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Senator Mohammad Ishaq Dar

Minister for Finance, Revenue,
Economic Affairs, Statistics
and Privatization

ISLAMABAD
13th May, 2016

Subject: LETTER OF DEVELOPMENT POLICY FOR COMPETITIVENESS AND GROWTH DEVELOPMENT POLICY FINANCING (CREDIT AND GUARANTEE)

Dear President Kim,

The Government of the Islamic Republic of Pakistan (Government) continues to pursue a comprehensive program of economic and social reforms. These reforms are essential to achieve continued economic growth, improve private sector investment and fiscal management. Our reform agenda is showing improved economic indicators and Pakistan is receiving accolades for this from the global economic community including the Asian Development Bank meetings held in Frankfurt and the IMF negotiations in Dubai this month. This progress imbues further enthusiasm from the government to ensure that our policy reforms have deep positive economic impact on our citizens.

On behalf of the Government, I am writing to request approval of the Pakistan Competitiveness and Growth Development Policy Financing (CGDPF) comprising an IDA Development Policy Credit in the amount of USD 500 million and an IBRD Policy-Based Guarantee in the amount of up to USD 420 million. The IDA credit will provide and the IBRD guarantee will enable the government to meet its external financing requirements. This Letter of Development Policy sets out the Government's key economic policy actions to be supported by this operation.

The main objective of the CGDPF is to deepen and accelerate the reforms supported by the previous DPC series so that higher economic growth can be achieved, more jobs can be created, and the vulnerable segments of population can be included more fully. This requires continued macroeconomic stability and fiscal discipline, but also a business environment that is conducive to private sector investment and private sector-led growth.

Our Vision

The Government's economic reform program focuses on macroeconomic stability, aiming at containing inflation below 6 percent, and achieving growth rate target of 7 percent by FY 2018. The reform program seeks to improve fiscal consolidation, reducing the fiscal deficit from 8.3 percent of GDP in FY 2013 to 3.8 percent in FY 2017 by increasing revenues, eliminating tax exemptions; adopting austerity in non development expenditure outlays, reducing subsidies and improving debt management. It also seeks to rebuild significant foreign exchange reserves to adequately meet our import requirements of around 4 months, adopt prudence in monetary policy and strengthen the central bank's independence.

Further, the Government seeks to implement growth-enhancing reforms through:

- **Comprehensive power sector reforms.** Reducing power subsidies; restructuring boards of power distribution and generation companies; attracting investments; strengthening the power sector regulator; and expanding alternative sources of energy.
- **Reforming or privatizing SOEs.** Privatizing by equity or strategic sales; or if restructuring, then requiring professional chief executives and board members and their compliance with Public Sector Companies (Corporate Governance) Rules 2013.
- **Improving trade competitiveness.** Simplifying tariff slabs and phasing out trade-distortive statutory regulatory orders (SROs).
- **Improve trade quantum with preferential trade alliances.** Increased efforts to benefit from all preferential trade alliances and taking full advantage of GSP+ scheme from European Union.
- **Enhancing the investment climate.** Strengthening the Board of Investment in implementing a plan for improving the business environment and setting up investment-friendly special economic zones.
- **Expanding access to finance.** Developing the State Bank of Pakistan's Financial Inclusion Program to enhance access of SMEs to financial services through regulatory reforms, product innovation, technology upgrade, financial literacy, and consumer protection.

Economic Context

Economic conditions have improved. The balance of payments position has significantly improved with an increase in international reserves resulting from strong remittances, foreign capital and financial inflows and improved current account due to lower global commodity prices including oil. Due to prudent monetary and fiscal management, the external sector challenges have been moderated and the foreign exchange market has been stable. Headline inflation remains low (2.8 percent on average during July-April FY 16).

In its first three years in office, this Government has achieved success with the design and early implementation of our economic reforms program. Upon taking office, our first priority was to re-establish macroeconomic stability and strengthen macroeconomic fundamentals, addressing significant internal and external imbalances. We also initiated a number of deep-rooted structural reforms together with stabilization measures and additional support for vulnerables.

In order to accelerate growth and maintain macroeconomic stability, we are stepping up reform efforts, to be supported by the CGDPF. After successfully restoring macroeconomic stability, we are pursuing deeper reforms and an accelerated implementation pace in removing discriminatory tax exemptions and improving the business environment. We have also updated and revised the poverty line using a more advanced methodology of Cost of Basic Needs (CBN), instead of the previously used Food Energy Intake (FEI) method which has become obsolete as it does not take into account non-food needs of households. Under the old Food Energy Intake (FEI) method, the poverty headcount, which was 34.7% in 2001, has come down to less than 10% in 2014. While adopting the Cost of Basic Needs (CBN) method, the poverty headcount in 2001 was 64% which has come down to 29.5% in 2014. The Government is committed to transpose the updated poverty line in its development policy framework.

The Government has requested IBRD support alongside the IDA credit in the form of a Policy Based Guarantee (PBG) for the issuance of government debt. The PBG in an amount of up to $420 million would complement the IDA credit in facilitating budgetary resources of up to US$1.5 billion in the current and next fiscal year. We are seeking this support to partly meet our financing needs for the current fiscal year with the IDA credit (US$500 million) while the PBG would help meet financing needs in the upcoming fiscal year. This resource amount assumes that the proposed PBG of up to US$420 million could raise up to US$1 billion in loan and/or bond proceeds in the capital markets, with an expected leverage of up to 2.5x depending on the financing alternative chosen.

The requested PBG will support our efforts to develop financial sector and facilitate its access to international markets. The PBG is expected to help diversify the Government's debt profile such that the increased borrowing requirements are met without curtailing inclusive growth. It is also expected to further strengthen the government's track record in international markets after regaining access through US$ 2 billion in bonds and the US$ 1 billion Sukuk in 2014 and US$500 million Eurobond in 2015. The GOP has retired Eurobond of US$500 million in March 2016, which was issued in 2006.

The proposed PBG will allow the banking sector to free up borrowing space for the private sector. Previous FSAPs and the ongoing FSAP Development Module have highlighted the Government's use of domestic debt. The PBG will help reduce Government borrowing from the domestic banking sector, freeing resources for private sector credit and thereby supporting the objective of a more competitive private sector.

In order to achieve higher and more inclusive growth, we have continued to implement an ambitious reform program to increase the quantity and quality of both private and public investment. On the private side, the reforms aim to create a robust investment climate, with improved clarity and transparency in the regulatory environment. The reforms undertaken to date by our Government have been successful in creating and enabling regulatory and facilitative environment with the objective of bringing SOEs at par with corporate governance principles. On the public side, continued improvements in revenue collection and debt management serve to create more fiscal space and increased public sector investment.

The business environment reforms are the first steps in an urgent, medium-term program. Pakistan is ranked 138 out of 189 economies on the Ease of Doing Business Rankings in 2016. We have prepared a National Doing Business Reform Strategy that provides reform recommendations covering all indicators with considerable granularity, delineating federal and provincial institutional and organizational responsibilities for implementation. The plan is currently being implemented both at national and provincial levels. We are committed to pursuing these reforms in the medium term, as some of the reforms will take more time to be implemented fully. Two of the areas where there is particular need for improvement in the short term are 'Access to Credit' and 'Paying Taxes'. Reforms supported in the requested operation seek to address these two areas specifically as indications of the broader reform effort.

FBR has improved the processes for paying taxes. In order to improve the business environment, the Government has continued to improve processes to simplify and streamline the payment of taxes and the salient features of such improved processes have been posted on the website of the Federal Board of Revenue (prior action 2).

The Government significantly strengthened financial intermediation and to allow more dynamic private sector growth. In order to support the policy operations, we have undertaken following legislations, i.e. the Financial Institutions (Secured Transaction) Bill, 2016 (prior action 1(a)), the Amendment to the Credit Bureau Act (prior action 1(b)), the Amendment to the Securities and Exchange Commission of Pakistan (SECP) Act (prior action 3), as well as the Financial Institutions (Recovery of Finances) (Amendment) Bill (prior action 4). The Government has also enabled the creation of a national bourse, the Pakistan Stock Exchange, replacing the now-merged stock markets of Karachi, Lahore and Islamabad.

Publishing the State-Owned Enterprises (SOEs) information. The Government has ensured the fiscal transparency and business confidence by publishing key financial information of all state owned entities with their consolidated financial and non-financial information for FY2013/14 (prior action 5).

The Government is strengthening insurance sector and paving the way for further private sector investment. In order to enable the corporatization of Pakistan's State Life Insurance Corporation (SLIC), the National Assembly has passed the State Life Insurance Corporation (Reorganization and Conversion) Act (prior action 6). This passage paves the way for the Government to complete the remaining steps to SLIC's full corporatization. The Government is also considering the corporatization of Postal Life Insurance (PLI), the other large State-owned life insurer. In this regard, the Ministry of Communications and the Ministry of Finance have both approved a roadmap for PLI's corporatization.

Phasing out of discriminatory concessions granted through Statutory Regulatory Orders (SRO). SROs are being removed in a phased manner over three years. The third and final phase-out of SROs will be completed with the approval of the Finance Bill FY2016/17 by the National Assembly (prior action 7).

As a key component of strengthening fiscal management, the Government has continued to improve its revenue collection. Over the past two years, the Federal

Board of Revenue (FBR) has made significant strides in strengthening the tax audit function and has recently adopted a modern audit policy (prior action 8).

Strengthening debt management. We have improved the organizational structure of the DPCO with an enhanced mandate, outlining all its functions including production of the Medium Term Debt Management Strategy (MTDS), as well as market, credit and operational risk management (prior action 9(a)). The approved MTDS for FY2015/16-2018/19 has been published (prior action 9(b)).

The Government has set the conditions for more effective and sustainable poverty reduction programs in the future by institutionalizing an improved mechanism for targeting safety net programs. While economic growth has been pro-poor in Pakistan, the Government remains committed to ensure that its investments in equity and social justice are as effective as possible. To this end, the Government has authorized the Benazir Income Support Programme (BISP) to update the National Socio-Economic Registry and to adopt dynamic updating of the registry in the future (prior action 10).

In addition, the Government has adopted a revised poverty line. We have updated, adopted and published a new poverty line. Under the old Food Energy Intake (FEI) method, the poverty headcount, which was 34.7% in 2001, has come down to less than 10% in 2014. While adopting the Cost of Basic Needs (CBN) method, the poverty headcount in 2001 was 64% which has come down to 29.5% in 2014. The Government has taken the decision to update the poverty line (prior action 11) on the basis of the Cost of Basic Needs (CBN) method in order to align our development policy framework with the Sustainable Development Goals (SDGs) of the United Nations. The new poverty line sets a much higher bar for inclusive development. Going forward, we will seek to consolidate these advances by strengthening the institutional set up for poverty measurement.

The Government is committed to pursuing the medium term reform program, including fully implementing and further deepening reform steps supported by this operation. The Government acknowledges that the reforms supported by the proposed operation require ongoing efforts in order to be implemented fully. The Government reaffirms its desire to continue with the broader reforms in order to achieve higher inclusive growth. For all of the supported actions, there are implementation efforts underway.

The Government is committed to shepherding all legal actions through to their implementation. Five pieces of legislation have been passed by the National Assembly as part of the reform program that this operation supports. They are (i) the Financial Institutions (Secured Transaction) Bill; (ii) the Amendment to the Credit Bureau Act; (iii) the Amendment to the Securities and Exchange Commission of Pakistan (SECP) Act; (iv) the Financial Institutions (Recovery of Finances) (Amendment) Bill; and (v) the State Life Insurance Corporation (Re-organization and Conversion) Bill. The Government will work with the Senate to get its approval for these bills, and would adopt necessary means available under the Constitution to ensure their enactment in satisfactory form and substance. Therefore, the Government is committed that these legislations actually bring about the enabling economic growth and development environment for respective public and private sectors of Pakistan.

Concluding remarks

The Government believes that the reform program outlined above and supported by the proposed operation will help accelerate and reinvigorate inclusive economic growth in Pakistan. We are going into the Pakistan Competitiveness and Growth Development Policy Financing with complete commitment to the reforms noted in the foregoing paras and very much appreciate the support of the World Bank Group in enabling us to achieve economic growth and our reform agenda.

Best wishes and kind regards,

Yours Sincerely,

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