructure. Similarly in Muzaffarabad District in AJK the handicraft sector was adversely affected. Asset damage and loss includes both structures and inventories.

Table 1: Estimate of Damage to Assets and the Reconstruction Cost

Type of Damage	Direct Damage Rs. Million	Reconstruction Cost
1. Commercial Building (totally and partially damaged at <i>book value</i>)		
Trade, marketplaces, restaurants	1,315	1,875
Financial Sector	111	151
2. Goods, Inventory, Equipment, working Capital		
Trade, marketplaces, restaurants	6,842	6,842
Financial Sector	310	310
Service Sector Direct Damage	8,578	9,178

* Reconstruction costs are assumed at 5% higher for completely destroyed buildings and 20% higher for partially destroyed buildings in order to incorporate seismic-resistant design standards.

Table 2: District Wise Break Down of Damage Estimates to Trade Sector

District	# of Establishments	Damaged (Totally and Partially)	Direct Damage (Rs. mill.)	Urban (Rs. mill.)	Rural (Rs. mill.)
NWFP			4120	189	3931
Abbottabad	10449	2090	598	107	491
Batagram	3236	2363	995	-	995
Kohistan	5010	1353	382	-	382
Mansehra	14073	4503	1544	82	1462
Shangla	4579	1557	600	-	600
AJK			4037	465	3572
Bagh	3280	2624	1009	56	953
Muzaffarabad	7868	5508	2251	307	1944
Poonch	3468	2601	777	102	675
Total Damage			8157	654	7503

6. **Financial sector impact.** With regard to the formal financial sector, most of the commercial bank branches were mainly serving as deposit taking institutions and had limited lending to the commercial sector; thus, damage to their loan portfolios is limited. Of the 230 branches operating in the area 18 suffered severe damage and collapsed in the earthquake, with 14 of those collapsed in AJK and 4 in NWFP. According to the State Bank of Pakistan, close to two hundred bank branches have resumed normal operations.

7. Microfinance institutions, remittances and unregulated borrowing were the main conduits for finance in the affected areas. For microfinance institutions, the sectors with the most lending were livestock, micro-enterprises, agriculture and at times, working capital. These institutions are significantly affected. For example:

- Sarhad Rural Support Programme and Khushali Bank, the two dominant players in the affected areas in NWFP, have estimated losses of Rs. 29.5 million from an outstanding balance of Rs. 38.7 million.

- In AJK it is estimated that the entire portfolio of Khushali Bank in the affected areas (2,747 clients and Rs. 17.4 million) has been adversely impacted.
- In the areas of Bagh, Rawalakot and Kotli in AJK the National Rural Support Program has a portfolio of Rs. 42.3 million which is adversely affected.
- On housing finance, the House Building Finance Corporation early estimates show that of a total outstanding portfolio of Rs. 763 million linked to 5,063 clients, approximately Rs. 217.3 million is affected.

C. Reconstruction and Recovery Strategy

8. In the short term, the aim must be to restore the abilities of businesses to restock basic supplies and re-engage in commerce. Restoring basic infrastructure, including primary residences and facilitating access to financial resources—from domestic and foreign remittances, microfinance institutions, and banks—is an essential first step. The key role of the Government will be to create an enabling environment which will allow entrepreneurs to quickly rebuild their businesses. It will also be useful for Government to ensure that relief material is procured from the local areas when possible. The risk of shortages and inflation will increase if the retail sector does not return to normalcy in the near term.

Critical Issues

9. ***Physical and social infrastructure.*** Restoring the region's basic physical and social infrastructure is the key for improving the rate of re-establishing commerce. In particular it is important to focus on rebuilding roads, re-establishing power and water connections and ensuring communications links.

10. ***Access to finance.*** The financial situation in NWFP and AJK will be made more difficult as banks historically shy away from small and medium enterprises as they are considered risky ventures. Often, collateral requirements crowd out many smaller entrepreneurs. Further, entrepreneurs and enterprises that operate informally cannot borrow at a reasonable cost because they do not have legal status or title to the land they occupy. Frequently, the only option for access to capital is through informal moneylenders who charge high rates and who may be able to lend only small sums relative to the needs of an enterprise. These factors will increase the complexity of ensuring access to financing for the region's small businesses.

11. ***Access to finance in the short term (up to 12 months).*** Creating channels for the delivery of sustainable credit programs in post-disaster areas is challenging as recipients will expect grants from government and the international donor community. It is therefore essential that a clear distinction is made between emergency grant-based programs aimed at restoring basic living conditions, and longer term financial resources aimed at restoring income generating livelihoods. Grant programs will need to be carefully designed, relying on international best practices, to minimize potential negative effects (such as undermining local financial institutions).

12. In the short term public finance can bridge some gaps in financing, but public financial assistance programs must complement, rather than compete with, private financing. While in the immediate aftermath of the earthquake grants may be provided to the severely hit micro and small entrepreneurs, later in the recovery period there should be a shift to mainly market-based loan products, as subsidized credit programs will be unsustainable. New financial products would better serve small and medium enterprises with tailored lending and savings products.

13. Efforts should focus on using existing institutions rather than creating dedicated state agencies. A mapping of non-microfinance NGOs – and Microfinance Institutions if the first are not available – from which grants would be managed will be needed. A mapping of both banks and non-banking institutions from credit programs can later be managed is also essential.

Medium to long term (12 months to 5 years)

14. Options for providing financial resources to firms may include:

- ***A Micro and Small Enterprise (MSE) lending facility.*** MSE lending windows could be created within interested (and eligible) existing financial institutions. Depending on the liquidity situations of these financial institutions, credit lines targeted at micro and small enterprises (following the EBRD model used in the Former Soviet Union and the Balkans) could be made available. These credit lines would need to be accompanied by resident technical advisers to help banks develop their MSE lending skills (i.e., developing financial products and procedures adapted to MSEs, moving from collateral based lending to cash flow and character based lending, decentralizing credit decisions, strengthening Management Information System, developing marketing and incentives for loan officers, etc.). Grant funding covers the technical assistance, including marketing, salaries and bonuses of loan officers for up to 6 months. If liquidity is not a constraint for financial institutions, technical assistance could be offered.
- ***Microfinance.*** A large number of small and informal businesses in the affected regions are likely to have accessed credit through non-commercial bank sources. It will be important for small business credit programs to be channeled through these organizations. Though the business environment may seem risky, it is important to adhere to good microfinance practices and core principles such as high portfolio quality, market interest rates and full cost-recovery pricing. MFIs should lift compulsory savings requirements in affected branches during the initial stages of reconstruction. This gives MFIs the opportunity to rebuild branches and locate clients. Reconstruction loans are also most effective once the relief stage is over, though they need to be monitored carefully as these loans do not generate regular cash incomes.

Technical Assistance

15. While it is unlikely that enterprises will require sophisticated technical assistance given the basic nature of their commercial enterprises, they could benefit from, for example, developing business plans, improving inventory management and strengthening financial management. Additionally, given that rural areas are most affected, efforts must be made to better link rural markets.

16. In re-establishing the private sector in affected areas, efforts should be made to partner with entrepreneurial networks and associations. There could play an important role in assisting banks in developing financial products answering the needs of MSEs. There is significant interest from domestic and international companies to assist in the economic recovery of the affected region. There is recognition by the private sector that they need to remain engaged in the disaster region for a number of years. Some companies are participating in ‘adopt a village’ schemes. Resources and know-how from linkages with firms in other parts of the country and outside the country need to be formalized. The challenge lies in how to institutionalize these efforts to ensure long term commitment.