Public Disclosure Authorized

Public Disclosure Authorized

Document of
The World Bank

FOR OFFICIAL USE ONLY

Report No. 105825-PK

INTERNATIONAL DEVELOPMENT ASSOCIATION

AND

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

PROGRAM DOCUMENT

FOR A PROPOSED DEVELOPMENT POLICY CREDIT

IN THE AMOUNT OF SDR 352.8 MILLION (US$ 500 MILLION EQUIVALENT)

AND

A PROPOSED POLICY-BASED GUARANTEE

IN THE AMOUNT OF UP TO US$420 MILLION TO

THE ISLAMIC REPUBLIC OF PAKISTAN

FOR THE

COMPETITIVENESS AND GROWTH DEVELOPMENT POLICY FINANCING

May 23, 2016

Macroeconomic and Fiscal Management,
Trade and Competitiveness, Energy Global Practices
South Asia Region

This document has a restricted distribution and may be used by recipients only in the performance of their official duties. Its contents may not otherwise be disclosed without World Bank authorization.

GOVERNMENT OF PAKISTAN FISCAL YEAR

July 1–June 30

CURRENCY EQUIVALENTS

(Exchange Rate Effective as of 30 April 2016)

Currency Unit: Pakistani Rupees (PKRs)

US$1.00 = PKRs 104.528

US$1.00 = SDR 0.7755519

ABBREVIATIONS AND ACRONYMS

ADB	Asian Development Bank
AML	Anti-Money Laundering
BISP	Benazir Income Support Program
BOI	Board of Investment
BOP	Balance of Payments
CCP	Competition Commission of Pakistan
CCT	Conditional Cash Transfer
CEM	Country Economic Memorandum
CEO	Chief Executive Officer
CGDPF	Competitiveness and Growth Development Policy Financing
CPEC	China Pakistan Economic Corridor
CPI	Consumer Price Index
CPS	Country Partnership Strategy
DB	Doing Business
DFID	Department for International Development
DPC	Development policy credit
DPCO	Debt Policy Coordination Office
DPO	Development Policy Operation
DTF	Distance to frontier
EFF	Extended Financing Facility
EMBI+	Emerging Market Bonds Index Plus
EOI	Expression of Interest
FBR	Federal Board of Revenue
FDI	Foreign Direct Investment
FIRO	Financial Institutions (Recovery of Finances) Ordinance
FRDLA	Fiscal Responsibility and Debt Limitation Act
FSAP	Financial Sector Assessment Program
FSIG	Fiscally Sustainable and Inclusive Growth
FY	Financial year
GCC	Gulf Cooperation Council
GDP	Gross Domestic Product
GRS	Grievance Redress Service
GSP	Generalized System of Preferences
H1	1st half of the Fiscal Year
HIES	Household Income and Expenditure Survey
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
IERU	Implementation and Economic Reforms Unit
IMF	International Monetary Fund
IO	Insurance Ordinance
IT	Information technology
JICA	Japan International Cooperation Agency
MOC	Ministry of Commerce
MoF	Ministry of Finance
MTDS	Medium Term Debt Strategy
NEPRA	National Electric Power Regulatory Authority
NFC	National Finance Commission
NFIS	National Financial Inclusion Strategy
NSER	National Socio Economic Registry
PBG	Policy-based guarantee
PC	Privatization Commission
PEFA	Public Expenditure and Financial Accountability
PFM	Public financial management
PIA	Pakistan International Airlines
PKR	Pakistan Rupee
PLI	Postal Life Insurance
PMRC	Pakistan Mortgage Refinance Company
POL	Petroleum, oil and lubricants
PPP	Public private partnership
REER	Real Effective Exchange Rate
SBP	State Bank of Pakistan
SDR	Special Drawing Rights
SECP	Securities and Exchange Commission of Pakistan
SLIC	State Life Insurance Corporation
SME	Small and Medium Enterprise

SOE	State Owned Enterprise
SORT	Systematic Operations Risk-rating Tool
SRO	Statutory Regulatory Order
TAGR	Trust Fund for Accelerating Growth and Reforms
TA	Technical Assistance
TF	Trust fund
TRE	Traded right entitlement
UAE	United Arab Emirates
UNDP	United Nations Development Programme
US	United States
USAID	United States Agency for International Development
WAPDA	Pakistan Water and Power Development Authority
WB	World Bank

Vice President:	Annette Dixon
Country Director:	Patchamuthu Illangovan
Vice President:	Jan Walliser/ Laura Tuck
Senior Practice Director:	Felipe Jaramillo/ Anabel Gonzalez
Practice Director:	Satu K. Kahkonen/ Cecile Fruman
Practice Manager:	Shubham Chaudhuri/ Esperanza Lasagabaster
Practice Manager (Guarantees)	Pankaj Gupta
Task Team Leader:	Enrique Blanco Armas, Connor P. Spreng,
Task Team Leader (Guarantees)	Sebnem Erol Madan

THE ISLAMIC REPUBLIC OF PAKISTAN
COMPETITIVENESS AND GROWTH DEVELOPMENT POLICY FINANCING

TABLE OF CONTENTS

SUMMARY OF PROPOSED CREDIT / GUARANTEE AND PROGRAM v
1. INTRODUCTION AND COUNTRY CONTEXT 1
2. MACROECONOMIC POLICY FRAMEWORK 4
2.1. Recent Economic Developments 4
2.2. Macroeconomic Outlook and Debt Sustainability 8
2.3. IMF Relations 17
3. THE GOVERNMENT'S REFORM PROGRAM 17
4. THE PROPOSED OPERATION 21
4.1. Link to Government Program and Operation Description 21
4.2. Rationale and Details of the Proposed Policy-Based Guarantee 22
4.3. Prior Actions, Results and Analytical Underpinnings 24
4.3.1. Improving the Business Environment 24
4.3.2. Enhancing Fiscal Management 32
4.4. Link to Country Partnership Strategy, Other Bank Operations and the WBG Strategy 38
4.5. Consultations and Collaboration with Development Partners 39
5. OTHER DESIGN AND APPRAISAL ISSUES 40
5.1. Poverty and Social Impact 40
5.2. Environmental Aspects 41
5.3. Public Financial Management, Disbursement and Auditing Aspects 42
5.4 Monitoring, Evaluation and Accountability 44
6. SUMMARY OF RISKS 45
Annex 1: Policy and Results Matrix 48
Annex 2. Letter of Development Policy 50
Annex 3. Fund Relations Annex 57
Annex 4. Pakistan: Debt Sustainability Analysis 58
Annex 5. Medium-Term Government Reform Plans 62
Annex 6. Privatization Program of the Government of Pakistan 64
Annex 7. Rationale for the policy-based guarantee 66
Annex 8. Indicative terms for the policy-based guarantee 72

The proposed operation was prepared by a team led by Enrique Blanco Armas (Lead Economist, GMFDR), Connor P. Spreng (Senior Economist, GTCDR) and Sebnem Erol Madan (Senior Infrastructure Specialist). The team consisted of Anthony Cholst (Operations Advisor), Amena Raja (Operations Officer) and Gabi George Afram (Program Leader), all SACPK, Uzma Basin (Senior Country Officer, SACPA), Yasuhiko Matsuda (Senior Public Sector Specialist) and Amjad Zafar Khan (Senior Social Protection Specialist), both GSPDR, Ghazala Mansuri (Lead Economist, GPVDR), Muhammad Waheed (Senior Economist), Saadia Refaqat (Senior Economist), Mehwish Ashraf (Research Analyst), Amelia Johnston (Consultant), all GMFDR, Kiran Afzal (Private Sector Development Specialist), Sarwat Aftab (Senior Private Sector Development Specialist), both GTCDR, Sarmad Shaik, Financial Sector Specialist (GFMDR), Clelia Rontoyanni (Senior Public Sector Specialist), Raul Junquera-Varela (Lead Public Sector Specialist), Akram El-Shorbagi (Senior Financial Management Specialist), all GGODR, Antonio Velandia-Rubiano, Lead Financial Officer, FABDM, Javaid Afzal, Senior Environmental Specialist, GENDR, Robert Schlotterer, Lead Infrastructure Finance Specialist, Vincent Launay, Infrastructure Finance Specialist, Zhengjia Meng, Young Professional, all GEEFS, Helene Bertaud (Senior Counsel, LEGES), Neil Pravin Ashar (Senior Counsel, LEGSO), Akthar Ali (Local Counsel, Consultant) and Faly Dialo (Finance Officer, WFALN). Shabnam Naz (Program Assistant) and Ehtesham-ul Haq (Program Assistant), both SACPK, and Mohammad Shafiq (Program Assistant, GMFDR) provided assistance to the team. The operation was prepared under the overall supervision of Shubham Chaudhuri, Practice Manager, GMFDR, Esperanza Lasagabaster, Practice Manager GTCDR, Pankaj Gupta, Practice Manager GEEFS, and Patchamuthu Illangovan, Country Director.

SUMMARY OF PROPOSED CREDIT / GUARANTEE AND PROGRAM

THE ISLAMIC REPUBLIC OF PAKISTAN

COMPETITIVENESS AND GROWTH DEVELOPMENT POLICY FINANCING

Recipient	Islamic Republic of Pakistan
Implementing Agency	Ministry of Finance (MoF)
Financing Data	• IDA Credit of Amount US$ 500 million with 25 years maturity including a 5 year grace period, a service charge of 0.75 percent per annum and a commitment fee of not more than 0.5 percent per annum. The interest rate will be 1.25 percent for the portion on blend terms (US$ 390.3 million) and 1.08 percent for the portion on hard terms (US$ 109.7 million). • IBRD policy-based guarantee (PBG) of up to US$420 million to support the origination of commercial financing at terms described in Annex 8.
Operation Type	Stand-alone Development Policy Financing operation, combining a single-tranche IDA Credit and an IBRD policy-based guarantee (PBG).
Pillars of the Operation And Program Development Objectives	The proposed operation will be structured around two development objectives and pillars, (i) improving the business environment, and (ii) enhancing fiscal management through improving revenue management and making public spending more pro-poor.
Result Indicators	• Improve the Doing Business Distance to Frontier Indicator for Getting Credit from 30 to 50. • Increase the number of taxpayers who submit a tax return online from 419,910 to 773,000. • Increase listed capital from PKR 1.18 trillion to PKR 1.46 trillion. • Increase housing finance market from 1.6 percent to 2 percent of private sector credit. • Make publicly available consolidated SOE financial information. • State Life Insurance Corporation is required to follow the Companies Ordinance 1984 as all corporate insurance companies • Increase tax revenues from 11 percent of GDP in FY2014/15 to 12.2 percent in FY16/17 • Share of public debt in foreign currency remains at 20-35 percent in line with the Government's Medium-Term Debt Strategy. • Number of households with updated poverty scorecard information registered in the National Socio-Economic Registry increases from zero to 2.5 million • New poverty rate published using latest data (2013-14) and poverty trend on old line, which had not been released since 2006, is publicly released
Overall Risk Rating	High
Climate and Disaster Risks	*(i) Are there short and long term climate and disaster risks relevant to the operation (as identified as part of the SORT environmental and social risk rating)? Yes* ☐ *No* ☒
Operation ID	P157207 and P159839

PROGRAM DOCUMENT FOR A PROPOSED IDA CREDIT AND AN IBRD POLICY-BASED GUARANTEE TO THE ISLAMIC REPUBLIC OF PAKISTAN

1. INTRODUCTION AND COUNTRY CONTEXT

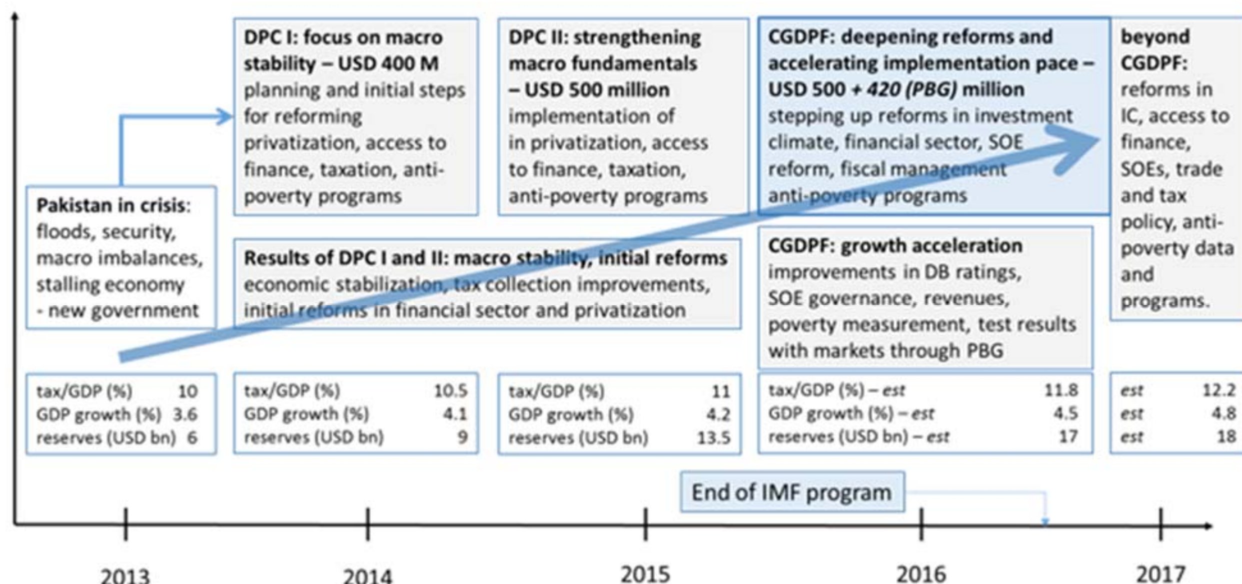
1. **This program document proposes a Competitiveness and Growth Development Policy Financing (CGDPF) operation.** The proposed operation combines a single-tranche stand-alone IDA development policy credit (DPC) of SDR 352.8 million (US$ 500 million equivalent) and an IBRD policy-based guarantee (PBG) in the amount of up to US$ 420 million to support the origination of commercial financing by the Islamic Republic of Pakistan. The proposed operation has two broad development objectives: (i) improving the business environment and (ii) enhancing fiscal management through improving revenue management and making public spending more pro-poor. The operation contributes to the Government's strategy for accelerating economic growth, pursuing fiscal consolidation and increasing investment. A stand-alone operation is being proposed to support a selected number of discrete reforms that the Government of Pakistan has implemented before entering the electoral cycle in 2017.

2. **The Government made significant progress in the design and early implementation of its economic reform program in its first two years in office.** Upon taking office, the Government's first priority was to re-establish macroeconomic stability and strengthen macroeconomic fundamentals, addressing significant internal and external imbalances. In doing so, it also initiated a number of crucial structural reforms. It cleared pending power arrears upon taking office; successfully completed the first equity and strategic sales of its privatization agenda; removed most discriminatory tax exemptions and concessions established through statutory regulatory orders (SROs) and transferred the authority to issue SROs to parliament. To improve the business environment, it created the One Stop Shop for business registration and strengthened the regulatory environment for the financial sector. It has also initiated a number of measures to improve tax policy and administration to address the chronically low tax revenue levels. Over the past few years the Government has also strengthened the pro-poor orientation and governance structures of the Benazir Income Support Program (BISP) and expanded the CCT for primary education. The previous Fiscally Sustainable and Inclusive Growth (FSIG) development policy credit series supported these reforms, thereby also contributing to restoring macroeconomic stability. Taken as a whole, the Government has been implementing a comprehensive, and challenging, set of reforms. Contrary to initial expectations at the time of preparation of the FSIG series, reform momentum has been maintained and GoP is deepening reforms and accelerating implementation, despite a challenging political environment.

3. **To accelerate growth and maintain macroeconomic stability the Government of Pakistan is stepping up reform efforts, which will be supported by the proposed operation.** After successfully restoring macroeconomic stability, the Government is stepping up efforts through deeper reforms and an accelerated pace of implementation, at a time in which political space seems to be narrowing as the next election approaches. Implementation continues in important areas that have been supported by previous operations, such as the removal of discriminatory tax exemptions and efforts to improve the business environment. Reform efforts are becoming more granular and focusing on more difficult aspects, for example in order to expand the tax base and improve tax compliance, FBR is reforming its approach to audits and is increasing

its focus on large taxpayers. Lessons learned are being applied – efforts to reform SOEs are going beyond individual privatization transactions and focusing on reforming whole sectors and improving the information base for both privatization and SOE reform. Understanding that access to finance is a key constraint to competitiveness, the proposed operation is supporting a significant overhaul of the legislative and institutional framework of the financial sector. The Government has also taken the bold move to adopt a revised poverty line, which increases the poverty headcount from below 10 percent to almost 30 percent, thereby putting to rest a ten-year controversy on the adequacy of poverty measurement that had resulted in no official poverty statistics being released for a decade. Figure 1 illustrates the deepening of reform efforts over recent years.

Figure 1: Aspirational trajectory of Pakistan DPO-supported reforms



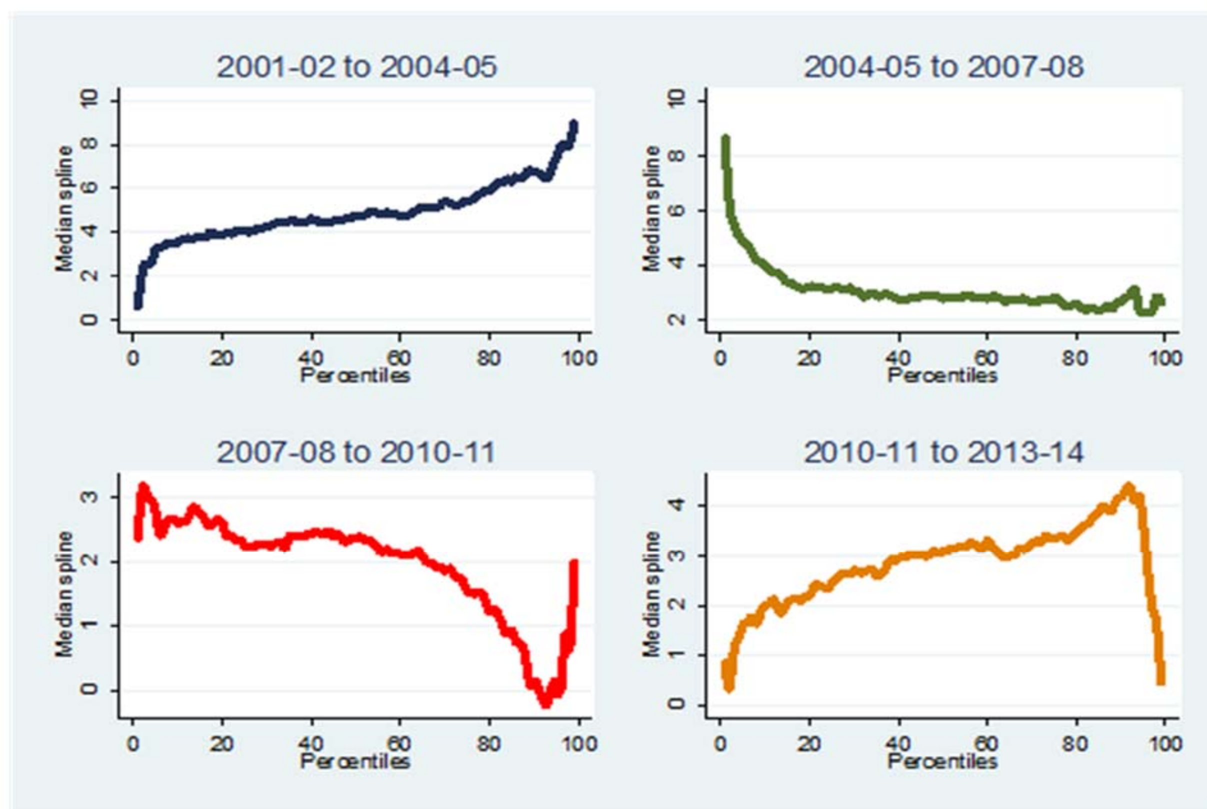
4. **The proposed operation will support the reform effort through both policy engagement and the choice of instrument – in this case combining the IDA credit with an IBRD policy-based guarantee (PBG).** The PBG will support the country's efforts to develop the financial sector and facilitate Pakistan's access to international markets. The PBG also means that the set of implemented reforms will be tested by markets, who will assess whether they do indeed put Pakistan on a different growth trajectory. The proposed operation and the choice of instrument used to support Pakistan's economic reforms are well-aligned with the Addis Ababa Action Agenda on Financing for Development adopted in July 2015, with a strong focus on domestic resource mobilization as well as the use of multilateral development finance to leverage additional resources from the private sector. Overall, the proposed operation is supporting an ambitious set of reforms with the potential to accelerate growth.

5. **The stepping up of reform ambition is particularly commendable in a relatively difficult political environment**. Pakistan's political environment is complex and not necessarily conducive to implementing an ambitious reform agenda. The country, a frontier in the fight against political extremism, is very often afflicted by terrorist acts – an attack in Lahore in March 2016 killed at least 75 people and injured almost 400 people, a large number of them women and children. The political agenda is also often captured by insurgencies, crisis-affected provinces and tensions with some

neighbors. Pakistan is a pluralist electoral democracy with a vigorous civil society and vocal local media, all contributing to very lively debates of any proposed government policy, often along party lines and not necessarily based on the merits of the proposed policies. Given this challenging political environment, government efforts to step up the reform momentum to accelerate growth are remarkable.

6. **Growth, though volatile and low in some periods, has been quite pro-poor in Pakistan over the past decade and a half.** The headcount poverty rate has fallen consistently over this period, from 34.7 percent in FY01/02 to 9.3 percent in FY13/14 (using the latest survey data and the old poverty line). Using incidence curves that plot the growth rate in consumption at each percentile of the distribution, it is evident that growth has been pro-poor in Pakistan through much of this period (see Figure 2 below). When growth first started to rise, the incomes of those at the top of the distribution grew faster than the incomes at the bottom. However, this quickly reversed, with those at the bottom growing faster than the top of the distribution. Between 2001 and 2004, for example, median income grew at 4.8 percent per annum while that at the bottom grew at close to 3 percent. In the next period (2004-2008), the bottom grew at more than 5 percent per annum while the median grew at only half that rate. After 2008, despite the global food price shock and the collapse of GDP growth, incomes at the bottom continued to grow faster than incomes at the top until FY10/11. In the period after that, as GDP growth began to rise once again, incomes at the top were growing faster than incomes at the bottom. Looking at the bottom 40 percent of the population—a measure of shared prosperity—we see a similar pattern. Understanding the process driving inclusive growth is an important agenda, and one that can be addressed fully only when there is greater trust in official government statistics. The Government's adoption of a revised methodology to measure poverty and a new poverty line, supported by this operation, is thus not only bold at this time but critical for effective anti-poverty programs in the coming years. It will contribute to a better understanding of the drivers behind successful poverty reduction over the last 15 years. Under the revised poverty line, the poverty head count has declined from 64.3 percent in FY01/02 to 29.5 percent in FY13/14.

Figure 2: Pakistan Growth Incidence Curves



7. **The reforms supported in the proposed CGDPF will contribute to efforts to accelerate growth and foster an inclusive growth pattern.** The proposed operation supports higher and inclusive growth through several channels. The business environment will be improved by reforms to simplify processes to pay taxes and increase the ease of accessing credit. The operation supports an overhaul of the legislative framework for financial sector development, which will also result in increased savings being channeled through the stock exchange and more credit available for housing. The operation is supporting an improved regulatory framework to progress the privatization agenda, by contributing to a level-playing field in the insurance sector and improving the information base for state-owned entities' (SOE) reform and privatization. Fiscal management is also being improved by creating fiscal space through increased revenues, which will allow the authorities to allocate additional resources to the social services and public investment, while reducing financing from the commercial banking sector and thus reducing the crowding out of the private sector. Measures to improve poverty measurement and the targeting of social safety net interventions will enhance the effectiveness of pro-poor policies. The proposed program builds on the success of the previous FSIG series and the ongoing IMF program by supporting reforms that will contribute to efforts to accelerate growth and foster an inclusive growth pattern.

2. MACROECONOMIC POLICY FRAMEWORK

2.1. Recent Economic Developments

8. **Economic conditions have improved over the past year.** The risk of a balance of

payments crisis has receded with a significant increase in international reserves resulting from strong remittances, foreign capital and financial inflows and the windfall gain from lower oil prices. With prudent monetary and fiscal management, the current account deficit remains moderate and the foreign exchange market has been stable. Headline inflation remains low (2.08 percent on average during July to April FY15/16) and fiscal consolidation continues.

9. **GDP growth continues to increase but remains timid at 4.5 percent projected in FY15/16, below the level required to accelerate job creation and significantly improve living standards.** The growth outlook for FY15/16 remains modest with growth expected to increase slightly to 4.5 percent of GDP from 4.24 percent in the previous year, driven by large-scale manufacturing growth of 4.0-4.5 percent and services growth of over 5 percent. The agriculture sector, after suffering a poor cotton harvest, is expected to have slowed to between 2.0 and 2.5 percent for FY15/16, compared with 2.9 percent in FY14/15. The near-term outlook will be supported by three major near-to-medium tailwinds—rising investments under the China Pakistan Economic Corridor (CPEC), persistently low international oil prices and the anticipated return of the Islamic Republic of Iran to the international community. The expected growth rate, however, remains well below the 5.5 percent target envisaged under Pakistan's Annual Plan FY15/16 and the growth rates of its South Asia peers. A further growth revival will remain contingent on the Government making further progress in addressing structural challenges like poor electricity availability, narrow fiscal space and inadequate access to credit.

10. **Pakistan has improved its external position, strengthening macroeconomic stability.** Also contributing to Pakistan's improved macroeconomic stability was its improved external position, with reserves reaching US$ 15.9 billion by end-December 2015, an increase of US$ 2.2 billion in the first six months of FY15/16, to more than 4 months of imports. A lower current account deficit and relatively healthy financial inflows contributed to the sustained build-up of foreign exchange reserves during H1FY15/16. However, this performance masks the structural weaknesses that continue to make the external sector vulnerable. Exports shrank by 11.1 percent in the first half of the fiscal year as an uncertain global economy magnified existing domestic bottlenecks. Imports similarly declined by 9.1 percent during the same period. The 6.2 percent growth in workers' remittances continued to compensate for the negative trade balance in absolute terms. Higher inflows in the capital and financial account this financial year were supported by the issuance of a US$500 million Eurobond.

11. **Remittances have reached record-high levels.** In FY14/15, remittances financed 45 percent of the country's import bill and 109 percent of the overall trade deficit. This impressive performance stems from two main factors: the consistent increase in the Pakistani diaspora, and the diversion of remittances from informal to formal channels, as the surveillance on global money laundering increases. The Gulf Cooperation Council (GCC) countries remained the largest source of remittances with a share of 65 percent of the total. Country-wise data shows that Saudi Arabia accounted for the largest share of total remittances to Pakistan (31 percent); with Saudi Arabia, the United Arab Emirates (UAE) (23 percent), the United States (14 percent) and United Kingdom (12 percent) together contributing 80 percent[1]. Moreover, almost 67 percent more Pakistani

[1] Remittances from Saudi Arabia, UAE, USA and UK grew by 19.1 percent, 35.3 percent, 4.93 percent and 4.92 percent respectively in FY14/15.

migrants entered the UAE in FY14/15 compared to the year before[2], primarily in the construction sector where mega-infrastructure projects are underway. The growth in remittances continued in FY15/16, albeit at a much slower pace than before, with 6.1 percent growth in the first eight months compared to the previous year. Seasonal factors explain some of this slowdown, but it also reflects the fall in oil prices and the consequent lower growth and fiscal tightening in GCC countries. The steady increase in remittances will come under pressure if oil prices remain low and Gulf Cooperation Council (GCC) countries cut public expenditure.

12. **The Rupee (PKR) has appreciated in real terms in the last year and a half.** The Rupee remained largely stable against the US dollar in H1FY15/16 as a result of the market's positive reaction to the build-up of reserves, with a small depreciation of 2.8 percent. The successful continuation of the IMF's EFF program has also improved sentiment in the foreign exchange market. With a relatively stable nominal exchange rate against the US dollar and inflation that is stable in comparison to peer countries, Pakistan's real effective exchange rate (REER) has appreciated in recent times. This appreciation[3] could be affecting Pakistan's export competitiveness[4], adding to structural constraints such as the poor investment climate, energy shortages and security concerns.

13. **Pakistan's fiscal balance is improving due to greater discipline.** Fiscal consolidation appears to be on track during H1FY15/16. The fiscal deficit of the consolidated government during H1FY15/16 stood at 1.7 percent of GDP – the smallest half-year deficit in the last three years. Total expenditure grew by 8.1 percent. Overall, tax collection has improved from 10.0 percent of GDP in FY12/13 to a projected 11.8 percent in FY15/16. Much of this improvement has been due to the first two phases of withdrawal of concessionary SROs under a three-year plan, which yielded an additional 0.7-0.8 percent of GDP in revenues. Non-tax revenues have declined as a share of GDP from 3.4 percent in FY12/13 to a projected 3.2 percent in FY15/16, partly as a result of legal challenges to collection of the Gas Infrastructure Development Cess (GIDC), which led to the collection of only 0.2 percent of GDP against a target of 0.6 percent of GDP. The Federal Government continued to hold recurrent spending under tight rein—federal recurrent spending grew by 3.7 percent compared to 2.4 percent in the same period last year. Provincial recurrent spending registered an increase on the previous year of 25 percent. However, because revenue growth has outstripped expenditure growth, Pakistan generated a primary surplus of 0.40 percent of GDP during H1FY15/16.

14. **Efforts continue to curb subsidy payments to the power sector.** The Government was able to reduce electricity subsidies from 2.3 percent in FY11/12 to 0.4 percent of GDP in FY15/16 by introducing significant increases for all tariff classes following the introduction of the National Power Tariff and Subsidy Policy Guidelines 2014[5]. Under this mechanism, the Ministry for Water and Power informs the regulator of the amount of subsidies provided, which ensures the subsidies

---

[2] *Source:* Bureau of Emigration and Overseas Employment, Government of Pakistan

[3] The latest Fund estimates point towards an overvaluation of Pakistani rupee between 5 and 20 percent (Source: IMF Country Report No. 16/2 Pakistan Selected Issues Paper, January 2016).

[4] Cross-country empirical relationships estimated by Fund economists suggest that a 10 percent real appreciation has a negative effect on exports of about 7 percent and a positive effect on imports (i.e., displacing domestic production) of about 9 percent, which would accrue over time. (Source: IMF Country Report No. 16/2 Pakistan Selected Issues Paper, January 2016).

[5] http://www.mowp.gov.pk/gop/index.php?q=aHR0cDovLzE5Mi4xNjguNzAuMTMwOjkwODAvbW93cC91c2VyZmlsZXMxL2ZpbGUvZmluYWwlMjAlMjBwb2xpY3klMjBGaW5hbCUyMDIwMTQwNDAxLnBkZg%3D%3D

are taken into account in its determination of consumer tariffs for the fiscal year. In June 2015, the Government notified the FY14/15 tariffs, as determined by NEPRA, and implemented surcharges in line with its commitment to reduce subsidies to 0.4 percent of GDP. The Government has also implemented a mechanism to maintain national uniform tariffs in distribution companies (Discos) while ensuring cost recovery. The Government began addressing both the flow and stock of payables in the power sector including by allocating budgetary resources, levying surcharges, gradual improvement in company performance and recoveries and initiating the process of privatization of power sector companies. In this regard, a circular debt capping model has also been developed with the Government meeting all quarterly accumulation targets. Quarterly loss reduction targets have been set for Discos and progress is underway with setting multiyear tariffs along with Discos' multiyear investment plans. As a result of these efforts, and the windfall of low oil prices, circular debt has increased only slightly in the first three quarters of FY15/16 to Rs. 331.5 billion. The Government is now in the process of revisiting its plan to reduce circular debt in light of delays in the privatization of Discos. The Government remains committed to gradually phasing out untargeted subsidies while continuing to protect the most vulnerable consumers.

15. **Public debt sustainability is starting to improve.** The public debt to GDP ratio decreased to a projected 64 percent[6] in FY15/16, but it remains above the 60 percent limit stipulated in the Fiscal Responsibility and Debt Limitation Act (FRDLA) of 2005.[7] More expensive, domestic debt dominates at 69 percent of the total debt composition. The government has succeeded in efforts to lengthen debt maturity and diversify financing sources through increased access to international financial markets (including sukuks), official lending from multilaterals and greater access to financing from the domestic banking sector, also allowing the Government to reduce its short-term borrowing from the central bank. However, current market volatility may affect government efforts to continue accessing international financial markets. The PBG proposed under this operation will support Pakistan's efforts to continue meeting part of its gross financing needs from international markets, despite tighter financing conditions (see Annex 7 for a detailed discussion on how the proposed PBG will support government efforts to access international financial markets).

16. **Prices have stabilized, supported by low oil prices.** For a third year in a row, headline CPI inflation is in single digits. Falling oil prices have not only contributed directly through reductions in petroleum product prices and electricity tariffs but also indirectly through reduced costs of manufactured goods and services. In FY15/16, inflation continues in single-digits but expectations are shifting towards a gradual increase. More notably, CPI inflation (y-o-y) has started to rise since October 2015 and currently stands at 4.0 percent in February 2016.

17. **The financial sector is healthy and private sector credit is recovering.** To foster private sector credit, the State Bank of Pakistan (SBP) cut its key policy rate by a cumulative 350 basis points (bps) in FY14/15, owing to favorable trends in oil prices and falling inflation. To anchor inflation expectations and improve liquidity management, the central bank announced a plan to set the policy rate between the floor and ceiling rates of the interest rate corridor in a forward-looking fashion, thus ensuring real interest rates remain positive. The banking sector has maintained

[6] This figure is sourced from World Bank calculations. The Government of Pakistan's estimate is projected at 63-64 percent.

[7] The FRDLA allows a departure from the threshold provided the Finance Minister specifies the reasons and the measures the Government intends to take to return below the threshold over an estimated period of time [Section 3 (4) of the FRDLA 2005].

improved performance and solvency. Year on year banking profitability improved, growing by 51 percent to June 2015. Non-performing loans (NPLs) declined to 12.4 percent of the overall loan portfolio in June 2015 and by virtue of adequate provisioning, net NPLs were 2.7 percent. The improvement in credit quality is broad-based, as NPLs in small and medium enterprises decreased slightly last year (to 32.2 percent) and NPLs in the consumer sector also decreased slightly to 10.6 percent. Private sector credit is recovering and has grown by 9.7 percent as of March 11, 2016 (y-o-y)[8]. Much of this increase stems from the manufacturing sector (particularly, chemicals and textile) and construction. Another positive development is the increase in credit for long-term investment purposes, notably in transport[9] and electricity sectors. To further enhance the domestic private sector's access to credit, the most recent Financial Sector Assessment Program (FSAP) mission to Pakistan recommended that the Government diversify its sources of borrowing, in particular by tapping external markets and extending debt maturities. The proposed PBG supports efforts in this direction.

18. **The market's perception of country risk is improving.** Pakistan's Emerging Market Bonds Index Plus (EMBI+) risk spread has declined from its peak in March 2013 of 1,011 bps to 517 bps in April 2016. Moody's changed the outlook for its Caa1 sovereign credit rating from stable to positive in March 2015. Later, in June 2015, Moody's upgraded Pakistan's foreign currency bond rating to B3 and assigned a stable outlook. Moreover, Standard & Poor's ratings agency raised Pakistan's credit rating outlook from stable to positive in May 2015 but affirmed its B- rating. Market confidence allowed Pakistan to raise US$2 billion in April 2014 through two dollar-denominated Eurobonds with bullet maturities and coupons of five years and 7.25 percent and ten years and 8.25 percent respectively, implying a spread of about 460-560 basis points over US Treasuries. The Government issued a US$1 billion five-year international Sukuk in November 2014 at 6.75 percent. More recently, in September 2015, Pakistan once again tapped international capital markets and issued a 10-year Eurobond worth US$500 million at 8.25 percent. As international markets had significantly tightened, the pricing of the bond was the same as a year earlier despite significant improvements in Pakistan's macroeconomic conditions. The proposed policy-based guarantee will support Pakistan's access to international markets at reasonable cost.

2.2. Macroeconomic Outlook and Debt Sustainability

19. **The outlook to FY18/19 is for moderately higher growth.** This is predicated on continued macroeconomic stability, as well as steady progress in implementing the main pillars of the Government's medium-term reform program, which tackle key constraints to growth. The outlook assumes that oil prices will increase moderately but remain low, and that political and security risks are managed.

20. **Growth acceleration will be gradual, and driven by strengthening investment flows on the demand side and productivity gains in services and manufacturing on the supply side.** The demand side is expected to be reinvigorated by investment (both public and private) and a mild recovery in exports as global demand picks up, following the expected moderate increase in oil prices over the medium-term. Gross fixed investment is expected to increase from 13.4 percent in FY14/15 to 14.2 percent of GDP by FY18/19. This increase is predicated on FDI picking up,

[8] Private sector credit contracted by 48 percent compared to the same date last March (y-o-y).

[9] This is primarily due to land transport for construction and road network under China Pakistan Economic Corridor (CPEC).

due in part to the China Pakistan Economic Corridor (CPEC). However, the economic impact of the CPEC will be limited in the short-run as increased investment will likely be offset by a significant increase in imports. Supply-side effects facilitated by higher power generation capacity and better infrastructure will be beneficial for the economy in the medium- to long-term. More generally, supply in the medium-term will expand as a result of productivity gains in the services, large-scale manufacturing and construction sectors, which should benefit from decreased power load-shedding and improvements in the business climate. The medium-term outlook assumes an increasing oil price trajectory and, given Pakistan is a net oil importer, this assumption has a sizeable impact on the trade bill (particularly imports) as well as direct and indirect effects on headline inflation. The cost to the Government budget from increased energy subsidies is expected to be offset by higher oil-related revenue receipts.

21. **Fiscal consolidation should improve financing conditions for the private sector.** Fiscal consolidation is expected to reduce the Government's borrowing needs, reversing the crowding out of private sector investment witnessed over the past few years, and creating fiscal space for public investment. Both external financing and domestic credit should be more readily available over time, aided by progress in fiscal consolidation, an improved external position and lower country risk. The proposed PBG is expected to act as a catalyst by supporting government efforts to access international financial markets to meet part of their gross financing needs, reducing government over-reliance on domestic debt, and creating space for provision of domestic credit to the private sector. The baseline macro projections are shown in Table 1 and explained below:

- *Growth and inflation:* GDP growth is expected to pick up to around 5.1 percent in FY17/18. Services are projected to expand, especially finance and insurance, transport and communication sectors. Manufacturing is expected to benefit from improved energy supply, better security, falling prices of industrial raw materials, implementation of CPEC-related investments and better private sector credit conditions. Consumption will be supported by a steady flow of remittances, albeit with constrained growth of around 5.7 percent compared with the historical five-year average of 16 percent. Investment is expected to benefit from better business conditions, strengthening FDI flows and increased public investment. Inflation is expected to steadily rise, averaging 5.1 percent over the projection horizon, as the base effect diminishes, domestic energy prices increase, and aggregate demand grows.

Table 1: Key Macroeconomic Indicators Pakistan FY12/13 to FY18/19[10]

	FY12/13	FY13/14	FY14/15	FY15/16	FY16/17	FY17/18	FY18/19
	Actual			Projections			
Real economy	(Percentage change; unless otherwise indicated)						
Nominal GDP at market prices (in bn. of rupees)	22,379	25,068	27,384	29,847	32,843	36,400	40,709
Real GDP growth (at factor cost)	3.7	4.0	4.2	4.5	4.8	5.1	5.4
Contributions:							
Agriculture	*0.6*	*0.6*	*0.6*				
Industry	*0.1*	*0.9*	*0.7*				
Services	*3.0*	*2.6*	*2.9*				
Per Capita GDP (current US$) 6/	1,275	1,317	..				
Unemployment rate 1/	6.2	6.0	5.9				
Consumer prices (period average)	7.4	8.6	4.5	4.0	5.0	5.5	6.0
Consumer prices (eop)	5.9	8.2	3.2				
Fiscal sector	(In percent of GDP; unless otherwise indicated)						
Expenditures	21.8	20.2	19.8	19.9	20.0	20.2	20.4
Revenue	13.3	14.5	14.4	15.0	15.5	15.9	16.3
Overall balance (excl. grants)	-8.5	-5.7	-5.4	-4.9	-4.6	-4.3	-4.1
Total public debt	64.7	64.7	64.4	64.0	62.1	60.2	57.7
Foreign currency public debt 2/	22.1	21.1	19.8				
Domestic currency public debt	42.5	43.5	44.5				
Monetary Sector	(Percentage change; unless otherwise indicated)						
Broad Money	15.9	12.5	13.2				
Credit to non-government	-0.6	11.1	5.6				
Interest (key policy interest rate)	9.0	10.0	6.5				
Balance of payments	(In percent of GDP; unless otherwise indicated)						
Current account balance (incl. transfers)	-1.1	-1.3	-1.0	-1.0	-1.5	-1.6	-1.7
Exports of goods & services	13.6	12.5	11.1	9.5	9.2	9.1	8.8
Imports of goods & services	21.0	20.4	18.6	16.7	16.5	16.5	16.2
Capital and financial account	0.2	2.9	2.0	1.7	1.4	1.5	1.5
Foreign direct investment, net	0.5	0.6	0.3	0.3	0.4	0.5	0.6
Gross official reserves (in US$ million, eop) 3/	6,047	9,172	13,538	17,455	17,190	17,091	16,500
Gross official reserves (in months of imports of G&S) 4/	1.5	2.2	3.5	4.2	3.9	3.6	3.4
Total external debt 5/	26.4	26.8	24.1	24.5	23.6	23.0	21.4
Rupees per U.S. dollar (period average)	96.8	102.9	101.5				
Memo:							
Crude oil, average ($/bbl) 7/	104.1	96.2	50.8	41.0	50.0	53.3	56.7
Nominal GDP at market prices (in US$ billion)	231.1	243.6	269.9				
GDP, PPP (current international $) 6/	837.8	890.3	..				

Sources: Pakistan authorities, IMF, World Bank Staff estimates

1/ National estimates.

2/ This includes medium and long term PPG debt as well as short-term external debt. This also includes IMF debt (both budget support and balance of payments support), Foreign currency bonds (NHA/NC) as well as PSEs non-guaranteed debt.

3/ SBP Gross Reserves exclude Cash Reserve Requirement, gold and foreign currency deposits of commercial banks held with SBP.

4/ In months of next year's imports of goods and services.

5/ Total external debt is inclusive of medium and long term PPG debt as well as short-term external debt, IMF and private debt.

6/ Source: WDI (as of March 29, 2016)

7/ Source: Commodity Markets Outlook, DECPG

- *Fiscal accounts:* The consolidated fiscal deficit (excluding grants) is projected to decline from 4.9 percent of GDP in FY15/16 to 4.1 percent by FY18/19 as shown in Table 2. Increased tax

[10] This macroeconomic framework has been developed by the World Bank. The Government's framework differs slightly. For example, the Government's data indicates that external debt was 21.4 in FY12/13, 20.2 in FY13/14 and 18.9 in FY14/15. The Government of Pakistan also projects slightly higher growth in 2015/16 and the following years as well as a faster pace of fiscal consolidation.

revenue, curtailed federal government expenditure and provincial surpluses will be the main contributors. The tax strategy adopted by the Government, including the elimination of discretionary tax concessions, aims at increasing tax revenue from 11 percent of GDP in FY14/15 to 13.1 percent in FY18/19, driven by federal tax collection. The Government's commitment to improve governance and efficiency of SOEs is expected to reduce demand for government grants. Tariff adjustments and reduced technical and non-technical losses will lessen electricity subsidies but higher oil prices are expected to reduce these declines to some extent (assuming 75 percent of the price increase is passed on to consumers). Thus recurrent expenditure is expected to decline from 16.2 percent of GDP in FY14/15 to 15.8 percent in FY18/19. Part of the fiscal space created would allow for a gradual increase in development spending, from 4.2 percent of GDP in FY14/15 to 4.6 percent by FY18/19.

Table 2: Key Fiscal Indicators Pakistan FY12/13 to FY18/19[11]

(In percent of GDP; unless otherwise indicated)

	FY12/13	FY13/14	FY14/15	FY15/16	FY16/17	FY17/18	FY18/19
	Actual			Projections			
Revenue and grants	**13.5**	**15.3**	**14.5**	**15.2**	**15.7**	**16.1**	**16.4**
Total Revenue	13.3	14.5	14.4	15.0	15.5	15.9	16.3
Tax revenue	10.0	10.5	11.0	11.8	12.2	12.7	13.1
Taxes on goods and services	4.3	4.6	4.6				
Direct Taxes	3.3	3.5	3.8				
Taxes on international trade	1.1	1.0	1.1				
Other taxes	1.3	1.5	1.6				
Nontax revenue	3.4	3.9	3.3	3.2	3.2	3.2	3.2
Grants	0.1	0.8	0.2	0.2	0.3	0.2	0.1
Expenditure	**21.8**	**20.2**	**19.8**	**19.9**	**20.0**	**20.2**	**20.4**
Current expenditure	16.7	15.5	16.2	15.6	15.6	15.7	15.8
Interest payments	4.4	4.6	4.8	4.3	4.4	4.4	4.4
Superannuation allowances & pension	0.8	0.7	0.7	0.8	0.8	0.9	0.9
Transfers (other than provinces)	1.4	1.5	1.5	1.7	1.6	1.5	1.5
Others	5.1	4.0	4.3	3.6	3.8	3.9	4.0
Provincial	4.9	4.7	5.1	5.2	5.1	5.0	5.0
Development expenditure & net lending	5.1	4.9	4.2	4.3	4.4	4.5	4.6
Statistical discrepancy	**0.1**	**-0.2**	**-0.6**	**0.0**	**0.0**	**0.0**	**0.0**
Overall balance (excluding grants)	**-8.5**	**-5.7**	**-5.4**	**-4.9**	**-4.6**	**-4.3**	**-4.1**
Overall balance (including grants)	**-8.4**	**-4.9**	**-5.3**	**-4.7**	**-4.3**	**-4.1**	**-4.0**
Financing	**8.5**	**5.7**	**5.4**				
External	0.3	2.2	0.8				
Of which : privatization receipts	0.0	0.0	0.0				
Domestic	8.2	3.5	4.7				
Memo:							
Primary balance (excluding grants)	-4.1	-1.1	-0.7	-0.6	-0.2	0.1	0.3
Primary balance (including grants)	-3.9	-0.3	-0.5	-0.3	0.1	0.3	0.4

Source: World Bank Staff calculations and estimates

- *Revenue mobilization:* Tax revenues are expected to increase from a projected 11.8 percent of GDP in FY15/16 to 13.1 percent by FY18/19. The increased revenue mobilization will be supported by higher growth and imports as well as successful implementation of the ongoing reforms in tax policy and administration. In the first eight months of FY15/16, revenues collected by FBR posted an impressive 20 percent increase, on the back of a broad-based

[11] These figures are sourced from World Bank estimates. The Government of Pakistan's estimates differ slightly.

increase in direct and indirect tax collection. The Government's strategy to broaden the tax base and reduce the tax gap is focused on five areas: (i) minimization of tax expenditure by phasing out SROs over a three-year program; (ii) an increase of sales tax rates on POL, and gradually bringing up the concessional sales tax rates on some sectors to the standard rate; (iii) increased rates and extension of the holding period on securities and immovable property for the purpose of the capital gains tax, and increased discriminatory rates for non-filers; (iv) revised procedures and thresholds for income and sales tax registration; and (v) identification of tax evaders in commercial and professional services sectors. The total estimated additional revenue expected from phasing out SROs over three years is about one percent of GDP, with the first phase accounting for about 0.4 percent of GDP in FY14/15 and the second phase in FY15/16 expected to yield an additional 0.4 percent of GDP. Non-tax revenues are assumed to fall from 3.3 percent of GDP in FY14/15 to 3.2 percent in FY18/19, partly as a result of diminishing US Coalition Support Funds from FY16/17 onwards.

- *Fiscal Financing Gap.* Gross financing requirements for the Government of Pakistan are projected to be PKR 7.6 trillion (US$73 billion) and PKR 9.2 trillion (US$84 billion) in FY15/16 and FY16/17 respectively (Table 3). Amortization of medium- and long-term public sector debt will increase significantly in FY16/17, particularly to domestic creditors. Multilateral official financing and domestic creditor financing will remain the main long-term financing sources. The Government will seek to continue accessing international financial markets, which will facilitate the Eurobond bullet repayments due from FY16/17 onwards (US$750 million in FY16/17 and US$1 billion in FY18/19). Continued volatility in global markets may constrain Pakistan's ability to access international financial markets at reasonable costs. The proposed operation combining an IDA credit and an IBRD PBG is in line with two of the elements of the Government's medium-term debt strategy: (i) availing maximum concessional external financing from development partners and (ii) continuing to access international financial markets. Increased financing from abroad will diversify the Government's funding and reduce its reliance on the domestic banking sector, creating much-needed space for private sector credit. Table 3 shows the Government's gross fiscal financing requirements and sources that will finance that gap.

Table 3: Pakistan Fiscal Financing Requirements and Sources FY14/15 to FY18/19

(in billions of PKR; unless otherwise specified)

	Actual	Projections			
	FY14/15	FY15/16	FY16/17	FY17/18	FY18/19
Financing requirements	**6,835**	**7,604**	**9,165**	**8,952**	**9,909**
Fiscal deficit (incl. grants)	1,442	1,397	1,419	1,500	1,616
Maturing short-term public sector debt (previous year stock)	4,101	4,737	5,087	5,919	6,734
Amortization of medium- and long-term public sector debt	1,292	1,470	2,660	1,534	1,559
To domestic creditors	1,067	1,175	2,227	1,363	1,110
To other official creditors (incl. IMF)	225	243	351	171	215
To Eurobonds	-	52	82	-	235
Financing sources	**6,835**	**7,604**	**9,165**	**8,952**	**9,909**
Privatization receipts	17	50	50	-	-
Short term debt disbursements	4,157	5,001	5,988	6,573	7,265
Long term debt disbursements	2,630	2,499	3,029	2,350	2,591
From other official creditors	203	492	515	402	408
From domestic creditors	2,325	1,903	2,405	1,891	1,948
From Eurobonds	102	104	109	58	235
Change in assets (decrease = +)	31	53	98	29	53

Source: World Bank Staff calculations and estimates

- *External Sector.* As a result of the expected moderate increase in oil prices, the current account deficit is expected to increase to 1.7 percent of GDP in FY17/18—from 1.0 percent in FY14/15. Faster economic growth will require higher imports of raw materials, machinery and fuels on top of sizeable oil imports. Exports are expected to grow at an average of 4.5 percent for the next three years. Steady remittances will continue to partly finance the current account deficit in the medium term, although budget cuts and slower growth in GCC countries (arising from the absence of a full recovery in oil prices) will affect migrants' employment options and remittances. Slightly higher foreign investment inflows under the CPEC and investments attracted by a gradually lower country risk will support the financial account, despite declining multilateral financial net inflows. Official foreign exchange reserves are projected to decline to 3.4 months of imports by FY18/19 as the trade deficit widens and repayments begin on the IMF EFF in FY17/18. Another reserve adequacy measure, reserves to short-term external debt and liabilities plus projected current account, is expected to hover around an average of 304 percent during the projection horizon.

- *External Financing Gap.* Gross financing requirements from the balance of payments are expected to be US$11.4 billion by end-FY18/19. IMF and official creditors' amortization is projected to decline gradually from US$2.9 billion in FY14/15 to US$2.2 billion by FY18/19. In contrast, the current account deficit is projected to increase in absolute terms and reach US$5.9 billion by FY18/19. Multilateral, bilateral and private debt-creating flows are expected to be the main financing sources. To meet external financing needs, the Government will continue to access international markets. As discussed earlier, continued volatility in global markets may constrain Pakistan's ability to access international financing at a reasonable cost for the required volumes. The proposed PBG will help Pakistan maintain access to international financial markets. Balance of payments financing requirements are shown in Table 4.

Table 4: Pakistan BOP Financing Requirements and Sources FY14/15 to FY18/19

(in millions of US dollars; unless otherwise specified)

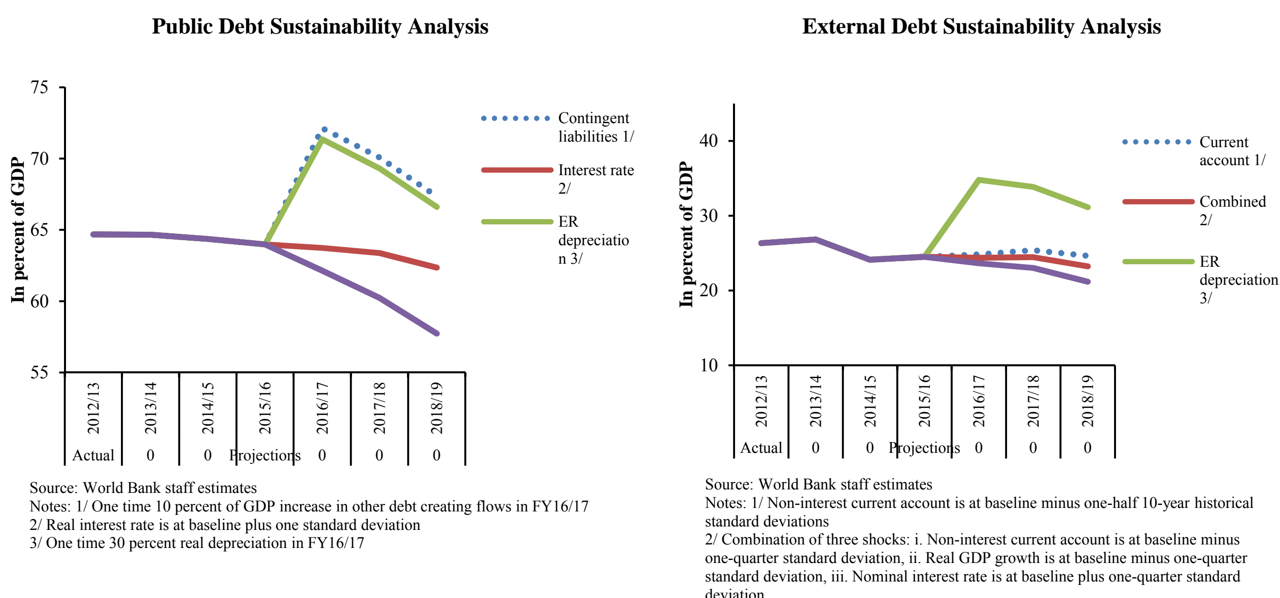
	Actual	Projections			
	FY14/15	FY15/16	FY16/17	FY17/18	FY18/19
Financing requirements	**7,040**	**7,412**	**11,092**	**8,617**	**11,375**
Current account deficit	2,709	2,790	4,525	4,949	5,947
Maturing short-term debt	582	1,185	1,929	1,472	835
Amortization of medium- and long-term debt	3,749	3,437	4,638	2,196	4,593
To IMF	1,225	-	-	126	417
To other official creditors	1,696	2,325	3,215	1,481	1,832
To private creditors	828	612	673	589	344
To Eurobonds	-	500	750	-	2,000
Financing sources	**7,040**	**7,412**	**11,092**	**8,617**	**11,375**
FDI and portfolio investments (net)	1,732	539	1,443	1,791	2,045
Capital grants	375	378	722	523	672
Other net capital and financial inflows	1,263	941	934	940	1,180
Short term debt disbursements	1,155	1,478	1,335	835	835
Long term debt disbursements	7,110	7,994	6,393	4,429	6,052
From IMF	2,611	1,962	60	-	-
From other official creditors	3,088	4,707	4,716	3,488	3,482
From domestic private creditors	411	325	617	441	570
From Eurobonds	1,000	1,000	1,000	500	2,000
Change in reserves (decrease = +)	(4,595)	(3,917)	265	99	591

Source: World Bank Staff calculations and estimates

Note: Portfolio investments exclude Eurobonds which are shown separately under amortization and disbursements.

- *Public Debt*. A projected primary surplus, combined with real GDP growth, is expected to lead to a further decline in Pakistan's public debt to GDP ratio, which is expected to decline below the legislative threshold of 60 percent by FY18/19 (see Figure 3 for the projected debt path and Figure 4 for a decomposition of debt dynamics). A debt sustainability analysis shows that the debt path is sensitive to exchange rate depreciation shocks and, to a lesser extent, the materialization of contingent liabilities, either from power sector arrears or SOE losses. The debt sustainability analysis is discussed further in Annex 4.

Figure 3: Pakistan Debt Sustainability Analysis FY12/13 to FY 18/19



Source: World Bank staff estimates
Notes: 1/ One time 10 percent of GDP increase in other debt creating flows in FY16/17
2/ Real interest rate is at baseline plus one standard deviation
3/ One time 30 percent real depreciation in FY16/17

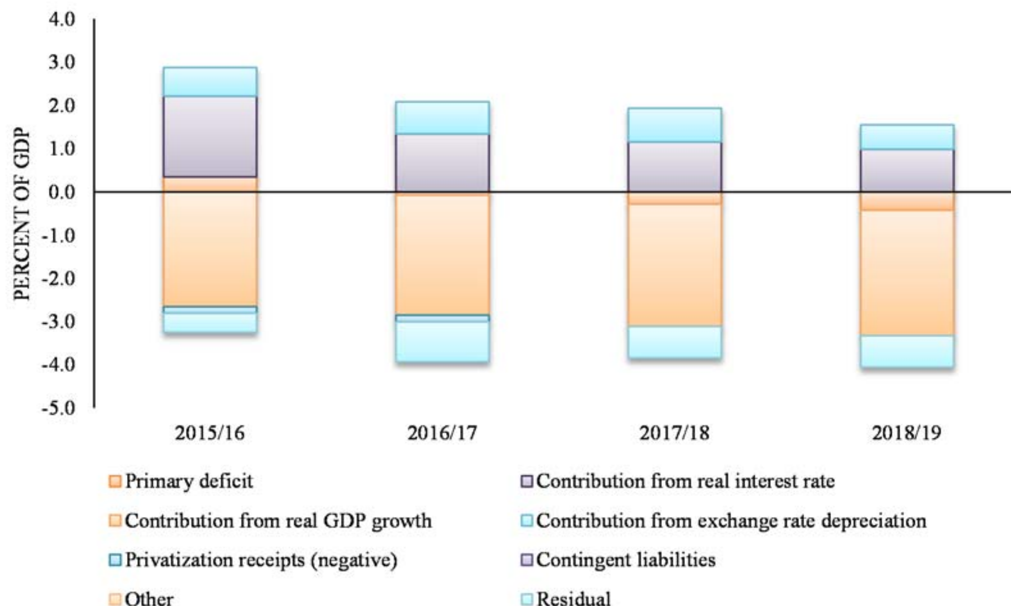
Source: World Bank staff estimates
Notes: 1/ Non-interest current account is at baseline minus one-half 10-year historical standard deviations
2/ Combination of three shocks: i. Non-interest current account is at baseline minus one-quarter standard deviation, ii. Real GDP growth is at baseline minus one-quarter standard deviation, iii. Nominal interest rate is at baseline plus one-quarter standard deviation

External Debt Composition as of June 30, 2015

	USD (mn)	*Share of total debt*	*% of GDP*
Monetary authoriities	7,760	11.9%	2.9%
General Government	46,851	71.9%	17.4%
Banks	2,338	3.6%	0.9%
Other sectors	8,198	12.6%	3.0%
Of which intercompany lending	2,676	4.1%	1.0%
Total External debt	65,147	100.0%	24.1%
Long term	59,386	91.2%	22.0%
Short term	5,762	8.8%	2.1%

Sources: Pakistan authorities

Figure 4: Composition of the Projected Change in Public Debt Levels



Source: Pakistan Public DSA 2015/16 - 2018/19

22. **There are significant downside risks to the projected outlook**. Pakistan remains vulnerable to domestic and external shocks. *Domestically*, the country is exposed to natural disasters, political events and terrorism. Challenging domestic political conditions like those suffered during the first half of FY14/15 may disrupt economic activity. Security risks may also disrupt economic activity, discourage investment and undermine fiscal consolidation. Slippages in the privatization program may affect private sector investment, lead to fiscal outlays and further increase Pakistan's contingent liabilities. In the case of DISCOs, further delays in privatization may slow the Government's efforts to reduce circular debt in the energy sector. A persistent dollar appreciation with limited exchange rate flexibility may erode export competitiveness. The combination of the upcoming national election in 2018 and the end of the IMF's EFF program in September 2016 may affect reform momentum. Delays in much-needed structural reforms would weaken growth prospects and discourage private investment. *Externally*, protracted global economic weakness, especially in the Euro area, China and Japan, could negatively affect exports. Pakistan benefits from significant remittance flows, particularly from oil-rich countries (around two-thirds of all remittances). Low oil prices represent a downside risk for remittances, as GCC countries may reduce public spending, leading to reduced demand for Pakistani migrant workers. But low oil prices also improve the current account deficit and create an environment conducive for reductions in energy subsidies. On balance, low oil prices have been positive for Pakistan, being a net oil importer. Conversely, a sharp increase in oil prices will worsen the trade deficit and could increase energy subsidies.

23. **Mitigation of these risks is best achieved by building domestic and external buffers to absorb shocks**. The Government of Pakistan has been rebuilding buffers by increasing reserves, tightening fiscal policy to reduce borrowing needs and conducting an appropriate monetary policy that has maintained relatively low inflation. Efforts to reduce fiscal deficits have resulted in a slight

decline in debt levels in the past few years, which is expected to continue in the medium-term.

24. **The macroeconomic framework is adequate for the proposed operation**. Economic activity is picking up, inflation is relatively low and the fiscal deficit is narrowing. Historic external imbalances are declining, the current account deficit remains modest and foreign exchange reserves have been rebuilt.

2.3. IMF Relations

25. **The IMF program is on track**. Pakistan entered a 36-month EFF with the IMF in September 2013 for an amount of SDR 4,393 million. So far Pakistan has undergone ten successful quarterly program reviews with the IMF under the EFF. In March 2016 the Fund's Executive Board approved the Tenth Review, making available another tranche of SDR 360 million (about US$502.6 million). Pakistan met the end-December 2015 performance criteria on net domestic assets and the fiscal deficit, but the indicative target on tax revenue was missed by a nominal margin. Staff argued that reform efforts should continue to strengthen public finances and external reserve buffers, to accelerate steps to widen the tax net and to address constraints to growth including by privatizing loss-making public enterprises, advancing energy reforms and improving the business environment. Discussions on the eleventh review were held from 2nd to 11th May 2016 and the IMF and the Pakistani authorities reached staff-level agreement on the completion of the eleventh review under the EFF arrangement.

3. THE GOVERNMENT'S REFORM PROGRAM

26. **The Government is pursuing a comprehensive economic reform program, supported by development partners.** Upon taking office, the new administration introduced a wide-ranging reform program. Under this program, the Government committed to adopting stabilization measures to eliminate the country's macroeconomic imbalances and initiating reforms necessary for a more efficient economy (Box 1). In its first two years, the Government developed, and started to implement, reform agendas in a number of areas: an energy policy in August 2013, a privatization strategy in October 2013, a tax reform strategy in February 2014, a three-year plan for phasing out SRO-based tax exemptions in June 2014, a plan for improving the investment climate in October 2014, a national financial inclusion strategy in January 2015 and a Tariff Rationalization Plan in March 2015.

Box 1: Key Economic Priorities of the Government's Program

The Government's economic reform program focuses on macroeconomic stability, aiming at bringing inflation down to 6–7 percent and achieving growth rate targets of 6–7 percent by FY17/18 or earlier. To do this, it has laid out the following policy agenda:

Stabilization

Fiscal consolidation. Reducing the fiscal deficit from 8.3 percent of GDP in FY12/13 to 3.5-4 percent in FY16/17 by increasing revenues by around 3 percent of GDP, eliminating tax exemptions, imposing austerity in non-social expenditure outlays, reducing subsidies and improving debt management.
Rebuilding external reserves to no less than 3 months of imports along with prudence in monetary policy. Scaling back monetary accommodation of fiscal deficits and setting up policy rates to keep positive real interest rates; strengthening the central bank's independence.

Main growth-enhancing reforms

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 restructuring and requiring compliance with the Public Sector Companies (Corporate Governance) Rules 2013.
Improving trade competitiveness. Simplifying trade slabs and phasing out trade-distortive statutory regulatory orders (SROs).
Improved trade quantum with preferential trade alliances. Increased effort to benefit from all preferential trade alliances and taking full advantages of GSP+ from the European Union.
Enhancing the investment climate. Strengthening the Board of Investment in implementing a plan for improving the business environment and establishing 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.

27. **The Government of Pakistan has sought to change the trajectory of growth with greater private sector development.** Raising private investment is crucial for the Government's ambitions to accelerate growth. The Government is focusing on policy reforms at the federal and provincial levels to enhance the enabling environment, including improving the legal framework and addressing constraints facing private sector participation. Efforts to improve competitiveness at the provincial level are being supported by the World Bank through a number of projects, e.g. the recently approved Punjab Growth and Competitiveness PforR. Recognizing access to finance as a serious impediment to inclusive growth in Pakistan, the Government is aiming to enhance financial intermediation and access to finance and enable a deepening of financial services and capital markets. The Government is also pursuing SOE reform, including by improving the corporate governance and accountability of SOEs. Although SOEs are a dominant part of the economy, there was previously no consolidated information on the financial performance of SOEs publicly available. The Government has now ensured that the public is informed about the financial performance of all federal SOEs by requiring the annual publication of key financial information of all state-owned entities and has published a first report with their consolidated financial and non-financial information for FY13/14.

28. **Pakistan needs targeted measures to benefit the poor and other disenfranchised groups to address persistent disparities.** The Government has committed to minimize the potential negative impact of fiscal adjustment and structural reforms on the poor and vulnerable. Spending on safety nets has significantly increased and a stronger institutional framework has been put in place to cushion vulnerable households from the negative effects of transitory income shocks. Upgrading the efficiency and targeting of social assistance programs is critical. The Government also seeks to mobilize revenues and improve development expenditures to create more fiscal space. Through technical assistance, the Bank is also supporting efforts to improve the quality of spending at the provincial level – by allocating a greater share of resources to the social sectors (education, health, social protection) as well as by strengthening systems to appraise, select and implement public investment projects.

29. **While Pakistan spends relatively little on social sectors, both federal and provincial governments have been spending more as fiscal space has grown in recent years.** In line with the 18th Constitutional Amendment, the provincial governments in Pakistan have primary responsibility for social services. Table 5 shows an increase in provincial health expenditure from 0.5 percent of GDP to 0.7 percent in the five years to FY13/14. Similarly, education spending has grown from 1.4 to 1.8 percent of GDP over the same period. Education, health and social protection constituted almost 32 percent of total provincial expenditures (current and development) in FY09/10 and have now increased to about 42 percent for FY13/14. While the Federal Government's budget is dominated by four major categories – general public service, defense, law and order and economic affairs – it has also increased spending on education and health over the period under review. At the provincial level, both Punjab and Sindh have been allocating an increasing share of their budget to social services. The Federal Government also regularly reports on expenditure under the Poverty Reduction Strategy Paper—provisional figures for H1FY15/16 show an 11 percent increase in total Federal 'pro-poor' spending, compared with the same period in the previous year from Rs. 440 billion to Rs. 488 billion. Overall, these trends suggest that Pakistani governments at both the national and sub-national levels are making increasingly pro-poor spending decisions as fiscal space widens.

Table 5: Government expenditure, by functional classification*

(In percent of GDP; unless otherwise indicated)

	FY09/10	FY10/11	FY11/12	FY12/13	FY13/14
	Actual				
Federal	*14.1*	*13.4*	*13.0*	*13.3*	*13.9*
General public service	8.1	8.1	7.6	9.5	10.1
Defence affairs and service	2.5	2.5	2.5	2.4	2.5
Public orders and safety affairs	0.3	0.4	0.4	0.4	0.3
Economic affairs	0.6	0.4	0.2	0.5	0.5
Environmental protection	-	0.0	0.0	-	-
Housing and community amenities	-	0.0	0.0	-	0.1
Health	-	0.0	0.0	0.1	0.1
Recreation, culture and religion	-	0.0	0.0	-	-
Education affairs and services	0.2	0.2	0.2	0.3	0.3
Social protection	-	0.0	0.0	0.1	-
Others 1/	2.4	1.6	2.0	-	-
Sub-national	*6.3*	*6.2*	*6.3*	*6.7*	*6.5*
General public service	1.4	1.3	1.5	1.7	1.4
Defence affairs and service	-	0.0	0.0	-	-
Public orders and safety affairs	0.8	0.7	0.8	0.8	0.8
Economic affairs	0.9	1.5	1.4	1.0	0.8
Environmental protection	0.1	0.1	0.1	0.1	-
Housing and community amenities	1.0	0.3	0.3	0.7	0.7
Health	0.5	0.5	0.5	0.6	0.7
Recreation, culture and religion	0.2	0.0	0.0	0.1	0.1
Education affairs and services	1.4	1.5	1.5	1.5	1.8
Social protection	0.1	0.3	0.2	0.2	0.2

Source: Ministry of Finance, Provincial Finance Accounts, Controller General of Accounts and World Bank Staff calculations

** Does not include net lending.*

1/ For federal government (FY09/10-FY11/12), this category is total development expenditure on account of non-availability of data on the basis of functional classification.

30. **The Government faces significant challenges in delivering its reform agenda.** While Pakistan's federal and provincial governments are pursuing an ambitious investment mobilization agenda, their ability to implement necessary and technically sound reforms is hampered by ongoing political resistance and an uncertain security environment marked by militancy and volatile relationships with neighbors. As vested interests fuel a vocal opposition, it has become increasingly difficult to maintain reform momentum in some areas such as privatization, which could affect energy sector reforms. Nonetheless, the Government has generally maintained focus on its economic reform program, even where strong resistance has forced it to revisit initial plans.

31. **Some initiated and planned reforms will take a longer time to implement and yield results**. Notwithstanding the achievements to date, many of the reforms are medium-term in nature and full results will materialize in the medium-term, and only after a sustained effort. The government's medium-term reform agenda is further elaborated in Annex 5.

4. THE PROPOSED OPERATION

4.1. Link to Government Program and Operation Description

32. **The proposed operation supports an ambitious reform agenda that deepens previous reform efforts and accelerates the pace of reform.** The previous FSIG DPC series jumpstarted a number of critical institutional and regulatory reforms structured around two main pillars: first, fostering private and financial sector development through privatization of SOEs, expanding access to finance, improving trade competitiveness, and enhancing the investment climate; and second, mobilizing revenue and redirecting spending to make it more pro-poor. The proposed CGDPF continues to support the implementation of crucial reforms initiated three years ago, such as the phasing out of the SROs. It deepens reforms in some areas where progress has been more uneven, such as in broadening the tax base and improving the investment climate, and introduces new reform areas that are deemed crucial, such as SOE reform, debt management and poverty measurement. Acknowledging the progress to date, the higher level of reform ambition and the challenging political environment, this operation proposes a combination of a number of instruments to support this ambitious reform program.

33. **The preparation of this operation benefited from the experience gained from the implementation of the previous FSIG DPC series.** The most recent FSIG series and the parallel Energy Sector DPC series reverse a relatively poor track record of policy reform operations before then. Assessments of the past and more recent experiences provide valuable country-specific lessons, and these have been borne in mind in designing and preparing this operation:

- Implementation of the previous FSIG series suggests a number of lessons, as reflected in the latest Implementation Status and Results Report of April 2016: (i) the depth of the program and the reforms being supported require a common understanding of the different steps to implement reforms and when implementation is sufficiently advanced to achieve the desired results. In preparing this operation, the Bank held early discussions with government counterparts at the highest levels to achieve a common understanding of the reform program, the level of ambition necessary to attain the desired results, and how this will be reflected in the formulation of the prior actions; (ii) the legislative process in Pakistan can be heavily politicized, with the potential of policy reversals along the way. In designing the current operation, the team was cognizant of the political economy of reforms being proposed and the potential for policy reversals, pacing the operation to coincide with the Government's legislative agenda; and (iii) the complexity of the reform agenda and the heightened risks identified in this operation require frequent coordination at the highest levels. In preparing this operation, the Minister of Finance has held monthly meetings with all stakeholders and the World Bank team to monitor implementation of reforms being supported and agree on any necessary corrective measures. The preparation of this operation has also taken into account experience that suggests that development policy operations tend to be more successful when complementary technical assistance is provided to implement the supported reforms. Implementation of all prior actions included in this operation has been supported by technical

assistance or investment projects. A lesson from the Energy Sector DPC was the importance of tackling difficult reforms through both technical advice and improvements in transparency by making information on reforms available to the public. This lesson informed the supported SOE reforms.

- Policy support operations, such as the proposed CGDPF, provide financing to a government upon completion of a set of critical policy and institutional actions agreed between the World Bank and the client. To achieve the results foreseen in the operation, successful implementation often requires the collaboration of other branches of the state beyond the executive, the private sector or the population at large. In selecting prior actions to be included in the program, it is important to carefully weigh the risks that a particular prior action may not be completed because of circumstances beyond the control of the Government, e.g. actions by the private sector during the privatization process or the Parliament during the legislative process. The preparation of this program has taken into account these risks, particularly in light of recent experiences with prior actions supporting the privatization process in the previous DPC series.

4.2. Rationale and Details of the Proposed Policy-Based Guarantee

34. **The proposed operation combines a single-tranche stand-alone IDA development policy credit (DPC) of SDR 352.8 million (US$ 500 million equivalent) and an IBRD policy-based guarantee (PBG) in the amount of up to US$ 420 million to support the origination of commercial financing by the Islamic Republic of Pakistan.**

35. **The Government of Pakistan has requested IBRD support 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 to the GoP of up to US$1.5 billion in the current and next fiscal year. The Government of Pakistan is seeking to partly meet its financing needs for the current fiscal year (ending on 30 June 2016) with the IDA credit (US$500 million) while the PBG would help meet the Government's financing needs in the upcoming fiscal year starting on July 1, 2016. The proposed PBG of up to US$420 million will raise commercial finance in the loan and/or bond proceeds in the capital markets, with an expected leverage of 1.2x to 2.5x depending on the financing alternative chosen. This is supportive of IBRD's overall objectives of leveraging its balance sheet and multiplying development resources and impact, as well as leveraging concessional windows in innovative ways.

36. **The proposed PBG would help Pakistan maintain access to foreign capital inflows at a sustainable cost and as budgeted in order to continue its strategy to improve competitiveness and accelerate growth.** While Pakistan has previously been able to access the international capital markets alone, recent Pakistan Government issuances (the latest in September 2015) have proven to be more challenging in raising adequate volumes of sovereign funding at acceptable financial terms. Those recent challenges are caused by the increasing market volatility for emerging market issuers trying to access international capital markets. Since the end of 2015 until very recently, the emerging bond market has been closed to low-rated issuers such as Pakistan. Pakistan's international bonds have performed better than some similarly-rated sovereigns, but are still susceptible to widening spreads and reduced appetite due to increased market volatility and weak sentiment. The proposed PBG would help Pakistan maintain access to foreign capital inflows at a sustainable cost and as budgeted in order to continue delivering its strategy to improve competitiveness and accelerate

growth.

37. **The proposed PBG will support the Government's efforts to create fiscal space for domestic credit.** Previous FSAPs and the ongoing FSAP Development Module have highlighted the need to diversify the Government's debt profile. Even though overall debt levels are comparable to relevant markets, the tenors and instruments utilized have been limited. In addition, the reliance on domestic debt has increased from 30.3 percent of GDP in FY08/09 to 44.5 percent of GDP in FY14/15, which has crowded out private sector credit. Pakistani banks' exposure to government securities has increased from 35 percent of total banking assets in FY 13/14 to 38 percent in FY14/15. Banks held almost 72 percent of outstanding PIBs at the end of June 2015, compared to 67.3 percent a year earlier. The PBG will help reduce the Government's borrowing from the domestic banking sector, freeing resources for private sector credit and thereby supporting the operation's objective of a more competitive private sector.

38. **The PBG has many additional benefits.** Following the conclusion of the IMF program in September 2016, the PBG would demonstrate continued international support to Pakistan. Evidence suggests that, as a result of positive signaling and by offering an improved risk profile, PBG-supported financing could attract new investors while ensuring continuity of access to international markets and maintaining market discipline. The PBG would also allow for greater World Bank resources to be available for other projects by extending the IBRD envelope.

39. **There are a number of financing alternatives that could benefit from the PBG**. The choice between the financing alternatives would be determined on the basis of market conditions at the time of placement and Pakistan's funding parameters such as volume, maturity, spread savings and World Bank guarantee utilized/leveraged. The financing amount to be raised with the support of the PBG would be determined in conjunction with the Government of Pakistan based on their financing needs for FY16/17 and in line with the recently approved Medium-Term Debt Strategy FY15/16-FY18/19, with due consideration to capital market dynamics and Pakistan's planned sovereign bond issuances. The proposed PBG would have no immediate impact on debt levels, since it will be used to meet existing (not additional) financing needs. In the medium-term, through reduced financing costs it may have a modest contribution to lower debt levels.

40. **The PBG structure is flexible.** Recent country experience in capital markets demonstrates that countries should build sufficient leeway into their financing timeline to ensure they have the flexibility to choose the right time to access the market. Secondly, countries should not limit themselves to a single market segment and instead develop alternatives to access multiple markets. The PBG would provide Pakistan with the flexibility to benefit from both of these lessons. As a result of its inherent flexibility, the PBG could be adapted in response to market conditions. It could be sliced up and used for accessing the same or different markets at multiple points in time. The PBG could support commercial financing in the loan and/or bond capital markets, and could be structured in a flexible way to provide principal and/or coupon coverage. The Bank's guarantee would be partial and apply on select debt service payments through a structure to be developed in coordination with the market and the Government. Possible guarantee structures could include rolling coverage of scheduled principal and coupon payments for an amortizing loan or bond or a bullet bond; or a percentage of all debt service payments throughout the life of the loan/bond; or back-ended coverage where debt service payments only at the end of the loan/bond tenor would be covered. Pakistan, as the issuer, would have the primary obligation to ensure timely repayment to

the investors. However, if Pakistan failed to make a guaranteed debt service payment, the holders of the financing could call on the Bank's guarantee for the amount of such a payment.

41. **During the preparation phase, the Bank would work with the Government and lead arranging banks to determine which segment of the market provides the best value for the guarantee and meets the Government's needs[12].** Several options could be contemplated for a PBG-backed financing. A more detailed discussion on the proposed PBG is included in Annexes 7 and 8.

42. **Approval will be sought from the Bank's Board for the proposed PBG operation alongside the IDA credit.** Board approval will be sought on the basis of the proposed terms of the PBG (see Annex 7 and 8). The market transaction would be prepared in parallel to the one-tranche IDA credit. The Executive Directors will be informed of the final terms and conditions of the PBG-supported commercial financing operation after execution. If there is any substantial change in the terms and conditions of the PBG, the approval of the Executive Directors will be sought prior to execution.

4.3. Prior Actions, Results and Analytical Underpinnings

43. **The eleven CGDPF prior actions and associated results indicators are set out in the Policy and Results Matrix (provided in Annex 1)**. Although there is continuity with the previous FSIG series in the areas being supported, the policy reforms represent a deepening of reform efforts and an acceleration of the pace of reform implementation. The operation completes some of the longer-term reforms initiated three years ago, it steps up efforts in areas where results have been more uneven and it adds some new crucial reforms areas. The policy actions are structured around two development objectives and reform pillars: (i) improving the business environment and (ii) enhancing fiscal management. The two pillars reinforce each other in supporting an increased level of investment. The reforms being supported would also seek to enhance the effectiveness of both private and public investments, by improving the business environment for private sector investment and the regulatory framework for privatization, and creating the necessary fiscal space for higher public investment and more pro-poor spending.

4.3.1. Improving the Business Environment

Enhancing the Investment Climate

44. **The business environment in Pakistan is weak, which has dampened economic growth and hindered the private sector's creation of better jobs.** Pakistan is ranked 138 out of 189 economies on the overall ease of doing business rankings in 2016, having slipped in the rankings in the last five years across most Doing Business indicators. Supported by the World Bank's Indicator-based Reform Advisory team, the Board of Investment (BOI) finalized a plan for improvement of the business environment in October 2014 for select indicators. This has been followed by support for the formulation of a National Doing Business Reform Strategy at the request of the Ministry of Finance (prepared in February 2016), providing reform

12 The Board approved a $460 million IDA guarantee and $588 million IDA credit for Dasu, a project in Pakistan, on 06/10/2014 (Board paper #80488-PK). The Bank will work with the authorities to appropriately sequence the market based financings to ensure that the depth and liquidity of the market doesn't suffer.

recommendations covering all DB indicators with considerable granularity and delineating federal and provincial institutional responsibilities for implementation. The plan is currently being implemented both at the national and provincial levels. Two of the areas in which Pakistan seems to be doing particularly badly and which affect private sector investment are access to credit and paying taxes, and reforms supported in this operation seek to address these. The World Bank is also providing technical assistance to provincial governments in relation to addressing the specific constraints facing PPPs, which will also remove barriers to investment. This issue is discussed in Box 2.

Box 2: PPP Framework in Pakistan

Although there is a Public Private Partnership (PPP) Policy[13] and an Infrastructure Development Facility (IPDF) at the federal level, the PPP agenda in Pakistan is being more actively pursued by the provinces. The Government of Sindh, for example, has a solid PPP framework and a PPP unit that has already completed transactions. Similarly, the Government of Punjab's PPP framework and a PPP unit are in place. The two provincial governments are receiving support for this work from the Asian Development Bank (ADB) through DFID funding. Meanwhile, the Government of Khyber Pakhtunkhwa and Government of Balochistan are interested in launching their own PPP approaches and have requested technical assistance. The World Bank's technical assistance[14] will support the roll out of the PPP Diagnostic Toolkit in addition to providing support in the areas of knowledge exchange and development of a PPP pipeline. The Toolkit is an effective mechanism for the evaluation of the: (i) existing institutional and legal framework; (ii) capacities of the PPP unit/department; and (iii) funding requirements for the development of PPPs and relevant infrastructure, based on which a customized and targeted assistance package can be developed with each client.

Prior Action 1: In order to improve the private sector's access to credit, (a) the National Assembly has passed the Financial Institutions (Secured Transaction) Bill; and (b) the National Assembly has passed the amendment to the Credit Bureau Act.

45. **Economic growth is constrained by poor financial intermediation, which is partly addressed by the Financial Institutions (Secured Transaction) Bill.** The use of movable property as collateral is not widespread in Pakistan. The underutilization of movables as collateral imposes a significant constraint, particularly for agricultural producers, women, and SMEs, who rarely have sufficient land or access to guarantors, which limits their access to and increases the cost of credit. The majority of SMEs are engaged in trade and services (51 percent and 35 percent, respectively), and have most of their assets in inventories and receivables or other forms of movable assets. A modern secured transactions framework in Pakistan would facilitate the use of movable property as collateral and help address the constraint that limited private sector credit imposes on economic growth. The current secured transactions system is limited by the time, cost, and uncertainty in (i) establishing claim to the property to secure payment of credit, while allowing the debtor to retain possession of the collateral; (ii) prioritizing claims; (iii) publicizing the ranking of the priority; and (iv) taking possession of the collateral for sale to satisfy the claim. With support from the World Bank and DfID, the Government prepared a "Secured Transactions Bill" in 2015, which was passed by the National Assembly in March 2016. The most positive aspects of the law are the extension of the possibility to create fixed and floating charges over all kinds of movable assets to individuals and to entities other than companies, and a broad definition of movable assets.

[13] Approved by the Economic Coordination Committee of the Cabinet in year 2010.

[14] Supported by DFID funding through TAGR (Trust Fund for Accelerated Growth and Reforms).

In addition, the design of the regime is based on the general principle of perfection by registration, an organized system of registration, and the swift enforcement of secured credit.

46. **To further enhance financial intermediation, the enactment of amendments to the Credit Bureau Act will be critical.** As Pakistan improves financial inclusion and financial infrastructure[15], the credit information framework is a critical reform area to protect consumers' and creditors' rights. Currently, no consumer in Pakistan can review, dispute, or verify their own credit report, which is a fundamental barrier to access to financial services as well as basic financial consumer protection. Public and private credit bureaus in Pakistan provide credit information on only 5 and 7 percent of the adult population respectively. Credit bureaus and credit registries are essential to a financial infrastructure that facilitates access to formal finance. When designed within a proper legal framework, credit bureaus and registries reduce information asymmetries, increase access to credit for small firms, lower interest rates, improve borrower discipline and support bank supervision and credit risk monitoring. The World Bank supported the passing of the Credit Bureau Act 2015 which addresses several good practices, such as improved transparency, clarity on the regulatory environment for private credit bureaus, consolidation of the supervisory authority's role, and provision of information collected from non-banks, such as utility companies. A critical amendment was required to ensure the effectiveness of the Act. The requirement for the State Bank of Pakistan (SBP) to verify all credit information reports needed to be retracted, since it contradicted the principle of increasing private sector participation in the credit information infrastructure and prevents SBP from transitioning from a credit bureau role to a supervisory role.[16] The Government of Pakistan has issued a Presidential Ordinance amending the Credit Bureau Act in early April 2016 and the National Assembly has passed the amendments to the Credit Bureau Act in May 2016.

47. **Results to be achieved with implementation of prior action 1:** The successful implementation of the Financial Institutions (Secured Transaction) Bill and the Credit Bureau Act will set the stage for the implementation of a comprehensive and detailed set of business environment reforms, as formulated in the National Doing Business Reform Strategy of February 2016. Within the result framework of this operation, the prior action will result in an improvement of the Doing Business Distance to Frontier (DTF) Indicator for Getting Credit from 30 in the Doing Business 2016 report to 50 in the 2018 report. DTF is a measure of regulatory performance and indicates how it has improved over time. This measure shows the distance of each economy to the "frontier," meaning the best performance observed. The DTF is reflected on a scale from 0 to 100, where 0 represents the lowest performance and 100 represents the frontier.[17]

---

[15] As recognized by the National Financial Inclusion Strategy 2020 and the State Bank of Pakistan Strategy 2020.

[16] As one of the Prior Actions under the previous DPO (FSIG-II) the passage of a Credit Bureau Act by the National Assembly without this provision was supported by the WBG. However, after the passage by the National Assembly the requirement for credit information verification by SBP was added before the law was passed by the Senate; rendering the law ineffective.

[17] For example, a score of 75 in DB 2015 means an economy was 25 percentage points away from the frontier constructed from the best performances across all economies and across time. A score of 80 in DB 2016 would indicate the economy is improving. It is useful to note the difference of the DTF as a measure of a country's performance independent of the performance of competitor countries, unlike the annual ease of doing business ranking, which compares economies with one another at a point in time. For more information on DTF, please see http://www.doingbusiness.org/data/distance-to-frontier.

Prior Action 2: The Recipient has posted improved processes to simplify and streamline the payment of taxes on the website of the Federal Board of Revenue.

48. **In order to reduce the compliance burden on private firms, the Federal Board of Revenue has improved processes to simplify and streamline tax payments and posted the salient features of these improvements on its website.** FBR is moving towards a fully automated tax administration that aims to significantly increase the electronic coverage of taxpayer services and business transactions. Optimizing and modernizing IT systems are the main requirements for improving revenue administration performance and facilitating compliance. In order to achieve this objective, simplification of forms and streamlining of business processes have to go in tandem with IT upgrading in order to reduce administrative and compliance costs. To that effect, FBR has simplified tax forms and facilitated online registration and electronic submission and payment of tax returns, a significant step forward in this process. Measures implemented to simplify and streamline processes to pay taxes include incentives to enhance e-filing and e-payment, facilitation of taxpayer registration online and redesigning the tax forms to simplify processes and remove redundancy. Going forward, all these simplified procedures will be included in the mainstream Inland Revenue Information System and are included on FBR's website for tax payers' information.

49. **Results to be achieved with implementation of prior action 2:** Similar to the longer-term impact of prior action 1, successful simplification and streamlining of the payment of taxes will set the stage for the implementation of the National Doing Business Reform Strategy. Simplifying forms and processes for paying taxes could reduce the number of hours per year needed to pay taxes from 594 (currently) to 360 (post reform). Within the result framework of this operation, the prior action will result in an increase in the number of taxpayers who submit a tax return online (by end March of the following year) from 419,910 in March 2015 to 773,000 in March 2017.

Capital Market Development

Prior Action 3: In order to improve governance and transparency of capital markets, (a) the National Assembly has passed an amendment to the SECP Act, to ensure compliance of the provisions applying to securities regulators with international norms and standards and to strengthen the enforcement powers of SECP; and (b) the SECP has issued an order in the matter of the integration of the three stock exchanges.

50. **To facilitate further improvements in financial intermediation, the Government of Pakistan will strengthen the governance and transparency of capital markets through amendments to the Securities and Exchange Commission of Pakistan (SECP) Act.** Since the promulgation of the SECP Act in 1997, the mandate provided to SECP has been enhanced by several legal reforms to empower and increase the scope of its regulatory and supervisory powers over the non-bank financial sector. In light of rapid and extensive changes in the SECP's jurisdiction, there was a need to address gaps in the SECP Act especially in relation to the powers and functions of the Policy Board. The most critical gaps included (i) the inability of SECP to act as an integrated regulator; (ii) inadequacy of enforcement powers; (iii) lack of disciplinary process for regulated entities; (iv) the absence of an alternative dispute resolution mechanism; and (v) lack of adequate powers to recover dues and penalties. An independent assessment by the International

Organization of Securities Commissions (IOSCO) in July 2015 proposed recommendations for amendments in the SECP Act to address these deficiencies. In particular, the amendments aim to (i) ensure the administrative, financial and functional independence of SECP; (ii) improve governance of SECP's Policy Board; (iii) regulate market conduct and investor protection practices; (iv) strengthen investigative, supervisory and punitive powers; (v) enable establishment of self-regulatory organizations; and (vi) facilitate international cooperation with foreign regulators. The amendments to the SECP Act have been discussed and endorsed by the CCI (Council of Common Interests) and was passed by the National Assembly in May 2016.

51. **The integration of Pakistan's three stock exchanges into a single stock exchange will improve governance and the functioning of the integrated stock exchange.** Pakistan's stock exchanges had been unable to procure strategic investments since they were demutualized in 2012. Until recently all three stock exchanges provided their own trading platforms to their respective TRE Certificate holders and their clients. However, trading was primarily concentrated in the Karachi Stock Exchange, thereby limiting competition between brokers and provision of adequate services to clients across the country. In order to further the objectives of the Stock Exchanges (Corporatization, Demutualization and Integration) Act 2012, the three stock exchanges entered into a Memorandum of Understanding on 25 August 2015, outlining the approach for integration. In January 2016, they integrated to form the Pakistan Stock Exchange. This is expected to (i) consolidate listing and trading across Pakistan; (ii) foster competition between brokers resulting in better pricing, execution, market outreach, and service delivery; (iii) improve liquidity, governance, regulatory supervision and cost efficiency; and (iv) increase the prospects of strategic investment, both domestic and foreign, in an integrated de-mutualized stock exchange.

52. **Results to be achieved with implementation of prior action 3:** Implementation of the amendments to the SECP Act and the integration of the three stock exchanges into the Pakistan Stock Exchange will support the longer-term development of Pakistan's capital markets. Within the framework of this operation, the prior action will result in an increase in listed capital base in capital markets from PKR 1.18 trillion in June 2015 to PKR 1.46 trillion by June 2017. The investor base will also increase from 220,235 to 250,000 over the same period.

Enhancing Financial Inclusion

Prior Action 4: The National Assembly has passed the Financial Institutions (Recovery of Finances Amendment) Bill.

53. **Housing finance is almost non-existent in Pakistan, while financing needs are high and the deficit of housing supply continues to grow.** Despite high potential demand, housing finance is essentially limited to credit provided by the State-controlled House Building Finance Company. The total housing finance market is estimated to be very low at 0.5 percent of GDP or 1.6 percent of private sector credit in 2014. Inefficiency of foreclosure is a major impediment for expanding housing finance, particularly private sector participation and product innovation. The Financial Institutions (Recovery of Finances) Ordinance (FIRO) 2001 provided a comprehensive legal framework on foreclosure. However, the primary provisions for out-of-court foreclosure and sales of mortgaged properties were deemed unconstitutional by the Supreme Court in October 2013, significantly deterring the development of the housing finance market.

54. **The development of a housing finance market requires the enactment of the Financial Institutions (Recovery of Finances) Amendment Bill, as it will address shortcomings in the current regulatory framework.** The SBP, in consultation with relevant stakeholders, proposed amendments in FIRO that were passed by the National Assembly in March 2016. The proposed amendments target both the efficiency of mortgage enforcement and the safeguards meant to protect debtors' interests. Under mortgage enforcement, the concept of willful default has been introduced to create more creditor discipline, and procedural changes have been proposed to ensure more effective foreclosure proceedings. At the same time, borrower protection has been enhanced, particularly with respect to sale of foreclosed properties to ensure that borrower rights are safeguarded and the process is both effective and transparent. The proposed amendments are a step in the right direction in their current form, but could be improved further, particularly by including (i) a differentiation between foreclosure proceedings of residential and commercial properties; and (ii) a provision regarding shortfalls between the debt outstanding and the price obtained in a forced sale. In addition, subsidiary legislation can complement the proposed amendments by elaborating on the definition and scope of willful default.

55. **The amendments provide the foundation to revive the policy focus on promoting housing finance in Pakistan, even as further improvements should be sought.** Ongoing, complementary reforms should be leveraged in land titling and administration of property transfers, and stagnated reforms should be reinitiated, such as the establishment of the Pakistan Mortgage Refinance Company (PMRC) and development of stable long-term funding sources. In addition, the amendments pave the way for implementation of complementary reform actions highlighted in Pakistan's National Financial Inclusion Strategy (NFIS). These include (i) a consumer education and protection program specifically geared towards housing credit and low income population segments; (ii) fair/responsible lending standards to prevent over-indebtedness; and (iii) promotion of other loss mitigation practices such as temporary and partial payment relief, forbearance or loan modification.

56. **Results to be achieved with implementation of prior action 4:** Implementation of the amendments to the Financial Institutions (Recovery of Finances) Bill will allow Pakistan to develop a heretofore dormant market for housing finance. Within the framework of this operation, the prior action will result in an increase in housing finance as a percentage of private sector credit from 1.6 percent in 2014 to 2 percent in June 2017.

Corporate Governance, SOE Reform and Privatization

Prior Action 5: The Recipient's Ministry of Finance has implemented a new directive requiring the annual collection and publication of key financial information of all State Owned Entities by publishing the first report on the Ministry of Finance's website.

57. **Although SOEs are a burden for the Government's budget, and privatization has been a declared priority for the Government, there is no publicly available consolidated information on the financial performance of SOEs.** The Government of Pakistan currently owns shareholdings in some 190 State-Owned Entities (SOEs). These entities are active in a wide range of economic sectors, most notably power generation and distribution, oil and gas, transport, and manufacturing. The state's ownership and oversight functions with regard to these SOEs are exercised in a decentralized manner whereby line ministries appoint Board Members and managers

of the SOEs within their remit. The Ministry of Finance has the authority to monitor the financial performance of SOEs based on audited financial statements and other information provided by line ministries and SOEs themselves. At present, however, consolidated information on the financial performance of SOEs is not publicly available; nor are other performance indicators related to SOEs' activities reported on a regular basis.

58. **The Ministry of Finance will ensure that the public is informed about the financial performance of all federal SOEs by publishing a report detailing consolidated financial and non-financial information.** Closing the information gap regarding SOE financial performance would bring several advantages both in terms of fiscal transparency and business confidence. SOEs have a major impact on public finances as the source of dividends but also—more significantly—as recipients of operating subsidies, government loans and guarantees, and capital injections. Financial support to SOEs has been a major contributor to the country's budget deficit and debt burden. The availability of consolidated information on the financial performance of SOEs would facilitate budget planning and the management of fiscal risks, and strengthen the effectiveness of scrutiny by the Parliament, the media, and society at large. As the Government has faced considerable political opposition in trying to move ahead with its privatization program (see annex 6 for a more detailed discussion on Pakistan's privatization program), this step represents an effort to build a political consensus, while also providing important information to potential investors. The first report covered the year FY2013/14 and was published in April 2016 on the Ministry of Finance's website. It includes the following information for each SOE: legal status, area of activity; share of government ownership and stakes of other shareholders; turnover by fiscal year; profits and losses by fiscal year; assets and liabilities; outstanding debt; debt covered by sovereign guarantees; budget subsidies received by fiscal year; loans received from the Government or other state institutions (e.g., State Bank of Pakistan); capital injections received from the Government by fiscal year; and number of employees.

59. **The availability of financial information on SOEs will assist the Government's efforts to implement their privatization plans, as well as to attract private capital to the SOE sector.** Transparency and credibility of corporate financial information is critical to investor confidence. In its absence, few investors will contemplate venturing into the SOE sector, whether by participating in privatization processes, acquiring equity through the stock exchange, or engaging in Public Private Partnerships. In addition, prospective investors will likely remain wary of sectors where SOEs are active in the absence of information on the extent of advantages (e.g. access to finance below market rates) that SOEs may enjoy on account of state ownership. To ensure the sustainability of this reform, the Ministry of Finance has issued a directive requiring the report on SOEs to be updated at least annually and specifying the information to be included in the report.

60. **Results to be achieved with implementation of prior action 5:** Implementation of the directive requiring the annual collection and publication of key financial information of all federal SOEs will inform public debates about SOE reform and privatization, including information on SOE performance and fiscal impact. Within the framework of this operation, the prior action will result in consolidated SOE financial information being publicly available from 2016 onwards.

Prior Action 6: To attract private sector investment and remove entry barriers in the insurance sector, the National Assembly has passed the State Life Insurance Corporation (Re-organization and Conversion) Bill.

61. **The insurance sector remains underdeveloped, with a penetration ratio (premium/GDP) of just 0.77 percent and density (per capita premium) of just USD 10.40.** Insurance coverage is estimated to extend to only 7 percent of the adult population. Access to insurance is an integral component within Pakistan's National Financial Inclusion Strategy, given its role in providing risk-mitigating mechanisms to segments of the population who are most vulnerable to economic shocks and natural disasters. The current relatively low level of development of the insurance sector is largely explained by historical factors including the departure of international companies from Pakistan, the large number of non-life players tied to family-based commercial or industrial groups, and the nationalization of the life insurance business in 1972. The life sector is led by State Life Insurance Corporation (SLIC) which reports under Insurance Ordinance (IO) but is not obliged to follow Companies Ordinance 1984 nor is its founding law linked to the IO. The other public life insurer, Postal Life Insurance (PLI), is exempt from the application of the IO. SLIC was founded in 1972, adopting ownership of the nationalized life insurance business of 32 insurance companies. It was tasked with providing all future life insurance needs of the Pakistani market until the re-entry of private insurers in 1999. The Life Insurance (Nationalization) Order 1972 not only established SLIC but provided that its operations would comply with the Insurance Act 1938 and that it was to be guided by the directions of the Federal Government. The Ministry of Commerce (MOC) with the approval of the Federal Government appoints the Chairman and the Directors who in turn set the management and operational policies and strategies.

62. **The corporatization of SLIC and PLI will help establish a level playing field in the Pakistan insurance sector.** As corporate entities, SLIC and PLI will be subject to the Public Sector Companies (Corporate Governance) Rules 2013, which sets out criteria for corporate governance decisions such as the composition of the board and the appointment of the CEO. Further, the Insurance Ordinance 2000 is currently being revamped to further promote a level playing field. These changes are expected to stimulate private investment throughout the sector. Corporatization of SLIC will also result in stronger management and information systems that will greatly enhance the value of its eventual privatization. The Government adopted the SLIC (Re-organization and Conversion) Act by Presidential Ordinance in March 2016, providing the legal basis for the reorganization and conversion of SLIC into a public limited company. The SLIC Act was passed by the National Assembly in May 2016. SLIC is one of 69 private entities approved by the Federal Government for privatization. The Privatization Commission, on November 3, 2015, advertised the Expression of Interest (EOI) for appointment of Lead Manager for the offering of minority shareholding in SLIC by means of Initial Public Offering. SLIC was registered under the Companies Ordinance 1984 on 13 May 2016. The Government has also initiated the corporatization process for PLI to enable a more effective privatization in the future.

63. **Results to be achieved with implementation of prior action 6:** Implementation of the corporatization of SLIC and the approval of the strategy for the corporatization of PLI will provide an important model for future SOE reforms, emphasizing corporatization and enforcement of strong corporate governance. Within the framework of this operation, the prior action will require SLIC to follow, just like all corporate insurance companies, Companies Ordinance 1984. SLIC will also be required to follow Public Sector Companies (Corporate Governance) Rules 2013. These changes will result in a leveling of the playing field for the life insurance sector.

4.3.2. Enhancing Fiscal Management

Mobilizing Revenue

64. **The revenue mobilization actions under this operation address structural weaknesses in Pakistan's tax system, thereby creating fiscal space for priority social and development expenditures and reducing the Government's domestic borrowing needs.** Weaknesses of the system include an inefficient tax administration; a narrow tax base (fewer than 10 percent of 39.4 million employed persons are registered); a skewed tax structure (68 percent of tax revenue is from indirect taxes); a complex and nontransparent tax system that favors numerous and generous ad hoc exemptions and concessions and facilitates corruption and tax evasion; and low provincial revenue collection efforts. Government efforts are focusing on broadening the tax base and on strengthening registration, enforcement, transparency and compliance. Reforms build on progress made in the previous FSIG series. The additional revenue brought by the tax policy and administration reforms in the past two years amounts to 1 percent of GDP.

Prior Action 7: The Federal Government has submitted to the National Assembly the Finance Bill FY16/17 which includes the third and final phasing out of discriminatory concessions granted through SROs.

65. **A narrow tax base is one of the main causes of Pakistan's low tax-to-GDP ratio (11 percent in 2014/15).** The tax base has been eroded by numerous concessions through discretionary Statutory Regulatory Orders (SRO). According to the Pakistan Economic Survey, tax expenditure for fiscal year 2014-15 had been estimated at PKR 412 billion (1.5 percent of GDP). Beyond the revenue forgone, the use of tax expenditures as a policy instrument can also have other types of costs or secondary effects. Examples of secondary effects include: (1) the administrative cost to the tax administration; (2) compliance costs for taxpayers; (3) macroeconomic effects; (4) implications for economic efficiency; (5) horizontal and vertical equity, and (6) the effects of fraud and abuse. As a result, tax expenditures can have a significant impact on taxes' efficiency, impartiality and simplicity. These instruments should have a well-defined policy objective and government intervention should be justifiable.

66. **The Federal Government will implement the third and final phasing out of discriminatory concessions granted through SROs.** The previous FSIG series supported the first two phases of FBR's three-year plan. SROs removed in the FY14/15 budget reduced the costs of tax exemption by around 0.4 percent of GDP and a further reduction of around 0.3-0.4 percent in FY15/16. The CGDPF will build upon these achievements by supporting in FY16/17 the final phase of the three-year plan. The revenue impact will be smaller than in previous years (between 0.1 and 0.2 percent of GDP) since the removal of SROs with significant fiscal impact was frontloaded in the first two years, but it will nonetheless contribute to a more transparent and fairer tax system. The process for determining the SROs to be removed has already started and involves consultations with sector ministries and other stakeholders. It will be completed only shortly before the Finance Bill is submitted to Parliament toward the end of the fiscal year. The Government aims to withdraw concessions granted through SROs as well as those which are embedded in different schedules of customs, sales tax and income tax acts. Reforms supported by the previous DPC series also eliminated FBR's legal powers to issue special tax exemptions and concessions through SROs, limiting the probability of a reversal of progress made to date.

Prior Action 8: The Recipient's Federal Board of Revenue has started to implement a new audit policy that includes risk profiling of taxpayers for improved tax compliance by initiating forty comprehensive audits of large taxpayers.

67. **Over the past two years, FBR has made significant strides in strengthening its tax audit function as evidenced by increases in both the number of tax audits and amounts of tax liability assessed.** Given the very small number of personal and corporate taxpayers in Pakistan, an improved audit function by FBR will be key for longer-term efforts to broaden the tax base. The number of audits increased from 36,759 in 2012 to 75,870 in 2014. The majority of tax audits were desk audits where FBR checks the internal consistency of tax returns and discrepancies between third-party information and information contained in tax returns. A random ballot is used to select cases for audit, which does not result in the targeting of the most serious and complex cases of tax fraud/tax avoidance.

68. **A sound audit strategy should contain risk parameters that guide the selection of tax audit cases.** One of the benefits of pursuing a risk management approach is that it provides the revenue authority with a structured basis for strategic planning and a focus on the underlying drivers of non-compliance. The level of scrutiny and intensity of audit activity should depend on the level of risk to revenue, which in turn is related to the taxpayer segment and where and when the risks occurs. Besides cases deemed to be high-risk from prima facie checks or issue-based audits, comprehensive audits are typically based on careful risk assessment and audit selection. A type of comprehensive audit practiced in some countries (for example, the United States) is the audit purely to facilitate risk profiling of taxpayers.

69. **FBR has started the implementation of a recently adopted modern audit policy that includes risk profiling of taxpayers by initiating 40 comprehensive audits of large taxpayers using the adopted risk criteria.** Conducting comprehensive audits that aim to control compliance of taxpayers who pose higher risk to revenue is a significant leap forward for FBR. Taking large taxpayers to task also requires considerable political will. It dramatically changes the compliance strategy of the tax administration through better-targeted tax audits. In view of the fact that these are complex tax audits that may be underway for a substantial period of time, the prior action only requires the issuance of a notice indicating that the tax audit has started.

70. **Results to be achieved with implementation of prior actions 7 and 8:** Implementation of the third and final phase of the facing out of SROs and the modern audit policy will allow the Government to continue improving its taxation regime. Within the framework of this operation, the prior actions will contribute to increasing tax revenues from 11 percent of GDP in FY2014/15 to 12.2 percent of GDP in FY2016/17.

Improving Debt Management

Prior Action 9: The Recipient's Ministry of Finance has improved debt management coordination through (a) ministerial notification expanding the existing functions of the Recipient's Debt Policy Co-ordination Office, and (b) publication of the approved medium term debt management strategy FY 2015/16 – 2018/19.

71. **The Ministry of Finance will institutionalize the Debt Policy Co-ordination Office (DPCO) as a middle office.** Debt management in Pakistan is scattered among various institutions and entities, most of them within Ministry of Finance (MoF), with little coordination among them. This structure affects debt management and has led to suboptimal borrowing choices, underdevelopment of the domestic debt market, exposure to financial risks and limited control of funding costs (IMF and World Bank, 2014; World Bank, 2014). Among the institutions working on debt management, DPCO is responsible for preparing the medium-term debt management strategy and monitoring the sustainability of public debt. However, the office has lacked the enabling mandate to adopt functions typical of a middle office such as credit and operational risk management. The Ministry of Finance has issued a notification that strengthens DPCO as a middle office and lays out the organizational structure supporting this enhanced mandate, outlining all its functions including production of the Medium Term Debt Strategy (MTDS), as well as market, credit and operational risk management. This reform will (i) contribute to fiscal sustainability by optimizing the debt management strategy; (ii) assist in lowering funding costs and contributing to the development of the domestic debt market by improving the issuance of securities in the local market, and; (iii) improve the decision-making process and enhance the financial expertise and capacity of the DPCO.

72. **The Government has approved and published the Medium Term Debt Management Strategy 2015/16-2018/19 to improve its decision-making on its borrowing mix.** In 2014 DPCO, supported by the Bank and the Fund, prepared the first Medium Term Debt Strategy for Pakistan (2014-18), which was approved by the Finance Minister. However, there was significant room for improvement in the quality of the document in two aspects: (i) the analysis leading to the formulation of the borrowing strategy which gives excessive weight to the cost and does not consider sufficiently market capacity to absorb the supply of government securities; and (ii) the formulation itself, particularly in analyzing the key tradeoffs like external versus domestic borrowing, fixed versus floating interest loans and on the selection of the mix of tenors for the domestic debt. To address these issues, the Government has prepared and approved a new MTDS with technical assistance from the Bank.

73. **Results to be achieved with implementation of prior action 9:** Implementation of the notification strengthening DPCO's role as a middle office and the country's latest MTDS will contribute to improved debt management and lower financing costs in the medium term. Within the framework of this operation, the prior action will help maintain foreign debt at between 20 and 35 percent of total debt, compared with 28 percent in 2015. This range is specified in the MTDS, which was developed with the aim of ensuring that public debt is sustainable and meets the Government's overall cost and risk objectives.

Improving Pro-Poor Policy Making

Prior Action 10: In order to strengthen targeting of safety net programs, the Recipient's Federal Government, through its Ministry of Finance, has authorized BISP to update the National Socio-Economic Registry with dynamic updating of the registry going forward, in accordance with a plan submitted by BISP.

74. **The Federal Government has adopted a policy decision to update the National Socio Economic Registry (NSER) based on a plan submitted by BISP.** The NSER is the backbone of

objective identification of the poor for social safety net interventions. This is used not only by the Benazir Income Support Programme (BISP) but also by 38 other federal and provincial agencies, research institutes and UN agencies for their pro-poor initiatives. An updated NSER can serve as a foundation for building an integrated social safety net system in Pakistan. Using the NSER as a basis for beneficiary identification, BISP directs more than three quarters of its cash transfer benefits to the bottom two quintiles of the population. This level of targeting effectiveness compares favorably to most social safety net interventions and is comparable with the world's best-known targeting mechanisms such as those in Brazil and Mexico. However, the data used in the NSER were collected in 2010 and require an update to be consistent with the recommended data lifespan of five years. The first phase of the updating process covering 16 districts for which the data have already become obsolete (by the 5-year norm) is expected to be completed by December 2016. During the first phase, BISP will test the viability of on-demand registrations in partnership with the National Database and Registration Authority (NADRA) as a means for ongoing dynamic updating of the collected data. BISP has initiated the implementation of the update by signing a service level agreement with NADRA. BISP will conduct an operational review of these on-demand registrations to draw lessons for the second phase of the NSER update.

75. **Results to be achieved with implementation of prior action 10:** Implementation of the updating process in roughly 16 districts will institutionalize an improved mechanism for targeting safety net programs and thus allow more effective and sustainable poverty reduction programs. Within the framework of this operation, the prior action will result in at least 2.5 million households with an updated poverty scorecard registered in the National Socio-Economic Registry by December 2016. In addition, this will provide BISP with necessary data and analysis to inform the Government's decision, inter alia, on the new cut-off point for determining eligibility of BISP interventions as well as on how to handle those households who will no longer be eligible according to the new cut-off point. These decisions are important elements of updating the entire beneficiary identification system.

Prior Action 11: The Recipient's Federal Government has published a new poverty rates series going back to 2005-06, using the cost of basic needs method and the most recent survey data (2013/14).

76. **Until recently, Pakistan had not published official poverty numbers since 2005.** This is not due to a lack of data or expertise. There are 8 rounds of consistent Household Income and Expenditure Survey (HIES) data available since 1998, including the most recent round in 2013/14. The HIES provides the data for producing headcount poverty at the national, provincial and rural urban levels. Since 1998, with the exception of 2001, the HIES has shown a consistent, and often rapid, decline in poverty. However, the Government stopped publishing poverty rates after the 2007-08 HIES round, which showed a further decline in poverty between 2005-6 and 2007-08. At this time, the Centre for Research on Poverty Reduction and Income Distribution, which was mandated to validate and release poverty numbers was also effectively dissolved. No official poverty rates had been published since 2005-06. Where interim poverty rates were reported for the years 2007-08 and 2010-11, they were presented as World Bank or UNDP estimates, rather than the Government's official headcount rate. Especially in light of the potential political sensitivities that hindered the update and publication of poverty numbers for over 10 years, the decision by the Government to update the poverty line, publish the relevant data, and institutionalize a mechanism to depoliticize the process is to be commended.

77. **There has been widespread questioning of the quality, independence and veracity of national statistical data. The resulting vacuum has led to ad hoc attempts to arrive at poverty trends, using inappropriate methods.** This has depleted confidence among citizens and media in the Government's efforts to reduce poverty or increase inclusion. It has also made any serious discussion of pro-poor policies difficult. The 8th National Finance Commission (NFC) award – which is pending—would also benefit from updated information on provincial poverty rates. The vacuum created by the absence of official poverty numbers has provided the space for alternative narratives, often based on questionable methodology, to acquire great relevance in the public discourse. Some of these show a rising trend in poverty with headcount rates as high as 50 percent. This is quite unfortunate given Pakistan has made real headway in improving outcomes for the most disadvantaged. Rigorous analysis by the Planning Commission has clearly established that the HIES data series is credible, though there is a real need for updating and strengthening statistical systems. It has also shown that the decline in poverty is corroborated using both independent data sources and looking at shifts in patterns of asset accumulation, school enrollment and consumption behavior. Despite this, the Government had not officially released the poverty rate since FY05/06. Using the 2001 poverty line, the poverty head count would be between 7.3 and 9.3 percent in 2013-14, which seems far too low for an inclusive development agenda. In recognition of this, the Government of Pakistan decided to revise the poverty line, supported by technical assistance from the World Bank.

78. **The new poverty head count is 29.5 percent of the population in 2014, compared to less than 10 percent using the old poverty line.** The new poverty line, which uses the Cost of Basic Needs method, sets a much higher bar for inclusive development, acknowledging that as societies develop, the minimum standards for a productive life, for personal dignity and social acceptability also change. The new line sets a minimum consumption threshold of PKR 3,030 per adult equivalent, per month, identifying nearly 60 million people as poor – compared with 20 million people under the old poverty line of PKR 2,259. Using the old poverty line, the poverty head count rate had consistently declined from 35 percent in 2001 to under 10 percent by 2014. Using the new poverty line, the poverty head count has declined from 64 percent in 2001 to 29.5 percent in 2014. Some of the drivers of this significant decline in poverty – regardless of the poverty line being used – can be found in Pakistan's rapid urbanization, significant infrastructure investments, substantial movement of labor to the non-farm sector, and massive increases in private remittance inflows by Pakistani workers.

79. **Going forward, it will be important to strengthen the institutional setup for poverty measurement.** The revision and adoption of the new poverty line is an important step in enhancing the use of poverty statistics for policy-making. Going forward, in order to fully restore the credibility of official poverty statistics, and their use for policy-making, a second step is critical: the establishment of a permanent and independent committee on poverty and inclusion. Such committees are typically legally constituted and have the authority to validate and release new poverty numbers when fresh data becomes available. They also advise the relevant statistical authority on the types of data needed for credible poverty and inclusion monitoring. Committees typically include members from the National Planning Ministry, the National Statistical Office and other relevant ministries (Finance, Social Protection etc. as needed), respected academics, and international institutions who have technical capacity on the issue of poverty measurement—usually the World Bank and UNDP. The establishment of such independent committees ensures that the regular monitoring of poverty and inclusion is depoliticized and sustainable and helps

build country capacity. Other countries (such as Mexico, Colombia, Peru and Chile, among recent examples) have constituted committees on poverty with sufficient authority and independence to remain outside the sway of political or other currents.

80. **Results to be achieved with implementation of prior action 11:** Adoption of the new poverty line will allow analysis and discussions to be focused on gaining a better understanding of drivers behind poverty alleviation in Pakistan and enhanced use of poverty measurement to inform policy making. It will thus set the stage (and the evidence base) for redirecting public spending to make it more pro-poor. Within the framework of this operation, the prior action will result in the new poverty rate being published using latest data (2013/14) and trends in poverty on the old line, which had not been released since 2006, being publicly released.

81. **The proposed operation rests on extensive analytical and advisory work undertaken by the Bank.** Table 6 lists analytical activities and their link to the prior actions supported by the CGDPF.

Table 6: Prior Actions and Analytical Underpinnings

Prior Actions	Analytical underpinnings
Pillar 1. Improving the Business Environment	
In order to improve the private sector's access to credit, (a) the National Assembly has passed the Financial Institutions (Secured Transaction) Bill; and (b) the National Assembly has passed the Amendment to the Credit Bureau Act.	GOP's Plan for Improving Business Environment 2014; Enhancing the Business environment—Pakistan Policy Notes; Doing Business Report 2016; SBP Microfinance Strategic Framework 2011–15.
The Recipient has posted improved processes to simplify and streamline the payment of taxes on the website of the Federal Board of Revenue.	GOP's Plan for Improving Business Environment 2014; Enhancing the Business environment—Pakistan Policy Notes; Doing Business Report 2016;
In order to improve governance and transparency of capital markets, (a) the National Assembly has passed an amendment to the SECP Act, to ensure compliance of the provisions applying to securities regulators with international norms and standards and to strengthen the enforcement powers of SECP; and (b) the SECP has issued an order in the matter of the integration of the three stock exchanges.	Financial Sector Assessment Program (FSAP) 2005 and FSAP Update 2010. A new update will be prepared in 2016.
The National Assembly has passed the Financial Institutions (Recovery of Finances Amendment) Bill.	Technical Note on Housing Finance as part of the National Financial Inclusion Strategy; SBP Microfinance Strategic Framework 2011–15;
The Recipient's Ministry of Finance has implemented a new directive requiring the annual collection and publication of key financial information of all State Owned Entities by publishing the first report on the Ministry of Finance's website.	Trust Fund for Accelerating Growth and Reforms (TAGR)
To attract private sector investment and remove entry barriers in the insurance sector, the National Assembly has passed the State Life Insurance Corporation (Re-organization and Conversion) Bill.	GOP's Strategy on Privatization; Time for Serious Corporate Governance—WB Policy Paper Series; Reforming SOEs—Pakistan Policy Notes; TA on Insurance Regulatory Reform
Pillar 2. Enhancing Fiscal Management	

Prior Actions	Analytical underpinnings
The Federal Government has submitted to the National Assembly the Finance Bill FY16/17 which includes the third and final phasing out of discriminatory concessions granted through SROs.	FBR Tax Reform Strategy 2014; Finding the Path to Job Enhancing Growth—CEM Report; Mobilizing Revenue—Pakistan Policy Notes; Trust Fund for Accelerating Growth and Reforms (TAGR)
The Recipient's Federal Board of Revenue has started to implement a new audit policy that includes risk profiling of taxpayers for improved tax compliance by initiating forty comprehensive audits of large taxpayers.	
The Recipient's Ministry of Finance has improved debt management coordination through: (a) ministerial notification expanding the existing functions of the Recipient's Debt Policy Co-ordination Office, and (b) publication of the approved medium term debt management strategy FY 2015/16 – 2018/19.	Trust Fund for Accelerating Growth and Reforms (TAGR); IDA and IMF, 2014, "Pakistan – Developing a Medium Term Debt Management Strategy (MTDS)
In order to strengthen targeting of safety net programs, the Recipient's Federal Government, through its Ministry of Finance, has authorized BISP to update the National Socio-Economic Registry with dynamic updating of the registry going forward, in accordance with a plan submitted by BISP.	Consolidating Social Protection—Pakistan Policy Notes; WB BISP Project Evaluation reports;
The Recipient's Federal Government has published a new poverty rates series going back to 2005-06, using the cost of basic needs method and the most recent survey data (2013/14).	WB technical paper which validates the quality of national data and the trend in headcount poverty and has shown that the data is reliable and the decline credible; WB technical note which provides options for a new national poverty line using international best practice and the latest round of survey data (2013-14)

4.4. Link to Country Partnership Strategy, Other Bank Operations and the WBG Strategy

82. **The proposed operation directly supports two pillars of the FY15-FY19 Country Partnership Strategy**. The FY15-FY19 CPS (Report No.84645-PK) was presented to the Board on May 1, 2014. CGDPF supports the CPS pillar of private sector development through its focus on enabling private-sector led growth through measures related to SOE reform and privatization, improved business environment and access to finance, all well-identified constraints to Pakistan's growth. In addition, through measures to improve fiscal management, this operation makes room for additional public investment. CGDPF supports the inclusion pillar of the CPS through improved pro-poor policies, the result of the decision to update the NSER and a revised poverty line that better reflects poverty dynamics in Pakistan. The proposed operation is also aligned with the World Bank Group Strategy and its goals of ending extreme poverty and promoting shared prosperity, through its focus on accelerating growth, which tends to be pro-poor in Pakistan, and measures to making public spending more pro poor.

83. **There are a number of other Bank operations complementing CGDPF.** A DPC series focusing on power and energy sector reforms was prepared in parallel to the FSIG series, with significant synergies via common policy goals on the creation of fiscal space ensuing from the reduction of tariff subsidies, the restructuring or eventual privatization of power distribution companies and power generation companies, as well as via the use of fiscal space to strengthen the safety net programs. Discussions are ongoing with the Pakistan authorities to continue supporting reforms in the energy sector through budget support operations. Other Bank

instruments are also being used to support the reforms in this operation. A DFID TF in support of economic reforms (TAGR) executed by the Government of Pakistan and the World Bank is supporting reforms in tax policy and administration, SOE reforms and privatization, as well as debt management. Reforms in the financial sector are also being supported by technical assistance and policy dialogue. Reforms to improve targeting of social assistance programs are supported by an investment operation while the revision of the poverty line and poverty measurement have also benefited from World Bank support. The extensive support being provided is in line with experience that policy-lending operations are more likely to succeed when policy reforms are also supported through other instruments.

4.5. Consultations and Collaboration with Development Partners

84. **This operation supports the implementation of the Government's Economic Reform Program that has benefitted from broad-based consultations.** CGDPF supports ongoing reforms that are included in the Government's economic reform program. Many of the reforms being supported also benefit from regular consultation processes, such as the legislative process. The World Bank has conducted a number of consultations related to analytical work underpinning this operation, such as the dissemination of the Bank's Policy Notes, the Country Economic Memorandum and the findings of a rich set of other analytical underpinnings. The operation is supporting medium term reform strategies that have been discussed with all stakeholders (privatization, tax reform, NFIS, BISP). Technical assistance for the implementation of reforms is, to a large extent, being funded by the Accelerated Growth and Reforms MDTF financed by DFID, which benefits from advisory panels consisting of technical experts from key donor agencies (DFID, ADB, IMF, WB and USAID) and relevant government officials. Given the participatory nature of the process in the formulation of government strategies and policies as well as the Bank's program and technical assistance, no additional consultations took place in the preparation of this operation.

85. **Coordination with the IMF.** Bank and IMF staff closely coordinate through joint review missions. The Bank's development policy operations bring depth and complementarity to the Fund's EFF structural agenda. Technical collaboration is ongoing on: (a) power sector reform through the Bank's DPC on power; (b) the financial sector reform, including a joint Financial Sector Assessment Program; (c) the debt management reform through joint technical assistance to the preparation of the Medium-Term Debt Strategy, and the ensuing strengthening of the DPCO; and (d) tax and trade policy and administration reforms. The World Bank is an active participant in the quarterly IMF-GoP meetings to review implementation of the EFF program.

86. **Coordination with other development partners.** DFID is financing technical assistance through the 'Accelerating Growth and Reforms' Trust Fund. The TA supports the implementation of reforms in the following areas: i) power sector; ii) privatization, SOE reform and investment climate; iii) tax policy and administration; and iv) debt management. DFAT is financing support to the Government in the area of trade and regional integration. ADB and USAID also provide lending and technical assistance to SOE reform and debt management. Finally, the Bank works closely with ADB and JICA on the power sector reform.

5. OTHER DESIGN AND APPRAISAL ISSUES

5.1. Poverty and Social Impact

87. **The business environment reforms supported under this operation will contribute to higher and more inclusive growth.** The key to improving outcomes for the poor lies in increasing the availability of good jobs. To do this, the private sector needs to grow, and new investment in productive activity is necessary. Research has shown that lengthy, complicated or costly regulatory procedures dissuade firms from entering markets and lowers the profits of innovative firms operating within those markets[18]. Addressing these constraints is thus likely to stimulate growth. Particularly in Pakistan, where growth has been largely pro-poor in recent years, higher growth is likely to lead to faster poverty reduction. More directly, the reforms aiming to improve access to capital are likely to create jobs and higher incomes for the poor; limited access to capital is a key constraint for SMEs, which employ 80 percent of the non-agricultural labor force and account for 90 percent of all enterprises in Pakistan and yet borrow only 5.6 percent of private sector credit as of June 2015. These reforms also contribute to greater financial inclusion, taking a small step towards providing financial services to the three in four adults, and nine in ten women, who lack access. Both theoretical and empirical studies have shown that financial exclusion inhibits human and physical capital accumulation, contributing to persistent income inequality and poverty.

88. **The reforms directed towards enhancing fiscal management will create the fiscal space to increase public investment and spending on social sectors**. Both the national and provincial governments have demonstrated a tendency in recent years to direct revenue growth towards pro-poor spending. The Federal Government in H1FY15/16 has increased its pro-poor spending (as measured by expenditure under the Poverty Reduction Strategy Paper) by 11 percent compared with the previous year. Punjab province, the largest of the provinces, budgeted for a 16 percent increase in health and education expenditure in FY15/16 compared with the previous year. Sindh has also allocated an increasing share of its budget to the social sectors. This suggests that any further fiscal space will continue to be used to increase spending for improved services delivery and social assistance for the poor. The operation will also support reform efforts to improve the pro-poor orientation of government programs, while BISP will continue to improve gender outcomes (see Box 3). Finally, the adoption of a new poverty line raises the bar for inclusive development in Pakistan, identifying nearly 60 million people as poor, in comparison to 20 million people under the old poverty line. Improved and more credible poverty measurement will support more effective pro-poor policy development and more accurate targeting.

89. **The withdrawal of SROs is not expected to have any significant negative social impacts.** SROs generated by the Federal Board of Revenue (FBR) revise parts of the current Customs, Income, Sales, and Excise tax codes. SRO-generated changes in the tax code can affect the total price of goods and services, which in turn may impact household purchasing power and welfare. The vast majority of exemptions being eliminated affect intermediate products with no clear direct impact on the consumption of the poor. Examples include machinery and parts for

[18] Bripi, Francesco. 2013. "The Role of Regulation on Entry: Evidence from the Italian Provinces." Working Paper 932, Bank of Italy, Rome; Hoffman, Richard C, Jonathan Munermo and Sharon Watson. 2014. "Business Climate and International Franchise Expansion." Paper presented at the conference "Doing Business: Past, Present and Future of Business Regulation," Washington DC, February 20-21; Yang, Judy S. 2014. "The Business Climate, Innovation, and Firm Profitability." Paper presented at the conference "Doing Business: Past, Present and Future of Business Regulation," Washington DC, February 20-21.

products that have a negligible presence in the budget of poor households. SRO 501 (2013) and 551 (2008) were the only SROs that included commodities of clear relevance to the consumption patterns of the poor, including dairy products, poultry, meat, salt and sugar and educational supplies. Both SROs created a list of "exempt" goods and services, or goods and services for which the applicable sales tax would not be applied at the point of sale. SRO 573 (2014) rescinded both these earlier SROs (among other revisions) as part of the Finance Bill FY 2016/17. A poverty and social impact analysis shows that the removal of all sales tax exemptions on items covered under SROs 501 and 551 could have increased headcount poverty by about 2.2 percentage points—raising it from 29.5 to 31.7 on the new poverty line. This large impact is due to the importance of the products affected by these SROs (milk and milk products, poultry, and sugar and sugar based products), which together accounted for a third of the total food budget of poor households in 2013-14. The removal of sales tax exemptions on these items would have led to tax rates in the order of 21 percent for milk and poultry and 14 percent for sugar. While this is an upper bound impact, which assumes that household food consumption patterns would remain the same after the tax (inelastic consumption), it is important to note that even half this impact would have been very substantial. This was avoided, however, by the Government's decision to bring these food items into the regular tax code when SROs 501 and 551 were rescinded and to continue to maintain the sales tax exemption. Based on this analysis, it appears that the Government has protected the consumption of the poor while phasing out the SROs.

Box 3. The Impact of BISP Cash Transfers on Women's Empowerment

- BISP cash transfers deliver benefits to the female head of each eligible beneficiary family to support woman's empowerment. This includes payments to widows or divorcees without male family members. BISP cash transfers currently reach 5.2 million families, or roughly 24 million people, nationwide. Of these, around 75 percent come from the poorest 40 percent of the population.
- As BISP cash transfers require a Computerized National Identity (CNI) card, registration in the program gives women the right of a citizen (voting, opening a bank account and the like). From 2009 to 2012, more than 15 million female citizens obtained a CNI card, largely due to registration with BISP.
- BISP payments strengthen women's role in their families. About 58 percent of women BISP cash-recipients reported spending funds as they wanted; 75 percent felt their importance in the family had increased; 62 percent took more decisions than before the transfer; and 72 percent reported an increased level of confidence.
- About 64 percent of female beneficiaries retained control over the cash transfer.
- Transfers appear to be producing a shift in community perceptions about women, with communities now accepting that women can travel to collect the transfer themselves.
- Transfers are also associated with higher women's participation in civic life. BISP women beneficiaries report being more likely to vote than non-beneficiaries.

5.2. Environmental Aspects

90. **The proposed reform program is generally environmentally benign, although increased private sector activity together with weak capacity of environmental agencies poses some risks.** Some of the prior actions proposed under Pillar 1 may help the private sector foster a more environmentally sustainable path. Of the proposed reform program, two prior actions, better access to credit and compliance with international standards to improve governance and transparency of capital markets, may have overall positive effects on the environment, natural resources and forests. Better access to credit and improvement of capital markets can promote cleaner production processes, leading to a reduction in air and water pollution and solid toxic waste

which have significant economic costs (World Bank, 2006 and 2008). Adoption of cleaner production process would, however, rely upon the enforcement capacity of environmental agencies, which is currently very weak. There is therefore a possibility that higher growth and better access to credit may actually lead to more industrial pollution, resulting in worsening air and water quality and contamination of soils. It would be important for the Government to increase the focus on strengthening the institutional capacity of environmental management institutions. However, pressure from competition in international markets and demand for ISO certification from international buyers could be an important trigger for better environmental management by the benefitting industries. Proposed reforms could also help the private sector set realistic and enforceable environmental standards that facilitate ISO 14001 certification, which would contribute directly to improved international competitiveness.

91. **Pakistan has adequate legislative cover, policy guidelines, and institutional mechanisms in place for managing the environment.** The Pakistan Environmental Protection Council, headed by the prime minister, is responsible for overall guidance on national environmental programs and policies. The Pakistan Environmental Protection Act of 1997 provides the legal underpinning for the environmental management in the country. While provinces have been empowered to legislate and formulate policies, all four provinces have adopted the Pakistan Environmental Protection Act as the relevant provincial Act. At the federal level, the Ministry of Climate Change is responsible for environmental protection. The Government has prepared a number of environment related policies including the National Environment Policy, the National Drinking Water Policy, the National Climate Change Strategy, the Pakistan Clean Air Program, and the National Environmental Quality Standards. While institutional arrangements for environmental management are quite elaborate at the national and sub-national level, implementation remains the key challenge across most of the country. For sustained growth, Government has to prioritize and integrate environmental management aspects into its development agenda to reduce the cost of environmental degradation and thereby impact on the poor segments of the society. This operation is not likely to cause any significant effect on Pakistan’s environment, forests, and other natural resources.

5.3. Public Financial Management, Disbursement and Auditing Aspects

92. **Pakistan has a fairly well-developed infrastructure for public financial management (PFM).** According to the Pakistan Federal Government Public Expenditure and Financial Accountability (PEFA) Update (2012), the trajectory of change is positive with PEFA scores comparing favorably with other countries in the South Asia region. With the implementation of the Financial Accounting and Budgeting System, a repository of all government expenditure and receipt transactions throughout the country is now readily available in a single database for decision-making. The audit cycle has been reduced from 33 to 8 months. The overall fiduciary risk associated with the proposed operation is “substantial”. The Federal Government has prepared a PFM reform strategy aiming to prioritize and focus the Government’s efforts to mitigate the PFM risks. The strategy is currently awaiting Cabinet’s approval, which is expected by October 2016. This assessment is made with due regard to the Government’s commitment to overall PFM reform exemplified by actions already taken at the federal and provincial levels, as well as the weaknesses in the PFM cycle identified in PEFA and other analytical reports. Pakistan’s national budget is published by the Government and accessible to the general public in printed form and through the Ministry of Finance website.

93. **Recipient and credit agreement.** The Credit would be made to the Islamic Republic of Pakistan, represented by the Economic Affairs Division of the MoF. The Credit proceeds would be transferred to the Government in accordance with the terms of the Financing Agreement.

94. **Funds flow arrangement for the development policy credit.** The Government will identify a foreign exchange account with SBP, which forms part of the country's official foreign exchange reserves, into which the proceeds of the Credit will be disbursed. The proceeds will be released in one tranche following approval and official communication by IDA of Credit effectiveness. The completion of the prior actions and the maintenance of a satisfactory macroeconomic framework are sufficient to release the funds. The Pakistan Rupee equivalent of the funds in the account will, within two working days, be transferred into the consolidated fund of the Government Account No. 1-Non-Food, held with SBP, which is used to finance budgetary expenditures. Within 45 days of disbursement of the IDA Credit, the Finance Secretary of MoF, will provide a written confirmation to IDA certifying the receipt of Pakistan rupee equivalent of the Credit into the consolidated funds account of the Government, the date of receipt, and exchange rate to translate the credit currency into Pakistan Rupees. In addition, the Bank will reserve the right to audit the dedicated deposit account and would request the Government's cooperation, if such an audit report is needed. In such an event, the auditors of SBP will be requested to provide a special opinion confirming that the DPC funds went into the state official foreign exchange reserves and an equivalent amount was credited into the state budget, taking into account the accuracy of the exchange rate used at the transaction.

95. **Disbursements.** Disbursements from the Consolidated Fund by the Government will not be linked to any specific purchases, and no special procurement requirement shall be needed. The proceeds of the Credit shall, however, not be applied to finance expenditures in the excluded expenditures as defined in the Financing Agreement. If any portion of the Credit is used to finance excluded expenditures as defined in the Financing Agreement, IDA will require the Government promptly upon notice from IDA, to refund the amount equal to the amount of the said payment to the IDA. Amount refunded to IDA upon such request will be cancelled from the Credit.

96. **Funds flow arrangements for the PBG.** The PBG is not a financing instrument whose proceeds would be disbursed by the World Bank to the Islamic Republic of Pakistan. Instead, the PBG would be provided for the benefit of the investors in the bond/Sukuk/loan (the "Guaranteed Financing") contracted by the Islamic Republic of Pakistan and would provide protection against a non-payment of selected interest and/or principal payments by the Islamic Republic of Pakistan under the Guaranteed Financing as further set out in the Guarantee Agreement that would be negotiated between IBRD and the investors/underwriters. Financing raised with the help of the PBG would be transferred to the Government following successful conclusion of negotiations among the Government, the investors/underwriters and IBRD of the agreements providing for the Guaranteed Financing and satisfaction of all conditions precedent for the disbursement/issuance of the Guaranteed Financing and the PBG, including payment of the applicable fees to IBRD for the provision of the PBG. The proceeds of the Guaranteed Financing would not be applied to finance excluded expenditures as defined in the Indemnity Agreement. If any portion of the Guaranteed Financing is used to finance such excluded expenditures, the Government would be required to reallocate a corresponding amount equivalent to such portion to other non-excluded expenditures or, if permitted under the particular type of Guaranteed Financing (such as in the case of a commercial loan), to prepay the corresponding portion of the Guaranteed Financing.

97. **The financial statements of SBP for the financial year ended 30 June 2014 were audited.** The auditors gave an unqualified opinion on the statements concluding that the statements gave a true fair view of the financial position, financial performance and cash flows. SBP, on behalf of the Government, will continue to maintain an appropriate accounting system in accordance with generally accepted accounting principles. The foreign exchange controls are adequate for this operation. An IMF Safeguards Assessment of the SBP was done in 2009 and updated in 2010 and 2013. The 2013 update confirmed that the majority of actions previously agreed with the SBP have been implemented, with further improvements of internal controls and foreign exchange reserve management still in progress, such as the recently established independent Monetary Policy Committee. By end-June 2016, the authorities will have designed a time-bound action plan for incorporating the remaining critical recommendations.

5.4 Monitoring, Evaluation and Accountability

98. **The MoF is responsible for overall oversight and implementation of the CGDPF.** The External Finance Division in the Ministry of Finance is the main counterpart for the overall operation, while parallel technical discussions related to the individual prior actions are conducted between World Bank teams and government counterparts, often linked to ongoing projects and technical assistance programs. Through this operation, these agencies are collaborating in the monitoring of these reforms, i.e. Ministry of Commerce, Ministry of Communications, Privatization Commission, Planning Commission, SBP, SECP and BISP. MoF, as the lead implementing agency, has extensive experience and is fully conversant with World Bank policies and procedures through investment-lending and policy operations.

99. **A results framework has been developed for the operation (see Annex 1).** This operation will benefit from the Government's own monitoring and evaluation mechanisms. Timely achievement of targets will be assessed and documents made promptly available, drawing on the regular supervision function of national accounting, fiscal, and household survey data and, if required, specialized surveys on access to finance. The World Bank will supervise and monitor progress, making adjustments as necessary, based on this results framework. Monitoring of the achievement of results will be facilitated by regular engagement of the teams implemented technical assistance programs in support of the reforms included in this operation (in tax policy and administration, debt management, SOE reforms and privatization, poverty measurement, financial sector development) as well as the implementation of projects co-financed by the World Bank (on social protection).

100. **Grievance Redress**. Communities and individuals who believe that they are adversely affected by specific country policies supported as prior actions or tranche release conditions under a World Bank Development Policy Operation may submit complaints to the responsible country authorities, appropriate local/national grievance redress mechanisms, or the WB's Grievance Redress Service (GRS). The GRS ensures that complaints received are promptly reviewed in order to address pertinent concerns. Affected communities and individuals may submit their complaint to the WB's independent Inspection Panel which determines whether harm occurred, or could occur, as a result of WB non-compliance with its policies and procedures. Complaints may be submitted at any time after concerns have been brought directly to the World Bank's attention, and Bank Management has been given an opportunity to respond. For information on how to submit complaints to the World Bank's corporate Grievance Redress Service (GRS), please visit

http://www.worldbank.org/GRS. For information on how to submit complaints to the World Bank Inspection Panel, please visit www.inspectionpanel.org.

6. SUMMARY OF RISKS

101. **The overall risk rating level of CGDPF is high (see Table 7 below).**

102. **Political risks to the operation are high, stemming from both the broader political and security situation in Pakistan which may distract policy makers, as well as from political resistance to the reform program itself.** In principle, the Government – with a majority in the lower house of Parliament – should have the support needed to implement legal, institutional, and regulatory reforms. However, in practice, opposition could emerge from those who will be adversely affected by specific reforms, such as reductions in tax benefits or the phasing out of tax exemptions and SROs, or privatization. And that could undermine the political coalition in power, and slow or stall reforms. Political risks have declined with several by-elections strengthening the current government and providing support for ongoing reform efforts. On the other hand, strong opposition to the Government's privatization agenda, most clearly seen in parliamentary discussions on the corporatization of Pakistan International Airways, may delay or altogether stall difficult reforms. As the next political cycle nears, the reforms themselves may become the target of the next political campaign. Political risks are mitigated by supporting a reform program that has benefited at inception from extensive consultative processes with different stakeholders on the design and implementation of reforms as well as a successful record of reform implementation over the past few years. The Government has also shown strong political will in following through with some controversial reforms. Risks are also mitigated by pacing the reforms to the Government's legislative agenda and by taking into account perceived political-economy constraints, as well as a continuous dialogue with government counterparts to calibrate the Bank's support to an ambitious legislative agenda.

103. **Macroeconomic risks stemming from possible domestic and external shocks are substantial.** Domestically, the country is exposed to natural disasters, political events and terrorism. Challenging domestic political conditions as those suffered during the first half of FY14/15 may disrupt economic activity. Security risks may also disrupt economic activity, discourage investment and undermine fiscal consolidation. Slippages in the privatization program may affect private sector investment, lead to further fiscal outlays and further increase Pakistan's already-high contingent liabilities. In the case of Discos, further delays in privatization may slow the Government's efforts to reduce circular debt in the energy sector. A persistent dollar appreciation with limited exchange rate flexibility may erode export competitiveness. The combination of the upcoming national election in 2018 and the end of the IMF's Extended Fund Facility program in September 2016 may affect reform momentum. Delays in much-needed structural reforms would weaken growth prospects and discourage private investment. Externally, protracted global economic weakness, especially in the Euro area, China and Japan, could negatively affect exports. Pakistan benefits from significant remittance flows, particularly from oil-rich countries (around 2/3 of all remittances). Low oil prices (even if they climb moderately, as forecast) represent a downside risk for remittances, as GCC countries may reduce public spending and lower investment leading to reduced labor demand and remittances from migrant workers. But it also improves the current account deficit and facilitates energy sector reforms to reduce energy subsidies. As a whole, low oil prices have been positive for Pakistan, being a net oil

importer as most other South Asian countries. Macroeconomic risks have declined over the last two years as the Government successfully addressed external and domestic imbalances, by tightening fiscal policy and reducing debt levels and efforts to increase the level of international reserves. Macroeconomic risks will be further mitigated if the Government maintains prudent fiscal and monetary policies, which result in a large reserve cushion and healthy fiscal accounts. In addition, the Bank and the IMF will keep working in tandem. After the end of the program, the IMF will continue with a strong engagement in Pakistan through intensive post-program surveillance and macroeconomic monitoring.

104. **The depth of the reforms being supported requires several mitigation measures to address substantial risks regarding institutional capacity, stakeholders and risks of judicial intervention**. Weak policy coordination, frequent staff turnover and counterpart capacity constraints may affect the operation and its aftermath. Reforms that affect economic rents of stakeholders (e.g. those related to tax exemptions, tax audits or privatization) may encounter significant resistance or even be challenged in court, as has happened in the past. These risks are mitigated in three ways. First, potential coordination failures are prevented by the organization of monthly meetings chaired by the Minister of Finance to monitor progress in reform implementation, attended by all relevant agencies as well as the World Bank. Second, in parallel to the CGDPF, the Bank and other development partners have continued to provide extensive and timely technical assistance (TA) to advance reforms. Third, the loss of social support to the reform agenda can be mitigated by the Government's strong electoral mandate, ratified in recent local elections, its reform implementation record to date, more effective media dissemination to stakeholders and citizens of the reform benefits achieved so far and their trade-offs, and extensive consultations. Key policy measures have also been challenged in court, which has sometimes delayed the implementation of reforms (e.g. in the energy sector, in tax administration). In some cases, the reforms being supported have been designed to take into account the risk of judicial intervention, e.g. the modern audit policy has been designed to avoid judicial challenges. The World Bank's ongoing technical assistance and other engagement will also seek to support sustained momentum on the reform agenda.

105. **Technical design risks are moderate.** The outcome of the PBG supported financing will be impacted by a number of variables outside the influence of the Government, such as pipeline of bond or loan financings in the debt markets, news flow out of emerging markets in general, oil price movements, and overall investor sentiment. This will be mitigated by working with the authorities to target the financing alternative and market segment that provide the best terms for the Guaranteed Financing in light of these factors and the Government's funding objectives with respect to volume and pricing.

106. **Fiduciary risks are substantial, and other risks are moderate or low.** Mitigation measures to address fiduciary risks are discussed in section 5.3. The National Climate and Disaster Risk Screening Tool was used to screen the operation for climate and disaster risks to identify potential risks at an early stage. The tool assessed the risks to achieving the first part of the development objective (enhancing private sector competitiveness) as low or moderate, while there were no risks to achieving the second part of the development objective (improving fiscal management). Other risks are expected to be moderate or low.

Table 7: SORT: Risk Categories

	Rating
1. Political and governance	**H**
2. Macroeconomic	**S**
3. Sector strategies	**L**
4. Technical design	**M**
5. Institutional capacity	**S**
6. Fiduciary	**S**
7. *Environmental and Social*	**M**
8. Stakeholders	**S**
9. Other	**S**
Overall	**H**

Annex 1: Policy and Results Matrix

Prior Actions for CGDPF	Results (June 2017)
Pillar I: Improving the Business Environment	
In order to improve the private sector's access to credit, (a) the National Assembly has passed the Financial Institutions (Secured Transaction) Bill; and (b) the National Assembly has passed the Amendment to the Credit Bureau Act.	**Results Indicator:** Doing Business Distance to Frontier Indicators for Getting Credit **Baseline** DB16: 30.0 **Target** DB18: 50.0
The Recipient has posted improved processes to simplify and streamline the payment of taxes on the website of the Federal Board of Revenue.	**Results Indicator:** Increase in the number of taxpayers who submit a tax return online by end-March the following year **Baseline** 419,910 in March 2015 **Target** 773,000 in March 2017
In order to improve governance and transparency of capital markets, (a) the National Assembly has passed an amendment to the SECP Act, to ensure compliance of the provisions applying to securities regulators with international norms and standards and to strengthen the enforcement powers of SECP; and (b) the SECP has issued an order in the matter of the integration of the three stock exchanges.	**Results Indicator:** Increased listed capital in capital markets **Baseline:** Listed capital of PKR 1.18 trillion as of June 2015 **Target:** Listed capital increases by 15 percent to PKR 1.46 trillion by June 2017
The National Assembly has passed the Financial Institutions (Recovery of Finances Amendment) Bill.	**Results Indicator:** Housing Finance Market as a percentage of private sector credit **Baseline** 1.6 percent in 2014 **Target:** 2 percent by 2017
The Recipient's Ministry of Finance has implemented a new directive requiring the annual collection and publication of key financial information of all State Owned Entities by publishing the first report on the Ministry of Finance's website.	**Results Indicator:** Availability of consolidated SOE financial information **Baseline:** Not available **Target:** Published
To attract private sector investment and remove entry barriers in the insurance sector, the National Assembly has passed the State Life Insurance Corporation (Re-organization and Conversion) Bill	**Results Indicator**: SLIC is subject to same rules as other corporate insurance companies **Baseline:** SLIC is not required to follow Companies Ordinance 1984 **Target:** SLIC complies with Companies Ordinance 1984.

Prior Actions for CGDPF	Results (June 2017)
Pillar II: Enhancing Fiscal Management	
The Federal Government has submitted to the National Assembly the Finance Bill FY16/17 which includes the third and final phasing out of discriminatory concessions granted through SROs	**Results Indicator:** Tax/GDP ratio **Baseline**: 11 percent in FY14/15 **Target:** 12.2 percent in FY16/17
The Recipient's Federal Board of Revenue has started to implement a new audit policy that includes risk profiling of taxpayers for improved tax compliance by initiating forty comprehensive audits of large taxpayers	
The Recipient's Ministry of Finance has improved debt management coordination through (a) ministerial notification expanding the existing functions of the Recipient's Debt Policy Co-ordination Office, and (b) publication of the approved medium term debt management strategy FY 2015/16 – 2018/19.	**Results Indicator:** Share of foreign debt as a percentage of total public debt **Baseline:** 28 percent in 2015 **Target:** 20-35 percent in FY16/17, in line with the Medium-Term Debt Strategy
In order to strengthen targeting of safety net programs, the Recipient's Federal Government, through its Ministry of Finance, has authorized BISP to update the National Socio-Economic Registry with dynamic updating of the registry going forward, in accordance with a plan submitted by BISP	**Results Indicator:** Number of households with updated poverty scorecard information registered in the National Socio-Economic Registry **Baseline:** 0 in 2015 **Target:** 2.5 million by June 2017
The Recipient's Federal Government has published a new poverty rates series going back to 2005-06, using the cost of basic needs method and the most recent survey data (2013/14).	**Results Indicator:** Adoption of a new poverty line **Baseline:** No poverty rate published since 2005-06 **Target:** New poverty rate published using latest data (2013-14) along with trend in poverty on old line, which had not been released since 2006

Annex 2. Letter of Development Policy

No.415-FM/2016

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)

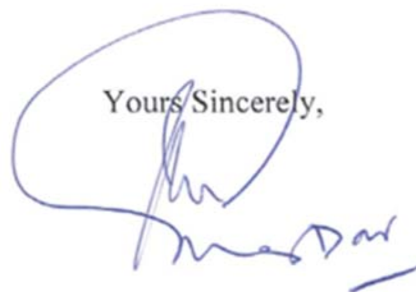
the Financial Institutions (Secured Transaction) Bill; (ii) the Amendment to the Credit Bureau Act; (iii) the Amendment to the Securities and Exchange Commission of Pakistan (SECP) Act; (iv) the Financial Institutions (Recovery of Finances) (Amendment) Bill; and (v) the State Life Insurance Corporation (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,



Mr. Jim Yong Kim,
President,
International Bank for Reconstruction and Development
1818 H Street, N.W.,
Washington DC, 20433
U.S.A

Annex 3. Fund Relations Annex

IMF Executive Board Completes Tenth Review Under the Extended Fund Facility for Pakistan

Press Release No. 16/137
March 25, 2016

The Executive Board of the International Monetary Fund (IMF) on March 25, 2016 completed the tenth review of Pakistan's economic performance under a three-year program supported by an Extended Fund Facility (EFF) arrangement. In completing the review, the Executive Board also approved the authorities' request for modification of the end-March 2016 performance criterion on the State Bank of Pakistan's stock of net foreign currency swaps/forward position. The Executive Board's decision enables the immediate disbursement of an amount equivalent to SDR 360 million (about US$502.6 million), bringing total disbursements to SDR 3.96 billion (US$5.53 billion).

On September 4, 2013, the Executive Board approved the 36-month extended arrangement under the EFF in the amount of SDR 4.393 billion (US$6.64 billion at the time of approval of the arrangement) or 216 percent of Pakistan's current quota at the IMF. (See Press release No. 13/322).

Following the Executive Board's discussion of Pakistan, Mr. Mitsuhiro Furusawa, Deputy Managing Director and Acting Chair issued the following statement:

"Economic activity has continued to gradually gain strength, and short-term vulnerabilities have receded. Building on these gains, further progress, including in the area of structural reforms, is needed to generate strong and inclusive growth and make the economy more resilient and competitive.

"The authorities' continued commitment to reach the program's fiscal targets is welcome. Further widening the tax net and ensuring the fairness of the tax system, together with prudent management of budgetary spending and close coordination with the provinces, remain important to consolidate the gains in addressing Pakistan's fiscal vulnerabilities while generating the necessary resources for higher priority spending in areas such as infrastructure, health, and education.

"The monetary policy stance remains appropriate. Falling oil prices have helped efforts to bolster foreign reserves. While the establishment of an independent monetary policy committee has been an important step in advancing central bank autonomy, addressing remaining recommendations of the 2013 Safeguards Assessment will be key to strengthen it further.

"Reinforcing financial sector resilience remains pertinent and efforts to enhance capital buffers of banks are encouraging. The recent amendments to the AML Act constitute a first step to widen the application of AML tools to the proceeds of tax crimes. Further efforts to strengthen the AML/CFT framework are welcome and will help strengthen financial stability and tax compliance.

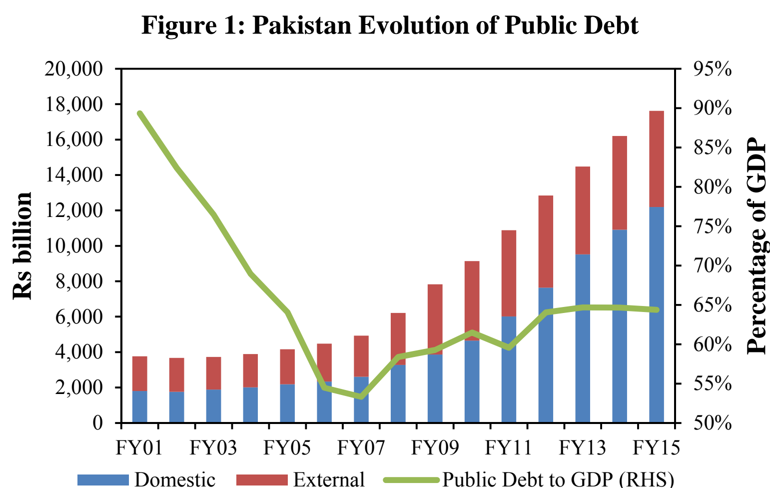
"Amid recent setbacks to the agenda to restructure or privatize loss-making public sector enterprises, continued resolve to complete the planned reforms remains important to address fiscal risks and strengthen economic efficiency. The authorities' focus on containing losses in affected companies is also welcome in this regard. Further improving the business climate, transparency, and governance should help generate high and more inclusive growth."

Annex 4. Pakistan: Debt Sustainability Analysis[19]

Overview

1. **Public debt continues to fall, though marginally.** Even though Pakistan's public debt to GDP ratio has been consistently above the 60 percent limit allowed by the Fiscal Responsibility and Debt Limitation Act 2005[20], a marginally downward trend is recently emerging. As compared to June 30, 2014 ratio of 64.7 percent[21], it fell down by 0.3 percentage points to 64.4 percent as of end-June 2015 (Figure 1). The government's continued efforts to ensure fiscal consolidation, stability in exchange rate and higher growth in nominal GDP contributed to this improvement. Domestic debt continued to dominate at 69 percent of total public debt. On the other hand, foreign currency public debt stood at 19.8 percent of GDP at the end of FY14/15 compared to 21.1 percent in previous year primarily due to translational gains[22] realized during most of the fiscal year.

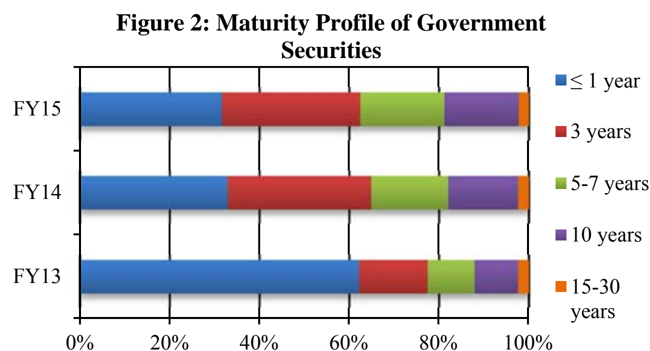
Figure 1: Pakistan Evolution of Public Debt



Source: State Bank of Pakistan

2. **Domestic borrowing mix remains diversified with the current portfolio holding more medium-to-long term instruments and significantly lesser short term debts (Figure 2).** In line with last year's trend, the market's continued interest in Pakistan Investment Bonds (PIBs)[23] in the first half of FY14/15 facilitated the Government to not only meet but far exceed the pre-auction targets[24]. In the second half, due to policy rate cuts, market interest to some extent shifted towards Market Treasury Bills (MTBs)[25].

Figure 2: Maturity Profile of Government Securities



Note: 1/ Government securities include MTBs, PIBs and GIS.
Source: State Bank of Pakistan

---

[19] This Annex has been prepared by Mehwish Ashraf (Research Analyst, GMFDR) with support from Syedah Mohsina Atiq (Consultant, GMFDR).

[20] In recent past, the public debt to GDP ratio exceeded in FY09/10 when it reached 62 percent and has remained above the threshold since FY11/12.

[21] This figure and subsequent data is sourced from World Bank calculations. The Government of Pakistan's calculations differ slightly, with a public debt to GDP ratio of 63.8 percent at June 30, 2014 and 63.5 percent at end-June 2015.

[22] Translational gain observed during FY14/15 implies the appreciation of US dollar against major currencies. In Pakistan, external loans are contracted in various currencies but disbursements are effectively converted into PKR. As PKR is not an internationally traded currency, other currencies are bought and sold via selling and buying of USD. Hence, the currency exposure of foreign debt originates from two sources: USD/other foreign currencies and PKR/USD. This two pronged exchange rate risk is called translational gain.

[23] Pakistan Investment Bonds are medium to long term debt instrument with maturities of 3, 5, 10, and 20 years.

[24] During Q2, on aggregate, acceptance of bids for PIBs was more than two times the auction target.

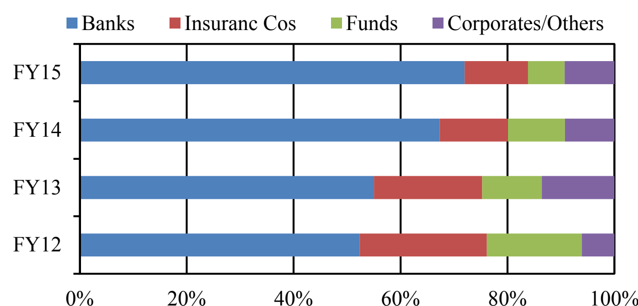
[25] Market Treasury Bills are short term debt instrument with maturities of 3, 6 and 12 months with most offers during FY14/15 coming in the latter two maturities.

While this change in composition of domestic debt is helpful in lowering rollover (and refinancing) risks, it has increased the cost of borrowing.

3. **With all its virtues, higher reliance on medium-to-long term domestic debt increases debt servicing[26].** PIBs – being an attractive instrument on account of declining term premiums[27] - dominated the domestic debt portfolio, constituting almost 34 percent of the total at end June 2015[28]. Similar to PIBs, the amounts accepted for MTBs in the second half of FY14/15 were higher than the targeted volumes, all of which increased debt service burden for the Government[29]. Resultantly, the interest payments on domestic debt were at 4.4 percent of GDP in FY14/15, up from 4.1 percent of GDP two years back when more than half of the domestic debt was of short maturity.

4. **Banks' exposure to government securities has considerably increased.** In FY14/15, 38 percent of total banking assets were in the form of government debt, up from 35 percent in previous year. Almost 72 percent of the outstanding PIBs at end-June 2015 were held by scheduled banks compared to 66 percent at June 30, 2014 (Figure 3). This increase in holdings reinforces the concept of maturity mismatch (long term assets versus short term liabilities) in the banks' balance sheets that may become a source of vulnerability in the near-to-long term.

Figure 3: Bank and Non-Bank Holdings of Pakistan Investment Bonds



Source: State Bank of Pakistan

5. **In absolute terms, total external debt fell by US$ 262 million to US$ 65.1 billion at end-June 2015 on account of revaluation gains even though positive inflows were observed.** Most of these were in the form of disbursements of multilateral and bilateral loans amounting to US$ 3.1 billion while US$ 2.6 billion were also received from the IMF under the Extended Fund Facility (EFF – approved by the IMF Executive Board on September 4, 2013). Furthermore, Pakistan ventured into the Shariah-compliant international capital markets after almost a decade and issued a 5-year US$ 1.0 billion Sukuk in November 2014 at a coupon rate of 6.75 percent.

Debt Sustainability analysis

6. **Under baseline scenario, Pakistan's public debt-to-GDP ratios are projected to decline over the medium term**. With a targeted consolidated fiscal deficit (excluding grants) of 4.1 percent of GDP by FY18/19, public debt is projected to fall from 64.4 percent of GDP in FY14/15 to 57.7 percent by FY18/19 (Table 1). Continued fiscal consolidation reflecting adjustment measures – including subsidy reduction, and tax policy and administration actions – and moderate economic growth are expected to support the decline in public debt ratios. Moreover, gross financing needs are expected to remain sizeable as the Eurobond bullet maturities continue to feature almost throughout the projection horizon[30] amounting to around 24 percent of GDP by FY18/19. Particularly, in FY16/17, these financing needs exhibit a hike on account of a massive bullet repayment under the domestic debt[31]. The proposed policy-based guarantee will

[26] Even though the Government has been able to retire more of its central bank borrowing as per the SBP Amendment Act (1956), this form of borrowing tends to be virtually interest free whereas domestic debt market issuance implies higher interest payments.
[27] Term premium is the amount by which the yield of a long-term coupon bond (in the case of Pakistan, PIB) exceeds that of a short-term zero-coupon bond (MTB). The first nine months of FY14/15 saw the term premium between PIBs and 3-month MTBs reduced significantly.
[28] New PIB issuance, lately, is being launched in the first month of a fiscal year and the same issue is re-opened during all auctions of that year. As a result, the bi-annual coupon payments fall due every January and July, thereby increasing the interest cost in tandem with increasing volumes.
[29] Interest payments on domestic debt amounted to Rs. 1.2 trillion in FY14/15 compared to Rs. 1 trillion in FY13/14.
[30] These are US$ 500 million in March 2016, US$ 750 million in June 2017, and US$ 2.0 billion in April 2019.
[31] Maturity of around Rs. 1.2 trillion for 3-year PIBs is falling due on July 18, 2016.

not have an impact on projected debt levels as it will be supporting planned issuances in line with the recently approved Medium Term Debt Strategy FY 2015/16-2018/19.

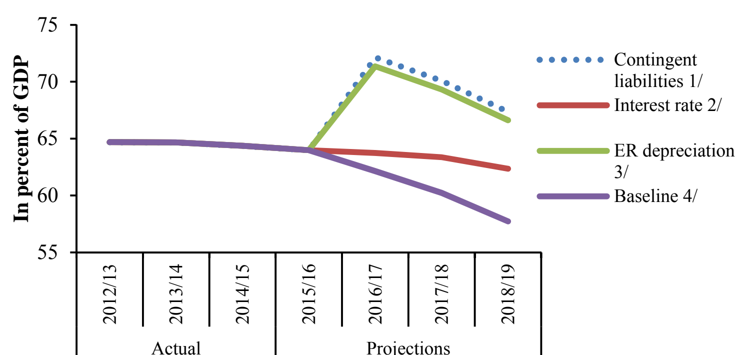
Table 1: Base case debt projections
(In percent of GDP, unless otherwise indicated)

	Actual			Projections			
	FY12/13	**FY13/14**	**FY14/15**	**FY15/16**	**FY16/17**	**FY17/18**	**FY18/19**
Public sector debt 1/	**64.7**	**64.7**	**64.4**	**64.0**	**62.1**	**60.2**	**57.7**
o/w foreign-currency denominated 2/	22.1	21.1	19.8	19.9	18.6	17.5	16.2
Key Macroeconomic and Fiscal Assumptions							
Real GDP growth (in percent)	3.7	4.0	4.2	4.5	4.8	5.1	5.4
Inflation rate (in percent, period average)	7.4	8.7	4.5	4.0	5.0	5.5	6.0
Primary deficit 3/	3.9	0.3	0.5	0.3	-0.1	-0.3	-0.4

Source: World Bank staff estimates
1/ General government gross debt
2/ This includes medium and long term PPG debt as well as short-term external debt. This also includes IMF debt (both budget support and balance of payments support), Foreign currency bonds as well as PSEs non-guaranteed debt.
3/ Includes grants. '-' means a surplus.

7. **Stress tests show that public debt is particularly sensitive to contingent liabilities and a real exchange rate depreciation shock.** The most important deterioration of public debt levels vis-à-vis the base case scenario takes place under a one-time contingent liability shock, a real depreciation shock and a real interest rate shock (Figure 4). In the case of the most extreme shock, one-time contingent liabilities shock equivalent to 10 percent of GDP to the baseline, the debt stock rises to 67.4 percent of GDP by FY18/19, almost 9.6 percentage points of GDP above the baseline. Second important shock is a 30 percent one-time real depreciation as a result of which the public debt ratio rises to 66.6 percent of GDP by FY18/19; 9 percentage points of GDP above the baseline.

Figure 4: Public Debt Sustainability Analysis



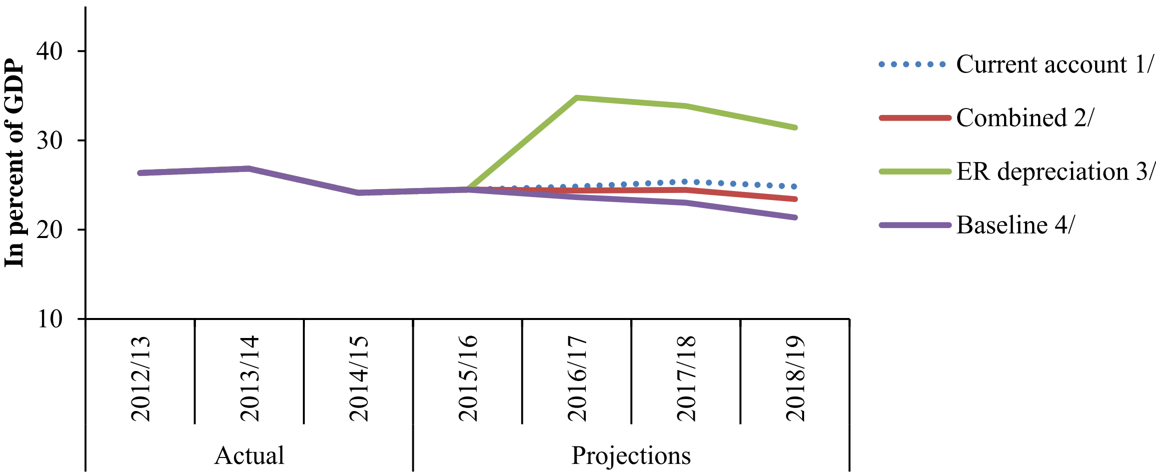
Source: World Bank staff estimates
Notes: 1/ One time 10 percent of GDP increase in other debt creating flows in FY16/17
2/ Real interest rate is at baseline plus one standard deviation
3/ One time 30 percent real depreciation in FY16/17
4/ Country team projections

8. **Public debt dynamics will remain a source of fiscal vulnerability**. Despite the gradual decline in public debt ratios, total interest payments will continue to absorb a large share of fiscal revenues (including grants), averaging to 28 percent of total revenues. The public debt-to-revenue ratio during the projection period is projected to average around 386 percent.

9. **However, external debt sustainability risk is projected to remain manageable under the baseline scenario.** External debt-to-GDP is projected to decline from 24.1 percent in FY14/15 to 21.4 percent by FY18/19, owing to moderately estimated financial (debt-creating) flows, expected Eurobonds, and sustained economic growth. Disbursements under the IMF EFF are projected to conclude in the first year of projections and primarily explains the temporary increase to 24.5 percent of GDP in FY15/16.

External debt is robust to most shocks and is expected to follow a declining path under most standardized-shock scenarios (**Figure 5**). Most extreme shock appear to be one time 30 percent real depreciation shock which increases the external debt to GDP ratio to 31.4 percent of GDP by end-June 2019, which is almost 10 percent of GDP higher than the base case. A non-interest current account shock raises the external debt by about 4 percent of GDP in FY18/19 relative to the baseline. Shocks to the economic growth rate and the external interest rate, make only small difference with respect to the baseline scenario.

Figure 5: External Debt Sustainability Analysis



Source: World Bank staff estimates
Notes: 1/ Non-interest current account is at baseline minus one-half 10-year historical standard deviations
2/ Combination of three shocks: i. Non-interest current account is at baseline minus one-quarter standard deviation, ii. Real GDP growth is at baseline minus one-quarter standard deviation, iii. Nominal interest rate is at baseline plus one-quarter standard deviation
3/ One time 30 percent real depreciation in FY16/17
4/ Country team projections

Annex 5. Medium-Term Government Reform Plans

1. **While CGDPF is a stand-alone operation, the reforms being supported are embedded in an ambitious medium-term reform agenda.** The reforms identified in the Prior Actions not only connect to the reforms supported by the previous DPC series, but are also part of a reform program that will realize much of its impact in the medium term. Key aspects of the government reform program have been summarized above. This annex seeks to highlight specifically the link between the stand-alone operation's reform steps and an ambitious reform agenda that the Government has taken on but which will take a longer time to implement and yield results.

2. **Prior Actions 1 and 2 directly connect to a broader investment climate reform program, which is deemed necessary for enabling a dynamic private sector to emerge and grow more quickly.** The government has been consistent in seeking to promote private sector-led growth through ongoing reforms, and has sought WBG support to define and implement the reforms. Prior Action 1 and 2 directly address two of the more challenging areas measured by the WBG Doing Business indicators, access to credit and paying taxes, but more importantly, they set the stage for implementation of the broader reform agenda in investment climate, the National DB Reform Strategy. The strategy was finalized in February 2016 and will, over the medium term, improve the regulatory environment for the private sector through reform implementation at federal and provincial level.

3. **Prior Actions 1, 3, and 4 seek to improve the private sector's access to and use of financing, though the GoP reforms over the medium term and WBG support for them go well beyond the Prior Actions themselves.** Enabling a dynamic private sector means that access to financing cannot be restricted to only the small part of the economy. However, Pakistan is home to an unbanked population of about 100 million, and only 13 percent Pakistani adults have an account with a formal financial institution. Job-creating MSMEs have been impacted heavily by the reduction in private sector credit. Through WBG support, the Government has developed and adopted Pakistan's National Financial Inclusion Strategy, which over the medium term will include reforms such as (i) promoting digital finance and electronic payments; (ii) expanding and diversifying access points; (iii) improving capacity of financial service providers; and (iv) increasing levels of financial capability. The strategic approach of WBG's ongoing and planned financial sector engagement combines financial, advisory, knowledge, and convening services, complemented by investments and private sector engagement through IFC. Advisory services, analytics and capacity-building include working closely with the Government and regulators on critical legal and regulatory reforms and with financial institutions to drive access and usage. Investments include financial support for financial/credit infrastructure and financial institutions.

4. **Prior Actions 5 and 6 are key ingredients to the broader effort to reduce the distortionary impact of State-Owned Enterprises.** The current government came into office with a plan to reinvigorate the privatization agenda and reduce the role of the state as a dominant actor in the economy. While Prior Actions 5 and 6 directly contribute to this agenda, they also set the stage for further reforms in the medium term. Enforcing transparency regarding the financial performance of SOEs is critical for maintaining public support and countering the misleading narrative of SOEs as the 'crown jewels' of the state that are being given away for pennies. Similarly, insisting on the clear distinction between corporatization and privatization is important not only for the insurance sector and the particular case of state-owned life insurers, but for the broader reform agenda. It is a distinction that has been too often lost in the privatization debate in Pakistan, that ownership (privatization or not) ultimately matters less than whether the enterprise in question is subject to the same rules and regulations as other/private actors (corporatization or not).

5. **The medium term agenda to improve Pakistan's export competitiveness and trade performance is supported by Prior Action 7, but also indirectly by Prior Action 8 and 9.** Pakistan's export competitiveness has been lagging in recent years. Export earnings in FY14/15 (USD 24.1 billion)

have fallen below the level in FY10/11 (USD 25.4 billion) and exports have continued to decrease month on month in FY15/16 as compared to FY14/15. This trend is a result of a worsening investment climate (discussed above); poor trade facilitation, logistics and infrastructure; and protectionist and discretionary trade policy. On trade facilitation, the WBG is providing technical assistance to design and implement reforms, in close coordination with support provided by ADB on improving logistics and infrastructure at border posts. The nature and current status of this work, ongoing design and implementation of improvements in hard- and soft-infrastructure at border posts, as well as improvements in trade facilitation policies and practice, does not lend itself well to direct inclusion in Prior Actions. However, when it comes to discretionary and protectionist trade policy Prior Action 7 continues the reforms supported under previous DPCs in eliminating distortionary SROs, while Prior Actions 7, 8, 9, and even 2 contribute to the longer term agenda of improving revenue collection and fiscal management, which in the longer term will enable GoP to reduce its current over-reliance on taxation of trade as a source of revenue.

6. **Prior Action 10 and 11 set the stage for improving the design, implementation, and monitoring of poverty reduction programs in the future.** As noted earlier, Pakistan achieved significant poverty reduction over the past years. Prior to these reforms the quality of data and methodology used to measure poverty was somewhat dated. The update in the poverty line and methodology will enhance the ability of GoP to achieve further poverty reduction in the future.

Annex 6. Privatization Program of the Government of Pakistan

1. **"Denationalization" started in Pakistan during the 1980s.** Legislative cover to the privatization program was provided through the Privatization Commission Ordinance promulgated in 2000. Around 167 transactions were completed before 2005. The proceeds from privatization totaled Rs. 476 bn.[32] The Ordinance created a Privatization Commission (PC), a corporate body governed and administered currently by a 16 member Board chaired by a private sector professional. The Board is independent, autonomous and has a majority of its members from the private sector. The Commission can carry out privatization, through a variety of modes including: (a) sale of assets and business; (b) sale of shares through public auction or tender; (c) public offering of shares through a stock exchange; (d) management or employee buyouts by management or employees of an SOE; (e) lease, management or concession contracts, etc.

2. **The privatization process had been dormant since 2006.** This had been a result of a number of constraints, including slower-than expected economic growth, the challenging security and law and order situation, as well as legal challenges to the privatization process. Privatization received renewed emphasis as a key pillar of the current government's economic reform program. As part of its policy for restructuring and reforming the economy, the PC has successfully completed 4 capital market transactions (United Bank Limited, Pakistan Petroleum Limited, Allied Bank Limited and Habib Bank Limited) and one strategic sale (National Power Construction Company). It has, however, encountered challenges in the sale of a strategic share of Pakistan International Airlines (PIA), where labor reactions and strikes delayed the planned solicitation of expressions of interest in late 2015.

3. **WBG DPCs have been instrumental in providing timely support for privatization transactions.** The FSIG series had prior actions, which pertained directly to the Government's Privatization agenda. However, based on lessons learnt from Heavy Electrical Complex (HEC) Strategic Sale (prior action of FSIG II),[33] the WBG has taken a more strategic approach of supporting reforms in sectors undergoing privatization instead of individual transactions. The current proposed operation therefore supports reforms in the insurance sector through the corporatization of SLIC as a prior action for the proposed DPC as well as the necessary steps to initiate the process for corporatization of PLI.

4. **In addition to the DPC, the WBG is using other instruments to support the privatization effort.** The Trust Fund for Accelerated Growth and Reforms (TAGR, DfID funded) supports the Government of Pakistan in SOE reforms. This includes institutional and technical capacity building of the relevant key stakeholders (PC, SECP, CCP, IERU) to monitor the performance of SOEs and to promote greater transparency and accountability in the sector. The Government's privatization effort is currently facing significant headwinds. The Government remains committed to SOE reform and privatization, but the process and timelines may need to be adjusted. This could have implications for energy sector reforms and in particular plans for the reduction of power sector arrears which relied on privatization of the Discos. The Government is in the process of updating the circular debt plan to monitor the power sector arrears in light of the delays in the privatization of the Discos. In order to regain the momentum on privatization and reduce the state's role in the economy, the Government has to spend its political capital in better explaining the privatization program and creating the necessary consensus as well as improving transparency and

[32] These included, inter alia, Telecom privatization (Rs.187 bn.); capital market offerings (Rs.133 bn.); Energy privatizations (Rs.52 bn.); Banking privatizations (Rs.41 bn.); and Chemical/ Fertilizer privatization (Rs.42 bn.).

[33] The state-owned enterprise strategic sale of HEC was considered to have been completed as represented in the Program Document (Report No. 96376-PK), following the bid award to Cargill Holdings Ltd, a signed Letter of Acceptance by the seller and the buyer, a Share Purchase Agreement initialed by both parties, the deposit of earnest money by CHL, and the delivery by CHL of a cheque for the payment of the full purchase price. However, shortly thereafter the cheque for the payment of the purchase price was returned unpaid. Privatization Commission revoked the Letter of Acceptance of the offer due to lack of payment. Thus HEC remains government-owned.

communications around the privatization process.

Annex 7. Rationale for the policy-based guarantee

1. The proposed PBG follows a request from the Government of Pakistan to the World Bank's International Bank for Reconstruction and Development (IBRD) for support in the form of a policy-based guarantee (PBG) in the context of the earlier requested CGDPF. The Government has requested a PBG of up to US$420 million.

2. The IBRD PBG would complement the IDA credit. The IDA credit and the PBG would facilitate budgetary resources to the GoP of up to US$1.5 billion[34]. The Government of Pakistan is seeking to meet its financing needs for the current FY (ending on 30 June 2016) with the IDA credit (US$500 million) while the PBG would help meet Government of Pakistan's financing needs in the upcoming fiscal year starting on July 1, 2016. This is supportive of IBRD overall objectives of leveraging its balance sheet and multiplying development resources and impact, as well as leveraging concessional window in innovative ways.

3. **While Pakistan in the past and through the sovereign has already successfully accessed the international capital markets on its own, recent GoP issuances (latest in September 2015) have proven to be more challenging in raising adequate volumes of sovereign funding at acceptable financial terms.** Those recent challenges are caused by the increasing market volatility for emerging market issuers trying to access international capital markets.

4. **The proposed IBRD PBG would act as a catalyst by providing Pakistan with the appropriate support to ensure it has access to foreign capital inflows at a sustainable cost and as budgeted in order to continue on its strategy to improve competitiveness and accelerate growth.** Gross fiscal financing needs are projected to increase from PKR 7.6 trillion in FY15/16 to PKR9.2 trillion in FY16/17 and further to PKR 9.9 trillion in FY18/19[35]. A relatively large share of this (around 60 percent) is short-term public sector debt (less than a year). Amortization of medium- and long-term public sector debt will increase significantly in FY16/17, particularly to domestic creditors. The Government seeks to increase financing from international markets to diversity financing sources and maintain its presence in these markets, which will facilitate the bullet repayments coming due from FY15/16 onwards. There is also additional commercial financing sought for select infrastructure projects with government support, such as the Dasu hydropower project by the Pakistan Water and Power Development Authority (WAPDA).

5. The proposed PBG would create fiscal space by reducing government borrowing from the domestic banking sector. By allowing Pakistan to tap international rather than domestic markets for its fiscal needs, the PBG would support the strategy suggested in the recently approved MTDS. This will reduce borrowing from the domestic banking sector, the main financing source for the Government of Pakistan in recent years, freeing resources to increase credit to the private sector, supporting the operation's objective of a more competitive private sector.

6. **The type and amount of financing to be raised with the support of the PBG would be determined together with the Government of Pakistan based on their financing needs for the next fiscal year and in line with the recently approved Medium-Term Debt Strategy FY15/16-FY18-19.** Due consideration would be given to overall debt/GDP ratios, capital market dynamics and Pakistan's

[34] Including commercial financing of up to US$ 1 billion that may be raised with the support of the PBG

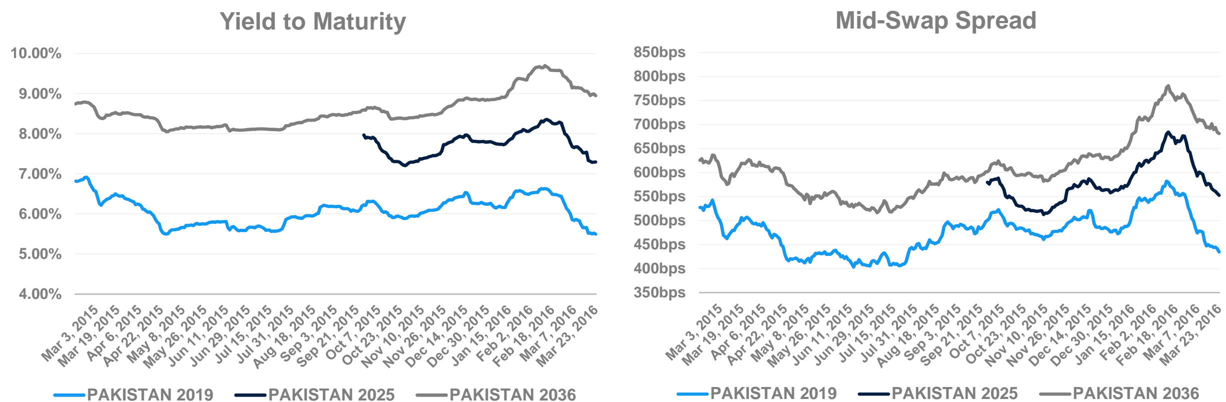
[35] Note these are World Bank estimates. The Government of Pakistan has slightly different estimates, including PKR 7.5 trillion in FY15/16 increasing to PKR 9.1 trillion in FY16/17

planned sovereign bond issuances.

1.1. Diversification of sovereign financing capabilities

7. Country risk perception is improving. Pakistan's Emerging Market Bonds Index Plus (EMBI+) risk spread has declined from its peak in March 2013 of 1,011 bps to 517 bps in April 2016. Moody's changed the outlook for its Caa1 sovereign credit rating from stable to positive in March 2015. Later, in June 2015, Moody's upgraded Pakistan's foreign currency bond ratings to B3 and assigned a stable outlook. Moreover, Standard & Poor's ratings agency raised Pakistan's credit rating from stable to positive in May 2015 but affirmed its B- rating. Market confidence allowed Pakistan to raise US$2 billion in April 2014 through two dollar-denominated Eurobonds with bullet maturities and coupons of five years and 7.25 percent and ten years and 8.25 percent, implying a spread of about 460-560 basis points over US Treasuries. The government issued a US$1 billion five-year international Sukuk in November 2014 at 6.75 percent. More recently, Pakistan tapped once again the international capital markets in September 2015 and issued a 10-year Eurobond worth US$500 million at 8.25 percent, though at the same yield as a year ago despite its improving credit ratings and having scaled back its issue size (Figure 1).

Figure 1: Pakistan yields and spreads vs US mid-swap



8. Since the end of 2015 until very recently, the emerging bond market was closed to low rated issuers. The bond markets for emerging market names have seen significantly reduced activity, as investors have been in risk-off mode as a result of slowing China growth and volatility around commodities. The issuance year to date in 2016 has been dominated by higher rated names such as highly rated Latin American and Asian issuers with all except a handful of issuers rated 'A' and above. While the risk appetite of investors in recent weeks has improved, in general all low rated sovereigns are facing a volatile and uncertain funding environment.

9. The PBG would provide Pakistan greater flexibility in weathering market volatility while achieving macro fiscal objectives. There are a number of financing alternatives that could benefit from PBG such as a Eurobond, loan or Sukuk. The choice between different financing alternatives could be determined on the basis of the market conditions at the time of the placement versus Pakistan's funding parameters such as volume, maturity, spread savings and World Bank guarantee utilized/leveraged. Recent country experience in capital markets demonstrates that countries should build sufficient time into their financing timeline to make sure they have the flexibility to choose the right time to access the market. Secondly, countries should not box themselves to a single market segment and instead develop alternatives to access multiple markets. The PBG would provide Pakistan with the flexibility to benefit from both of

these points.

10. Optimal Financing Amount. Financing amount to be raised with the support of the PBG would be determined together with the Government of Pakistan based on their financing needs for FY16/17 (see Table 1) and in line with the recently approved Medium Term Debt Strategy FY 2015/16-2018/19, with due consideration given to capital market dynamics and Pakistan's planned sovereign bond issuances. PBG will be provided to the extent necessary to mobilize commercial financing.

Table 1: Government of Pakistan Gross Financing Requirements

(in billions of PKR; unless otherwise specified)

	Actual	Projections	
	FY14/15	FY15/16	FY16/17
Financing requirements	**6,835**	**7,604**	**9,165**
Fiscal deficit (incl. grants)	1,442	1,397	1,419
Maturing short-term public sector debt (previous year stock)	4,101	4,737	5,087
Amortization of medium- and long-term public sector debt	1,292	1,470	2,660
To domestic creditors	1,067	1,175	2,227
To other official creditors (incl. IMF)	225	243	351
To Eurobonds	-	52	82
Financing sources	**6,835**	**7,604**	**9,165**
Privatization receipts	17	50	50
Short term debt disbursements	4,157	5,001	5,988
Long term debt disbursements	2,630	2,499	3,029
From other official creditors	203	492	515
From domestic creditors	2,325	1,903	2,405
From Eurobonds	102	104	109
Change in assets (decrease = +)	31	53	98

Source: Government of Pakistan

11. Positive signaling, bridging the knowledge gap. Following the conclusion of the IMF program in September 2016, the PBG would demonstrate continued international support to Pakistan. The Government's reform agenda would form one of the bases on which GoP would engage with the market for a PBG-supported financing. Evidence also suggests that PBG-supported financings are successful in bringing new investors by offering an improved risk profile and better messaging while ensuring continuity of access to international markets and maintaining market discipline.

12. Extend IBRD envelope for the program. IBRD resources are limited and a PBG would allow for greater World Bank resources to be available for other projects, bringing technical support and assistance and allowing for further interventions.

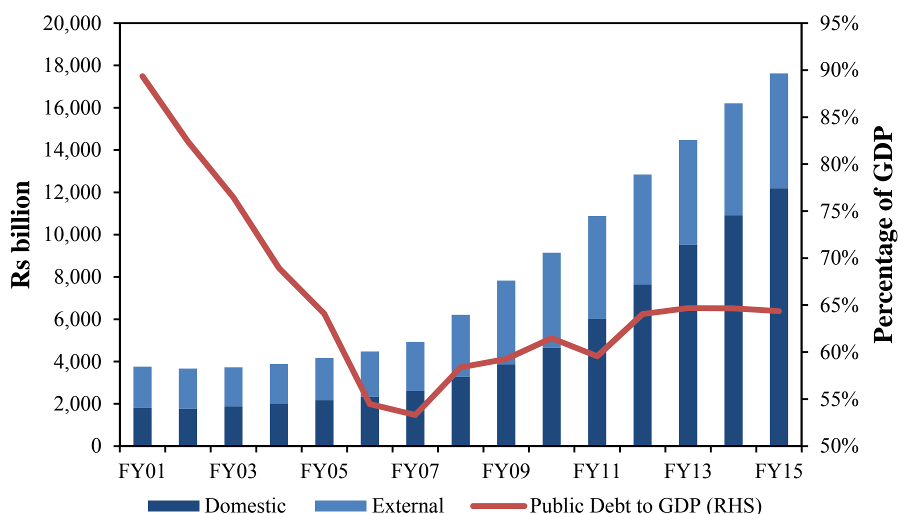
1.2. Maintain fiscal stability and create necessary fiscal space

13. Fiscal space for domestic credit. The proposed policy-based guarantee is expected to act as a catalyst by supporting government efforts to successfully access international financial markets to meet part of their gross financing needs, reduce government over-reliance on domestic debt, and at the same time

enable the creation of much-needed space for provision of domestic credit to the private sector.

14. Domestic debt continued to dominate at 69 percent of total public debt. On the other hand, foreign currency public debt stood at 19.8 percent of GDP at the end of FY14/15 compared to 21.1 percent in the previous year primarily due to translational gains realized during most of the fiscal year (Figure 2).[36]

Figure 2: Pakistan Evolution of Public Debt



Source: State Bank of Pakistan

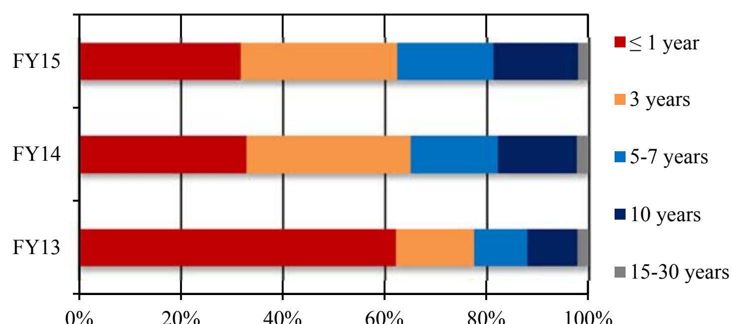
15. Pakistani banks' exposure to government securities have considerably increased. In FY14/15, 38 percent of total banking assets were in the form of government debt, up from 35 percent in the previous year. Almost 72 percent of the outstanding PIBs at the end of June 2015 were held by scheduled banks compared to 67.3 percent as of June 30, 2014. This increase in holdings reinforces the concept of maturity mismatch (long-term assets versus short-term liabilities) in the banks' balance sheets that may become a source of vulnerability in the near- to long-term.

16. The GoP has successfully started lengthening the domestic debt average maturity. While this change in composition of domestic debt is helpful in lowering rollover (and refinancing) risks, it has increased the cost of borrowing. Domestic borrowing mix remains diversified with the current portfolio holding more medium-to-long term instruments and significantly lesser short term debts (Figure 3). The interest payments on domestic debt were at 4.4 percent of GDP in FY14/15, up from 4.1 percent of GDP

[36] Note these figures are sourced from World Bank calculations. The Government of Pakistan's estimates differ slightly.

two years back when more than half of the domestic debt was of short maturity.

Figure 3: Maturity Profile of Government Securities



Note: 1/ Government securities include MTBs, PIBs and GIS.
Source: State Bank of Pakistan

17. **External debt sustainability risk is projected to remain manageable under the baseline scenario even though public debt dynamics will remain a source of fiscal vulnerability.** Various sustainability indicators have registered improvements in Pakistan's debt management over the last two fiscal years[37]. Despite the gradual decline in public debt ratios, total interest payments will continue to absorb a large share of fiscal revenues (including grants), averaging to 28 percent of total revenues. The public debt-to-revenue ratio during the projection period is projected to average around 390 percent. External debt-to-GDP is projected to decline from 24.1 percent in FY14/15 to 21.5 percent by FY18/19, owing to moderately estimated financial (debt-creating) flows, expected Eurobonds, and sustained economic growth. External debt is robust to most shocks and is expected to follow a declining path under most standardized-shock scenarios (please refer to Figure 5 in Annex 4)

18. **PBG will not impact Debt/GDP ratios as it will be supporting planned issuances in line with the recently approved Medium Term Debt Strategy FY 2015/16-2018/19.** Under baseline scenario, Pakistan's public debt-to-GDP ratios are projected to decline over the medium term. With a targeted consolidated fiscal deficit (excluding grants) of 4.1 percent of GDP by FY18/19, public debt is projected to fall from 64.4 percent of GDP in FY14/15 to below 60 percent by FY18/19[38]. Continued fiscal consolidation reflecting adjustment measures – including subsidy reduction, and tax policy and administration actions – and moderate economic growth are expected to support the decline in public debt ratios.

1.3. Transaction Structuring

19. The PBG structure is flexible. The available PBG could support commercial financing in the loan and/or bond capital markets and could be structured in a flexible way to provide principal and/or coupon coverage. The Bank's guarantee would be partial and apply on select debt service payments through a structure to be developed in coordination with the market and the Government. Possible guarantee structures could include rolling coverage of scheduled principal and coupon payments for an amortizing loan or bond or a bullet bond, or a percentage of all debt service payments throughout the life of the loan/bond or back-ended coverage where debt service payments only at the end of the loan/bond tenor

[37] For example, refinancing risk of the domestic debt portfolio was reduced through lengthening of the maturity profile at the end of June 2015. Percentage of domestic debt maturing in one year was reduced from 64 percent at the end of June 2013 to 47 percent in June 2015.

[38] These figures are sourced from World Bank calculations. The Government's estimates differ slightly - see footnote 19.

would be covered.

20. PBG would be provided by IBRD. Taking into account Pakistan's blend country status, the proposed PBG would be issued by IBRD. This would be the first IBRD PBG for Pakistan. The proposed amount is consistent with Pakistan's exposure limit.

21. Mechanics of the PBG. Pakistan as the issuer would have the primary obligation to ensure timely repayment to the investors. However, if Pakistan failed to make a guaranteed debt service payment, the holders of the financing could call on the Bank's guarantee for repayment of the amount of such payment. Following payment by the Bank under its guarantee, under its Indemnity Agreement with the GoP, the Bank would have sole discretion to decide whether to demand immediate repayment from Pakistan or to extend terms for repayment over time. The guarantee would not be reinstated for any amounts paid under the guarantee; however, any uncalled amounts of the guarantee would remain in place according to the original structure. Please refer to the draft term sheet in the Annex hereto for further detail on terms and conditions of the proposed guarantee.

22. At this stage, different financing alternatives supported by the PBG are possible. Several options could be contemplated for a PBG-backed financing for the GoP. Based on the Bank team's informal market soundings, Pakistan could utilize the guarantee in support of, for example, a public bond, Sukuk or Loan.

23. **During the preparation phase, the Bank would work with the GoP and lead arranging banks to determine which segment of the market provides the best value for the guarantee and meets the needs of the GoP.** The choice between different financing alternatives would be determined on the basis of the market conditions at the time of the placement in light of Pakistan's funding parameters such as volume, maturity, spread savings and World Bank guarantee utilized/leveraged. It is important to establish with the Government of Pakistan and the lead arranging banks (to be mandated following concept approval) which markets best serve to meet Pakistan's objectives as part of finalizing guarantee and financing terms closer to the time of issuance.

Annex 8. Indicative terms for the policy-based guarantee

This term sheet contains a preliminary general summary of indicative terms and conditions of a potential IBRD policy-based guarantee (the Guarantee) for a capital markets or loan market transaction to be entered into by Pakistan. These terms would be subject to further development based on Pakistan's choice regarding the financing structure.

This term sheet does not constitute an offer from IBRD to provide a Guarantee. The provision of the Guarantee is subject, inter alia*, to satisfactory appraisal by IBRD of the operation, further consideration, selection, review and acceptance of the underlying financing structure and transaction documentation, and the approval of Management and the Board of Executive Directors of IBRD in their sole discretion.*

Common Terms for All IBRD Guarantee Structures[39]	
[Issuer][40]**[Borrower]**[41]:	Islamic Republic of Pakistan (Pakistan)
Guarantor:	International Bank for Reconstruction and Development (IBRD)
Financing currency:	[USD]
Financing amount and structure:	Up to US$ [•] million of [•]% coupon [amortizing] [notes][42] [loan][43] (the Financing) [in tranches of different maturity][with [*insert frequency*] payments of interest].
Beneficiaries of the IBRD Guarantee	[Noteholders][44] [Commercial bank lenders, or the Agent on their behalf, each to be identified][45].
Maximum IBRD Liability:	A partial amount of the Financing, not to exceed US$[ ] million[46].
Final maturity:	Up to [30][47] years.
Guaranteed Event:	Failure by Pakistan to [make certain payments of [principal] [and interest] on][repay at scheduled maturity the principal amount of] the Financing [TBD].
Guarantee Fee:	Pakistan will pay to IBRD a Guarantee Fee of [ ][48] percent per annum on the present value of the Maximum IBRD Liability, payable upfront on a present value basis.

[39] Also see "Additional Terms and Documentation required for Proposed Structure (1): IBRD Guaranteed Bond" and "Additional Terms and Documentation required for Proposed Structure (2): IBRD Guaranteed Loan" below.
[40] If note guarantee.
[41] If loan guarantee.
[42] If note guarantee.
[43] If loan guarantee.
[44] If note guarantee.
[45] If loan guarantee.
[46] In present value terms
[47] Maturity length to be determined.
[48] FY2016 fees will apply.

Standby Fee:	25 basis points per annum. The Standby Fee is assessed on the committed but not outstanding amount of IBRD's financial exposure under the Guarantee.
Up-front Fees[49]:	Front-End fee: 25 basis points of the Maximum IBRD Liability.
[Non-]Accelerability of Guarantee:	The Guarantee [can/ cannot] be accelerated and become payable prior to the scheduled debt service payment dates [under any circumstances], including as the result of a Guaranteed Event.
Payment of Additional Amounts:	The Guarantee is limited to the [principal of][and interest on] the Financing payable on the relevant scheduled payment date and would not cover any additional amounts payable by Pakistan with respect to such Financing.
Exclusions, Limitation/Suspension and Termination Events:	Standard exclusion, limitation/suspension and termination events for transactions of this nature.
Subrogation:	If and to the extent IBRD makes any payment under the Guarantee, and IBRD has not been reimbursed in full by Pakistan under the Indemnity Agreement or as otherwise agreed with Pakistan, IBRD will be subrogated immediately to the extent of such unreimbursed payment to the Beneficiaries' rights and to exercise such rights to seek reimbursement for amounts paid by IBRD under the IBRD Guarantee.
Right to offer to Purchase:	[Upon payment default by Pakistan, IBRD will have the right to offer to purchase all rights, title and interests of the Beneficiaries in the Financing at par plus accrued and unpaid interest.][50]
Indemnity Agreement	
Parties:	IBRD and Pakistan.
Indemnity:	Pakistan will reimburse and indemnify IBRD on demand, or as IBRD may otherwise direct, for all payments under the Guarantee and all losses, damages, costs, and expenses incurred by IBRD relating to or arising from the Guarantee.
Covenants:	Standard covenants for agreements of this nature.
Remedies:	If Pakistan breaches any of its obligations under the Indemnity Agreement, IBRD may suspend or cancel, in whole or in part, the rights of Pakistan to make withdrawals

[49] External counsel and auditor fees will be reimbursed by the Issuer

[50] Required if IBRD guarantees interest.

	under any other loan or credit agreement with IBRD, or any IBRD loan to a third party guaranteed by Pakistan, and may declare the outstanding principal and interest of any such loan or credit to be due and payable immediately. A breach by Pakistan under the Indemnity Agreement will not, however, discharge any guarantee obligations of the World Bank under the IBRD Guarantee.
Governing Law:	The Indemnity Agreement will follow the usual legal regime and include dispute settlement provisions customary for agreements between member countries and IBRD.

Additional Terms and Documentation required for Proposed Structure (1): IBRD Guaranteed Note	
Fiscal Agent:	To be identified (the Fiscal Agent).
Lead Managers:	Commercial and/or investment banks to be identified (the Lead Managers).
Distribution:	[To be determined]
Listing:	[To be determined]
Form and Settlement:	[To be determined]
Selling Restrictions:	[To be determined]
Roadshows	Representatives of IBRD, including its legal counsel, would attend all roadshows or investor presentations relating to the Financing.
Conditions Precedent:	Usual and customary conditions for financing of this type including but not limited to the following: a) Provision of relevant legal opinions satisfactory to IBRD (including a legal opinion from the appropriate official of Pakistan relating to the Indemnity Agreement); b) Payment in full of the Guarantee Fee, the Front-End Fee, the relevant installment of the Standby Fee, and expenses and costs of IBRD external counsel and other related expenses; c) Conclusion of an Indemnity Agreement between IBRD and Pakistan, the Fiscal Agency Agreement among the Fiscal Agent, Pakistan and IBRD (expected to include the Guarantee), a Purchase Agreement among the Lead Managers and Pakistan, a Warranty Agreement among the Lead Managers and IBRD, and any other applicable documentation, including preparation of an Offering Memorandum whose presentation of the Guarantee is acceptable to IBRD; and

	d) Satisfaction of any other conditions precedent under the financing documents.
IBRD-Guaranteed Fiscal Agency Agreement	
Description:	Agreement among Pakistan as Issuer, Fiscal Agent and IBRD as Guarantor setting out terms and conditions of the Financing, mechanism for payment on the Financing, and containing the terms and conditions of the notes and the Guarantee.
Guarantee Support:	IBRD would guarantee the payment of [principal [and interest] amounts due on [scheduled payment dates][scheduled maturity]] up to the Maximum IBRD Liability [and the associated interest], which the Fiscal Agent would have otherwise received from the Issuer for the benefit of the noteholders under the guaranteed financing documents, but for the occurrence of a Guaranteed Event, following confirmation from the Fiscal Agent of the Issuer's failure to make such payment. [The Fiscal Agent may make a demand on IBRD for payment under the Guarantee if, [ ] Business Days prior to the scheduled payment date of a guaranteed payment on the Financing, the Issuer has not transferred amounts sufficient to make such payment to the appropriate account of the Fiscal Agent. After receiving a duly completed Demand Notice, IBRD will make payment to the Fiscal Agent on behalf of the noteholders on or before the relevant due date for making the scheduled payment on the Notes.] The Guarantee [can/ cannot] be accelerated.
Choice of law:	[New York or England]
Status of the Guarantee:	The obligations of IBRD under the Guarantee will constitute direct, unsecured obligations of IBRD and will rank *pari passu* with all other unsecured obligations of IBRD from time to time outstanding, provided that IBRD shall have no obligation to effect equal or rateable payment(s) at any time with respect to any such other unsecured obligations and shall have no obligation to pay other unsecured obligations at the same time or as a condition of paying sums due under the Guarantee and *vice versa*..
Warranty Agreement	
Description:	IBRD would enter into a Warranty Agreement with the Lead Managers in order to make and receive certain representations and warranties about the information each set of parties provides to the other in that type of transaction, as well as to receive certain representations,

	warranties, and undertakings from the Lead Managers [, including but not limited to a representation and warranty that the Lead Managers have not engaged in any Sanctionable Practice in connection with the transaction].
Offering Document	
Description:	Document describing the offering of the Financing and providing market-standard information for investors regarding the Financing, Pakistan, IBRD and the Guarantee.
Purchase Agreement	
Description:	Pakistan would enter into a Purchase Agreement with the Lead Managers relating to the offer, initial purchase and distribution of the Notes.
[Deed of Guarantee][51]	
Description:	IBRD may enter into a Deed of Guarantee setting out the terms of the Guarantee for the benefit of the Noteholders.

Additional Terms and Documentation required for Proposed Structure (2): IBRD Guaranteed Loan	
IBRD-Guaranteed Loan Agreement	
Description:	Agreement among Pakistan as Borrower, the Agent [on behalf of][and the] Lenders and IBRD as Guarantor setting out terms and conditions of the Financing, mechanism for payment on the Financing[, and containing the Guarantee][52].
Guarantee Support:	IBRD would guarantee the payment of [principal [and interest] amounts due on [scheduled payment dates][scheduled maturity]] up to the Maximum IBRD Liability [and the associated interest], which Agent on behalf of the Beneficiaries would otherwise have received from the Borrower but for the occurrence of a Guaranteed Event, following confirmation from the Agent of the Borrower's failure to make such payment. The Guarantee [can/ cannot] be accelerated.
Choice of law:	[New York or England]

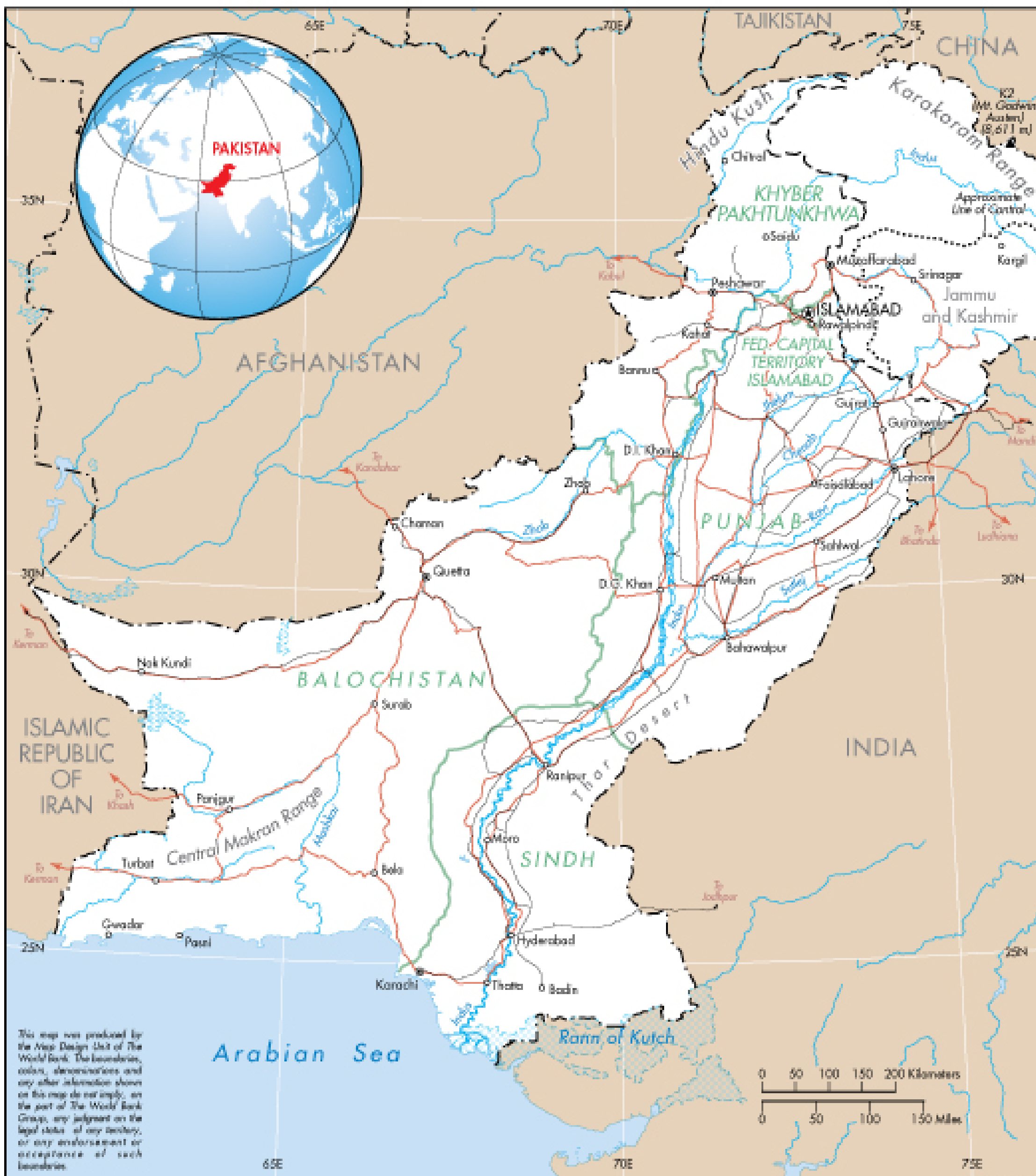
[51] Likely required if issuance takes place under English law. Other types of documentation and disclosure may be required if issuance takes place under U.S. law.
[52] The Guarantee could be contained in the IBRD Guaranteed Loan Agreement or separately in an IBRD Guarantee Agreement between IBRD and the Agent on behalf of the Lenders.

Conditions Precedent to IBRD Guarantee:	Usual and customary conditions for financing of this type including but not limited to the following: a) Provision of relevant legal opinions satisfactory to IBRD (including a legal opinion from the appropriate official of Pakistan relating to the Indemnity Agreement); b) Payment [in full] of the Guarantee Fee, the Front-End Fee and the relevant installment of the Standby Fee; c) Conclusion of an Indemnity Agreement between IBRD and Pakistan, and any other applicable documentation, acceptable to IBRD; and d) Satisfaction of any other conditions precedent under the financing documents.

IBRD 33460R

PAKISTAN

- SELECTED CITIES AND TOWNS
- PROVINCE CAPITALS
- NATIONAL CAPITAL
- RIVERS
- MAIN ROADS
- RAILROADS
- PROVINCE BOUNDARIES
- INTERNATIONAL BOUNDARIES



NOVEMBER 2010