ADB

Report and Recommendation of the President to the Board of Directors

Project Number: 42163
September 2008

Proposed Program Cluster and Loans for Subprogram 1
Islamic Republic of Pakistan: Accelerating Economic Transformation Program

Asian Development Bank

CURRENCY EQUIVALENTS
(as of 1 July 2008)

Currency Unit	–	Pakistan rupee/s (PRs)
PRe1.00	=	$0.015
$1.00	=	PRs68.40

ABBREVIATIONS

ADB	–	Asian Development Bank
ADF	–	Asian Development Fund
AETP	–	Accelerating Economic Transformation Program
AML	–	anti-money laundering
ASPL	–	Agriculture Sector Program Loan
CFT	–	combating the financing of terrorism
CPPA	–	Central Power Purchasing Agency
DISCO	–	power distribution company
ECC	–	Economic Coordination Committee
FATF	–	Financial Action Task Force on Money Laundering
FMU	–	Financial Monitoring Unit
FY	–	fiscal year
GDP	–	gross domestic product
IMF	–	International Monetary Fund
LIBOR	–	London interbank offered rate
MOF	–	Ministry of Finance
NBFC	–	nonbank finance company
NTC	–	National Trade Corridor
NTDC	–	National Transmission and Dispatch Company Limited
OCR	–	ordinary capital resources
PASSCO	–	Pakistan Agricultural Storage and Supplies Corporation
PSDP	–	Public Sector Development Program
RTGS	–	real-time gross settlement
SBP	–	State Bank of Pakistan
SECP	–	Securities and Exchange Commission of Pakistan
TA	–	technical assistance

NOTES

(i) The fiscal year (FY) of the Government ends on 30 June. FY before a calendar year denotes the year in which the fiscal year ends, e.g., FY2007 ends on 30 June 2007.

(ii) In this report, "$" refers to US dollars.

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Legend:
CWAE: Central and West Asia Agriculture, Environment and Natural Resources Division
CWGF: Central and West Asia Governance and Finance Division
CWID: Central and West Asia Infrastructure Division
CWOC: Central and West Asia Country Coordination and Regional Cooperation Division
PRM: Pakistan Resident Mission

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LOAN AND PROGRAM SUMMARY

Borrower	Islamic Republic of Pakistan
Proposal	The proposal comprises (i) a program cluster for the Accelerating Economic Transformation Program (AETP) with four subprograms totaling \$1.8 billion to \$2 billion, (ii) two loans totaling \$500 million equivalent for subprogram 1 of the AETP, and (iii) a technical assistance (TA) grant of \$800,000. The proceeds of subprogram 1 will be used by the Government mainly to cushion the impact of food and fuel inflation through the provision of targeted safety nets for the affected segments of the population. Of the \$500 million for subprogram 1, \$200 million will be from Asian Development Fund (ADF) resources.
Classification	Targeting classification: General intervention Sector: Law, economic management, and public policy Subsector: Economic management Themes: Sustainable economic growth, governance, inclusive social development Subthemes: Promoting macroeconomic stability, financial and economic governance, other vulnerable groups
Environment Assessment	Category C. No adverse environmental impact was identified.
Program Rationale	Pakistan's economy has been seriously affected by the skyrocketing international prices of oil and food. The severity of the exogenous shocks, aggravated by the uncertainties surrounding the recent political transition, has been felt on several fronts over the last fiscal year (June 2007-July 2008): the year-on-year overall domestic inflation reaching 24% from 7%; deterioration in the external accounts with current account deficit widening to 8.5% of GDP from 4.8%; depreciation of the Pakistani rupee (PRs) by 22%; foreign exchange reserves declining by more than 40% to \$6 billion (about 1.5 months of imports); and unprecedented fuel, food and electricity subsidy needs, which rose four-fold to PRs408 billion (\$6 billion) from their original budgeted level. Symptomatic of the declining investor confidence, the Karachi stock index dropped by more than 35% during April-July 2008, and the spreads on sovereign debt have surpassed 1,100 basis points at end-August 2008 from less than 200 basis points in early 2007. The outcome of all this has been a decline in real gross domestic product (GDP) growth to 5.8% from 7% during the previous year. These challenges facing Pakistan have come despite steady real GDP growth of 7.3% on average per year during FY2004-FY2007. But they have also come in the context of, as well as due to, persistent fiscal, trade and investment imbalances and lack of any significant structural changes in the economy.

Pakistan now needs to transform itself in three directions:

First, it has to address the immediate distortions facing the economy, particularly in the agriculture and energy sectors. The pricing and procurement system for wheat needs to be restructured, and subsidies better targeted to benefit the poor and vulnerable. Untargeted wheat subsidies cost the Government PRs40 billion ($600 million) in fiscal year (FY) 2008. In the electricity sector, Pakistan doest not yet have an automatic tariff adjustment mechanism. The Government needs to reform the subsidy system in the sector, since it has not been able to settle the payments owed to distribution companies, which has resulted in a vicious circular debt problem and debt overhang. This needs to be addressed urgently to resolve the present energy crisis. Electricity subsidies are estimated to have cost PRs133 billion in FY2008 ($2 billion). In addition to these subsidy needs, an estimated $1.6 billion is required to partially protect the poor.

Second, Pakistan needs to strengthen financial intermediation to facilitate structural transformation. At the macro level, the Government has relied heavily on the central bank for its fiscal requirements, a practice that needs to be reversed. In parallel, the legal and regulatory framework should be strengthened to manage risks more effectively in the financial sector, promote consumer confidence, and deepen financial intermediation.

Third, over the medium to long term, the production and trade structure of the economy needs to be transformed so Pakistan can compete more effectively in the global economy. A deeper industrial base is vital, along with a more productive agricultural sector, greater value creation in the service sector, and far greater export sophistication. To achieve this, the Government has to (i) address short-term policy and institutional distortions, (ii) identify industries where it might compete on a global scale, and (iii) attract private sector investments.

ADB has worked in the past with Pakistan alongside other development partners to support reforms and investments in all three directions. The challenges now facing the country are diverse and significant that immediate assistance is needed to address the short term constraints and to provide safety nets for the poor, while paving way for boosting Pakistan's competitiveness.

Government's Policy Response and Strategy

Immediate priorities: To address the present macroeconomic challenges, the Government has adopted a four point stabilization plan, working in tandem with the State Bank of Pakistan (SBP). It has also sought technical advice from development partners, including the International Monetary Fund (IMF), the World Bank and ADB in developing the plan, which focuses on: (i) ensuring price stability and effective demand management through interest rate adjustments; (ii) pass-through of subsidies while protecting the poor from economic shocks; (iii) shoring up foreign exchange reserves; and (iv) restoring fiscal discipline and reducing borrowing from SBP.

Medium-term agenda: As it deals with the short-term challenges during the current fiscal year (by June 2009), the Government also plans to launch medium-term structural reforms in two key directions. Increasing infrastructure investments in power and transport is a key part of its strategy, besides adopting measures to deepen Pakistan's industrial base and making its agriculture sector more productive. The Government plans to achieve this by rationalizing its own involvement in key economic sectors, and by attracting greater private sector participation. The fiscal space generated will help ensure adequate social safety nets as well as adequate spending on health, education and other priorities. In parallel, Pakistan also has adopted a framework for a medium-term financial sector strategy to strengthen financial intermediation and promote confidence.

Impact and Outcome

The AETP will help Pakistan achieve and sustain higher economic growth in the medium term. The expected outcome of the AETP is structural economic transformation through (i) removal of short-term distortions in the agriculture and energy sectors; (ii) strengthening of financial intermediation; and (iii) development and implementation of a national structural transformation strategy.

Special Features

The AETP will help Pakistan address the challenges posed by the ongoing food and energy crisis in a systematic manner. Subprogram 1 is also one of ADB's responses to the food crisis in the region, a response that was first announced by the President at the ADB Annual Meeting in May 2008 and recently set forth in the paper *ADB's Response to the Food Crisis.*

Coordination with Development Partners

ADB has worked with other development partners on the short-term as well as the medium-term issues. On macroeconomic stabilization measures, ADB has relied on advice from the IMF and the World Bank and exchanged views with other bilateral partners. Part of the short and medium-term agenda, as it relates to agriculture, infrastructure and finance sector issues, is well grounded in ongoing investment and policy support by ADB and other partners. Regular dialogue has taken place, including in finalizing the AETP actions, with the concerned partners. The structural transformation agenda is new and being developed. Several institutions support investment climate and competitiveness reforms, with some specializing in selected sectors. Once the principal studies under the AETP are completed by early 2009, ADB will coordinate closely with all stakeholders in helping the Government chalk out the future reform directions.

Period and Tranching

The AETP will be structured as a program cluster with four single-tranche subprograms to be implemented approximately between June 2007 and July 2011, comprising

(i) subprogram 1 (covering reforms from June 2007 to September 2008) - addressing the food and energy crisis, supporting short-term investment climate measures, and paving the way for medium-term structural transformation;

(ii) subprogram 2 (October 2008 to June 2009) - further reforms for structural transformation;
(iii) subprogram 3 (July 2009 to June 2010) - expanding reforms to enhance private sector participation in key sectors; and
(iv) subprogram 4 (July 2010 to June 2011) - completion of the initial phase of structural transformation.

Financing Plan

The proposed loans for subprogram 1 are as follows:

(i) A loan of $300 million from ADB's ordinary capital resources will be provided under the London interbank offered rate (LIBOR)-based lending facility. The loan will have a 15-year term, including a grace period of 3 years; an interest rate to be determined in accordance with ADB's LIBOR-based lending facility; a commitment charge of 0.15% per annum; and such other terms and conditions set forth in the draft loan agreement.
(ii) A loan of $200 million equivalent from ADB's Special Funds resources will be provided, with an interest rate of 1% per annum during the grace period and 1.5% per annum thereafter; a term of 24 years, including a grace period of 8 years; and such other terms and conditions as set forth in the draft loan agreement.

The subprogram 1 loans totaling $500 million equivalent will be available following satisfaction of subprogram 1 policy actions and after loan effectiveness.

To retain the reform momentum and predictability of financing, the Government has requested that subprogram 2 of the AETP be processed during September 2008–June 2009, for possible approval before the end of June 2009 in the amount of $500 million. Subject to reform progress and financing requirements, subprograms 3 and 4 could each be in the range of $400 million to $500 million, with the entire program cluster's aggregate amount in the range of $1.8 billion to $2 billion. The scope and amounts for each subprogram will be finalized during the review and processing of the respective subprograms.

Counterpart Funds

The Government shall ensure that the local currency generated from the proceeds of the OCR loan shall be used first, to support the adjustment costs of reforms to be initiated and implemented under subprogram 1, and second, to finance expenditures for the Government's general development purposes. The Government shall ensure that the local currency generated from the proceeds of the ADF loan shall be used to support the poor and vulnerable households under the two targeted social safety net programs set forth in output 1 of subprogram 1.

Executing Agency

The Ministry of Finance (MOF) will be the Executing Agency for the AETP.

Implementation Arrangements

MOF will coordinate with the concerned ministries on the AETP content, and will help ensure that the reform agenda stays on course. The State Bank of Pakistan (SBP) will handle the implementation of actions under subprogram 1 and future subprograms relating to the financial sector, in coordination with MOF. The Government will ensure that other regulatory agencies or ministries are consulted as required. ADB will closely monitor program implementation to ensure that envisaged outputs and outcomes are achieved.

Procurement and Disbursement

Loan proceeds will be used to pay for items procured in ADB member countries, other than the items specified in the negative list of ineligible items and imports financed by other bilateral and multilateral sources. The proceeds of the program loan will be disbursed in accordance with the provisions of ADB's simplification of disbursement procedures and related requirements for program loans. Loan proceeds disbursed against imports will require a certificate from the Government stipulating that the value of the total imports of Pakistan, minus its imports from nonmember countries, ineligible imports, and imports financed under other official development assistance, is equal to or greater than the amount of the loan expected to be disbursed during a particular year. ADB reserves the right to audit the use of loan proceeds to verify the accuracy of the Government's certification.

Program Benefits and Beneficiaries

The AETP will not only help stabilize the macroeconomic situation but also benefit target groups affected by fuel and food inflation. It will help:

(i) Meet the large and immediate fiscal needs.
(ii) The Government transition from the current system of inefficient and untargeted subsidies toward a targeted safety net program for the poor. Beginning with about 2 million households immediately, and expanding to cover 5 million households during the 2008-2009 fiscal year if the safety net program implementation is smooth, the AETP could potentially target up to 9 million households.
(iii) It will raise public confidence in the banking system through a depositor protection scheme, and stronger financial intermediaries that are better able to mobilize and allocate resources and risks.
(iv) It will open the way for structural transformation.
(v) It will cut transaction costs for businesses by reducing red tape and improving the investment climate.
(vi) Overall, the AETP framework will enable ADB to sustain policy dialogue on structural reform in sectors where ADB has been actively involved through past and current investments.

Risks and Assumptions

While some of the risks of the AETP are political and outside its scope, its design will mitigate a range of others, including the following:

(i) **Interest group resistance.** This is likely, as those affected by reforms in the short-term may resist. The Government is adopting a good communication strategy to articulate the long-term and country stability interests that are behind the reforms. Further, the

program cluster nature of the AETP ensures prior actions by the Government before financing is provided.

(ii) **Weak capacity.** This is a generic concern, which is elevated in case of complex reforms. Adequate design and implementation support is being mobilized under AETP through technical assistance. The agenda under the AETP is also largely home-grown.

(iii) **Global food and fuel crisis.** The measures under AETP are predicated on there being a global recovery. Although global price trends will be a major determinant, AETP measures will rationalize subsidies and target them better to cushion Pakistan against some exogenous shocks.

(iv) **Lack of policy coordination**. The AETP will demonstrate the clear benefits of product diversification, industrialization, processing and value creation and will therefore help build consensus. ADB's current analytical and design work on transformation is supported by well-known institutions, which will bring credibility to the reforms and help build momentum.

At the same time, the risks associated with *not* supporting Pakistan's safety net programs and the longer-term economic transformation agenda are also high. In the absence of timely reforms, the Government's budget will continually be burdened by costly and inefficient subsidies, leaving fewer resources for development financing. The financial sector will be vulnerable to systemic risks and investors will be vulnerable to market fraud and misconduct. Without meaningful structural transformation, growth may once again be stalled and macroeconomic stability disrupted, bringing the country back to the previous cyclical pattern. High and persistent macroeconomic imbalances will constrain investments and economic growth, and aggravate poverty.

The underlying assumptions for the AETP include

(i) strong and sustained leadership and commitment to reforms,

(ii) development partner coordination, and

(iii) open dialogue with the private sector and other key stakeholders.

Technical Assistance

AETP embeds a TA to help implement the AETP and to design the reform agenda for subprograms 2–4. It will also help monitor subprogram 1 implementation and provide the Government with timely policy advice as requested. In particular, the TA will support implementation of a national structural transformation agenda, and advisory work on the financial sector. It is estimated to cost $1,040,000. ADB will provide $800,000 on a grant basis from ADB's TA funding program and the Government will contribute $240,000 equivalent. In parallel, resources from an existing TA (Support for Governance Reform) financed by the Department for International Development of the United Kingdom will be used to support the effective management of budget resources in the AETP context. In addition, an ongoing subproject under the same TA will support Pakistan's anti-money laundering efforts.

I. THE PROPOSAL

1. I submit for your approval the following report and recommendation on (i) a proposed program cluster to the Islamic Republic of Pakistan for the Accelerating Economic Transformation Program[1] (AETP) comprising four subprograms; and (ii) two proposed loans for the first subprogram of AETP (subprogram 1). The report also describes proposed technical assistance (TA) to support the AETP and, if the Board approves the proposed program cluster and loans, I, acting under the authority delegated to me by the Board, will approve the TA.

II. THE MACROECONOMIC CONTEXT

A. Current Challenges Facing Pakistan

2. **Recent Past**: Pakistan's economy increased its resilience over a five year period preceding mid-2007, despite gradually rising oil prices and the devastating earthquake in October 2005. Real gross domestic product (GDP) growth accelerated from 3.1% during fiscal year (FY) 2002 (July 2001-June 2002) to 9% in FY2005, before leveling off at 6.8% in FY2007. Economic growth had just begun to be driven more by investment than by consumption.

3. **Current Challenges**: In contrast to the picture over the last few years, the macroeconomic situation sharply deteriorated during FY2008 and July-August 2008, due largely to exogenous oil and food price shocks, the tumultuous political transition and security concerns. Aggravated by long-standing structural inefficiencies in the agriculture, industry and energy sectors, the economy slowed down to 5.8% in FY2008. Overall inflation went above 24% year-on-year in July 2008, from just above 7% a year earlier. Fiscal and current account deficits shot up. The Pakistani rupee (PRs) depreciated by 22% since July 2007, with almost half of that decline taking place in July-August 2008. State Bank of Pakistan's (SBP) gross international reserves declined from $14.3 billion at the beginning of FY2008 to $8.6 billion at end-June 2008, and further to $6 billion or 1.5 months of imports. The political events and economic uncertainties, compounded by the value erosion in international financial markets, led to a steep decline in investor sentiments. The Karachi stock index, a top performer in the region, dropped by more than 35% during April-July 2008. Standard and Poor's downgraded Pakistan's debt rating from B+ to B in May 2008 followed by Moody's. In parallel, the sovereign spreads on Pakistani bonds rose from about 400 basis points in July 2007 to over 1,100 basis points at end-August 2008.

4. **Macroeconomic Imbalances**: Leading to the adverse outturns, Pakistan has built up significant macroeconomic imbalances, with a rise in fiscal and current account deficits, and an expanding savings–investment gap. The fiscal deficit rose to 7.4% of GDP in FY2008 from 4.3% in FY2007, due to lower revenue growth and rising expenditures brought about by unprecedented food and fuel price hikes and by the concomitant increase in subsidies. The current account deficit in FY2008 increased to 8.4% of GDP compared with 4.8% of GDP in FY2007, due to worsening conditions in all three accounts—trade, services, and income. The import bill increased considerably because of rising international commodity prices and overshadowed the 15.9% increase growth in exports in the fiscal year. Textile exports (accounting for almost 60% of Pakistan's exports) recorded a very low growth of 3.8% in FY2008. Pakistan also faced a large current account deficit in FY2007 that was financed by large capital inflows. In FY2008, however, portfolio investment declined by 98.9% while foreign direct investment growth stagnated, largely as a result of political events. The growth in

[1] The design and monitoring framework is in Appendix 1.

remittances, while strong at 17.4% (reaching over $11 billion) has not been sufficient to offset the decline in other components of the capital account.

5. **Fiscal Constraints**: In the short term, the large fiscal imbalances lie at the heart of Pakistan's unstable macroeconomic situation. The current deficit level breaches the 4% ceiling mandated under the Fiscal Responsibility Act, 2005. The Government may have no option but to continue to run a revenue deficit, even if it is committed under that act to eliminate the deficit by FY2008. The fiscal situation, if not addressed, will have a profound and costly impact on overall macroeconomic stability and growth prospects. There are four key facets. First, commodity price hikes pushed up the subsidies for oil, electricity, wheat, and fertilizer. For FY2008, actual subsidies amounted to PRs407.5 billion ($6.0 billion), almost four times higher than the original budgeted amount of PRs114 billion ($1.7 billion). Second, interest payments, particularly on domestic debt, has been growing and will almost double over FY2009–FY2011 to PRs430 billion ($6.3 billion) over the level in FY2005 (PRs230 billion). Third, revenue growth has not accelerated. Pakistan's revenue to GDP ratio continues to be amongst the lowest in the region, at around 10% of GDP. Fourth, development expenditures, which more than doubled since FY2003 to 5% of GDP in FY2007, need to be maintained at a fiscally sustainable level. Election-related promises pushed up budgeted spending to PRs520 billion in FY2008, although the actual spending amounted only to PRs423 billion due to low absorptive capacity. In recent months, the new Government has allowed a steady (but insufficient) rise in domestic oil prices, adjusted the electricity tariff, cut down the Public Sector Development Program (PSDP), and frozen supplementary grants to departments. However, these measures have not been sufficient to contain the situation, and the fiscal deficit needs to be financed. Appendix 2 presents a summary of the current fiscal challenges facing Pakistan.[2] Table 1 presents some key macroeconomic indicators, and Table 2 presents the medium-term fiscal framework indicators.

Table 1: Key Macroeconomic Indicators

Indicator	2000	2004	2005	2006	2007	2008[a]
Real GDP growth (%)	3.9	7.5	9.0	5.8	6.8	5.8
Inflation (%; average of period)	3.6	4.6	9.3	7.9	7.8	12.0
M2 growth (% annual growth)	9.4	19.6	19.3	14.9	19.3	15.3
External debt (% of GDP)	43.6	34.1	31.1	28.2	27.1	26.6
External debt service ratio (% of exports of goods and services)	31.5	32.5	14.9	13.8	12.9	11.8
Total debt (% of GDP)	85.2	69.4	64.3	58.8	56.7	—
Overall fiscal balance (% of GDP)	(5.1)	(2.4)	(3.3)	(4.3)	(4.3)	(6.5)
Current account balance (% of GDP)	(1.5)	1.3	(1.6)	(3.9)	(4.8)	(8.4)
Exchange rate (PRs per $)	51.8	57.6	59.4	59.9	60.6	62.6
Gross official reserves with State Bank of Pakistan ($ million)	991	10,554	9,791	10,760	13,345	8,577
in months of imports	1.2	9.3	6.3	5.2	5.9	2.9

GDP = gross domestic product; M2 = broad money; PRs = Pakistan rupees.
[a] Provisional.
Sources: Economic Affair's Wing, Finance Division, Government of Pakistan. 2008. *Pakistan Economic Survey 2007-08.* Islamabad; Federal Bureau of Statistics. 2007. *Pakistan Statistical Yearbook 2007.* Islamabad.

[2] Supplementary Appendix A presents an analysis of Pakistan's current macroeconomic situation and prospects.

Table 2: Consolidated Fiscal Framework (% of GDP)

Indicator	2000	2004	2005	2006	2007	2008 [a]
Total Revenue	**13.4**	**14.3**	**13.8**	**14.2**	**14.9**	**14.3**
Tax Revenue	10.6	11.0	10.1	10.6	10.2	10.0
Nontax Revenue	2.8	3.3	3.7	3.6	4.7	4.3
Total Expenditure	**18.5**	**16.7**	**17.2**	**18.5**	**19.2**	**21.7**
Current Expenditure	16.4	13.5	13.3	13.6	15.8	17.7
Of which: Subsidies	0.6	1.2	1.0	1.3	1.2	—
Of which: Interest Payments	6.9	4.0	3.4	3.4	4.2	4.7
Development Expenditure and Net Lending	2.5	2.9	3.5	4.8	5.0	4.0
Primary Fiscal Balance	**1.8**	**1.8**	**0.5**	**0.5**	**(0.1)**	—
Overall Fiscal Balance	**(5.1)**	**(2.4)**	**(3.3)**	**(4.3)**	**(4.3)**	**(7.4)**
Financing Fiscal Deficit	—	**2.4**	**3.3**	**4.3**	**4.3**	**7.4**
External Financing	—	(0.1)	1.9	2.0	2.3	1.4
Internal Financing	—	2.2	1.0	1.0	1.8	6.0
Bank	—	1.1	0.9	0.9	1.2	4.9
Nonbank	—	1.1	0.1	0.1	0.7	1.1
Privatization Proceeds	—	0.3	0.4	1.3	0.2	0.0

[a] Provisional.

GDP = gross domestic product

Sources: Economic Affair's Wing, Finance Division, Government of Pakistan. 2007. *Pakistan Economic Survey 2006-07.* Islamabad; Economic Affair's Wing, Finance Division, Government of Pakistan. 2008. *Pakistan Economic Survey 2007-08.* Islamabad; State Bank of Pakistan. *Annual Report 2006/07*. Karachi.

6. **Poverty and the Impact of Food and Energy Inflation.** Pakistan's poverty profile has seen many swings over the last 2 decades. Poverty incidence was 25.5% in the early 1990s, before rising to 34.5% in FY2001, and declining to 23.9% in FY2005 and 22.3% in FY2006, according to government estimates.[3] Other studies have estimated it at 29.3%–36.4% (44 million–45 million people).[4] Meanwhile, the latest Government estimates point to a further reduction in the poverty rate to 22.3% in 2005/06. Household expenditure surveys indicate that the share of food in total expenditures is inversely related to income levels, which means that a sharp rise in food price can have a devastating effect on the poor. Food expenditures make up an average of about 60% of household expenditures of the poor in Pakistan. Food prices increased by more than 20% in the first quarter of 2008, and by 32% year-on-year as of June 2008. ADB's analysis[5] shows that a 10% increase in food prices could drive an additional 7 million into poverty in Pakistan; a 20% increase, 14.7 million; and a 30% increase, 22 million.[6] After food, the second major household expenditure is energy, the price of which increased by about 30% in the first quarter of 2008. The rise in poverty incidence from such an increase in energy prices is estimated to be much smaller at about 1.5 percentage points. ADB's analysis also shows that, if every poor person were to be compensated to offset the loss in real

[3] Based on a Government-set threshold of 2,350 calories per adult equivalent per day, which is the official poverty line.

[4] World Bank. 2007. *Pakistan: Promoting Rural Growth and Poverty Reduction*. Washington DC (Report: 39303-PAK, Sustainable and Development Unit, South Asia Region); Anwar, T. 2006. Trends in Absolute Poverty and Governance in Pakistan: 1998-99 and 2004-05. *Pakistan Development Review* 45 (Winter, Part II, PP.777-793). These studies show an incidence ratio of 29.2% and 29.3%, respectively, using different inflation factors (survey based on inflation to reflect inflation in the rural areas that are home to the bulk of the poor) to determine poverty lines. A recent assessment shows that the application of the Government's monetized poverty line of PRs878.6 per person results in a larger incidence ratio of 36.4%. Under this method, rural poverty incidence is 45.7% and urban poverty is 22.1%. Chaudhry, A.A., and T.T. Chaudhry. 2008. *The Effects of Rising Food and Fuel Costs on Poverty in Pakistan*. Lahore School of Economics.

[5] ADB. 2008. *Food Prices and Inflation in Developing Asia: Is Poverty Reduction Coming to an End?* Manila (May, Special Report). Chaudhry, A.A., and T.T. Chaudhry (footnote 4).

[6] In terms of incidence, a 20% increase in food prices can take poverty incidence to as high as 37%–44%, or a full 8 percentage points above the current estimated incidence levels. A 20% increase in food prices can increase rural poverty by as much as 8–9 percentage points and urban poverty by 5 percentage points.

expenditure caused by food and energy price increases, the Government may incur an annual cost of between PRs18.5 billion (0.3% of GDP) and PRs83 billion (1.3% of GDP).[7]

B. The Government's Policy Response to the Challenges

7. The Government has adopted a four point plan to deal with the macroeconomic and social impact of the exogenous shocks, as laid out in Box 1.

Box 1: Pakistan's Policy Response to the Current Macroeconomic Challenges

The Government of Pakistan and the State Bank of Pakistan (SBP) have worked in tandem over the last few months to adopt and implement a four-point plan focused on:

- ✓ **Dealing with inflation**: SBP has raised its discount rate by 350 basis points over the last fiscal year; cash reserve and statutory liquidity requirements were increased by 100 basis points in May 2008. Besides strengthening demand management, this measure will also bring commercial banks into the Government debt market. In parallel, the Government has been coordinating with provincial counterparts to reduce administrative barriers on mobility of goods.
- ✓ **Passing-through the subsidies, while protecting the poor from economic shocks**: The Government has reiterated its commitment to achieving the 4.7% fiscal deficit target. Domestic fuel prices are being adjusted on a fortnightly basis, with domestic prices of gasoline and high octane fuel at 1.7 times that of import prices. Subsidies on kerosene and light diesel oil are being brought down. The Government plans to increase power tariffs by 62% in the coming months, with the first increase of 31% to be made effective from early September 2008. In parallel, the Government has allocated PRs41 billion ($600 million) in the budget for fiscal year 2009 for social safety nets, which will provide support for up to 5 million households from the adverse economic shocks. The Government plans to expand the safety net cover over the next three years.
- ✓ **Shoring up foreign exchange reserves**: The Government and SBP have taken three main steps. First, they are negotiating a deferred oil payment facility with friendly oil exporting countries, which could result in deferring about $5 billion per year. Second, an aggressive privatization program will be pursued. Third, they have imposed a range of administrative measures to conserve foreign exchange have been introduced, including a 50% limit on advance payment for imports, a margin requirement of 35% for opening letters of credit for non-essential imports, and a stipulation requiring prior SBP consent for outward remittances of more than $50,000.
- ✓ **Restoring fiscal discipline and reducing borrowing from SBP**: The Government aims to address the level of recurrent and development spending. It has also set a target of keeping the net borrowing from SBP to zero on a quarterly basis. The Government is also launching short-term debt instruments to reduce the reliance on SBP borrowing.

8. **Federal Budget 2008/09:** The federal budget for 2008/09 aims to reach the lower fiscal deficit of 4.7% of GDP through fiscal consolidation involving rationalization of public expenditure and achieving strong growth in revenues. On the expenditure side, the total allocation for subsidies including those for power, oil, food, and fertilizer, at PRs295 billion is 28% less than the actual subsidy level in FY2008. To curtail inefficient and untargeted recurrent spending, the Government announced in the budget to eliminate oil subsidies by December 2008 and the differential power subsidy by the end of the fiscal year or earlier. In addition, a freeze on non-salary spending was imposed in government departments to curtail current expenditure. However, the PSDP for 2008/09 at PRs550 billion was proposed to be 22% higher than the revised PSDP for 2007/08. But this too has been reportedly cut by more than PRs100 billion in

[7] Supplementary Appendix B contains an analysis of poverty in Pakistan.

August 2008. On the revenue side, the tax revenue of PRs1.3 trillion for 2008/09 is 24% higher than the actual tax receipts last year. Two major revenue mobilization measures included in the budget included increasing the maximum rate of import duty to 35% and sales tax increased from 15% to 16%. With a view to cut down imports as the trade and current account deficits continued to climb and foreign exchange reserves precipitously fell in July and August 2008, the Government announced additional custom duties of 15 to 50% on the import of about 350 luxury items and consumer goods. The steps announced by the Government in the budget to stabilize the economy and reduce the fiscal and current account deficits have to be implemented in full to reinforce sustainable growth.

9. To protect the poor from the impact of high commodity inflation caused by soaring international prices and reduction in subsidies, the Government in the budget also instituted several relief measures. These included: raising minimum wages for unskilled workers; granting 20 percent increase in the basic pay and pensions of all government employees; setting up of the Benazir Income Support Program with initial allocations of PRs34 billion and cash grants of PRs1,000 to identified poorest households; establishing a national employment scheme to create self employment opportunities; and a Peoples Work Program to create employment opportunities and build small scale infrastructure with an allocation of PRs28.4 billion.

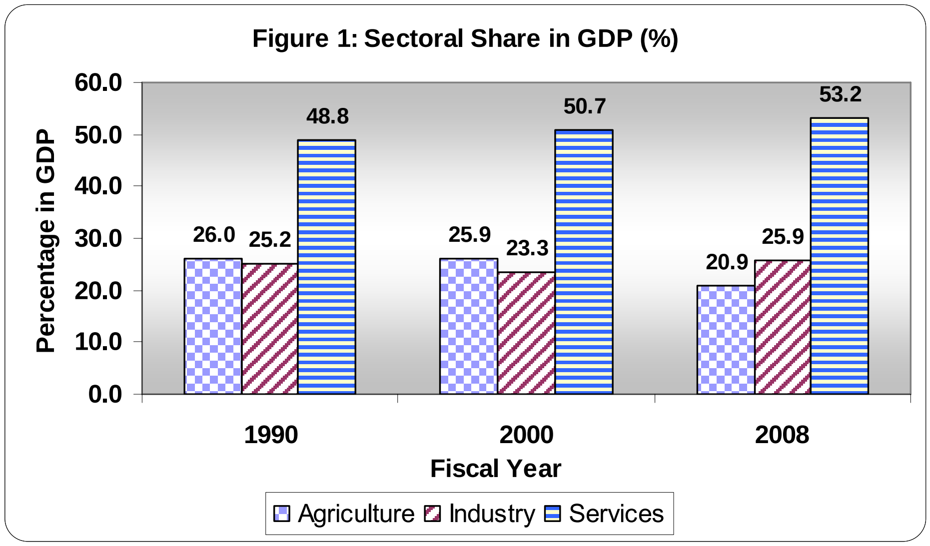
10. **Medium-Term Context.** Clearly, the present challenges facing the country are not all short-term. The lack of adequate structural reforms is among the primary reasons for the persistent and frequent episodes of fiscal and current account deficits, in turn constraining investments and economic growth, and aggravating poverty. The current challenges, if left unattended, will stall growth again and disrupt macroeconomic stability. Youth unemployment is already over 10%. Job creation is vital, in an environment of political and security uncertainties. In the longer run, Pakistan needs to widen and deepen the industrial and export base, increase productivity, and expand private sector involvement. ADB's latest Country Strategy and Program Update for Pakistan (2006–2008)[8] supports the Government's emphasis on higher sustained growth. The proposed AETP will help initiate the structural changes needed to achieve and sustain higher growth levels through a process of economic transformation.

III. THE SECTOR

A. Why Does Pakistan Need a Structural Transformation of its Economy?

11. The shares of key economic sectors in total output have been stagnant in Pakistan for many decades. Agriculture accounts for 21% of GDP now, declining from 26% two decades ago. The share of industry declined in 1990s by two percentage points to 23.3% by the end of the decade, before gradually increasing to 26% at present, while that of services has increased from 49% in 1990 to just above 53% now. Figure 1 presents the changes in sectoral shares since 1990. More recently, overall real GDP growth slowed in FY2008 largely due to the poor performance of agriculture and manufacturing. Within services, trade, transport and finance have registered strong growth. Particularly, extensive structural reforms in the financial sector since the early 1990s have unleashed extraordinary growth. The share of the financial sector is 6.5% at present.

[8] ADB. 2005. *Country Strategy and Program Update for Pakistan (2006–2008).* Manila.



GDP = gross domestic product

Source: ADB. 2008. Key Indicators for Asia and the Pacific 2008. Manila

12. Despite robust economic growth until last year's slow-down, Pakistan has continued to have fiscal, trade, and investment imbalances.[9] Successful economies in Asia such as Malaysia and Thailand have considerably strengthened their macroeconomic fundamentals over the last 2-3 decades, by undertaking significant structural transformations which in turn have led to high growth rates with favorable macroeconomic balances. These countries changed their output and employment structures dramatically, transferred resources to sectors with higher value-added and diversified production. Firms within these countries have learned to produce and export a more sophisticated and technologically advanced range of products, and their labor productivity has increased significantly. Pakistan needs a structural transformation of its economy, as described in Appendix 3. It needs to grow more quickly and to sustain higher growth, to provide more jobs, and to increase the welfare of its growing population. It needs to specialize in niche areas, and not to be trapped in areas where it no longer has a comparative advantage.

13. **Need to Sustain Growth.** Pakistan registered an average annual growth rate of 5.5% during 1960–2007. However, because of its relatively high population growth, between the mid-1980s and the early 2000s the per capita growth rate declined markedly (Figure 1 in Appendix 3). Since 2001, however, this trend has reversed and policy makers hope to maintain this performance in the medium term.

14. **Need to Deepen the Industrial Base.** To achieve sustained growth, Pakistan needs to deepen its industrial base, as well as to improve its performance in agriculture and services. While the share of the manufacturing sector in total output is not low (nearly 20%), it has remained stagnant since the 1970s (Figure 3 in Appendix 3). The share of manufacturing value-added accounted for by high-technology products is low and has remained so during the last

[9] Private investment increased to 16.2% of GDP in FY2007 from 15.4%, in FY2005 supported by improving business confidence and an increase in public investment. Private savings increased between FY2005 and FY2007 but, given continued strong consumption, this was not enough to finance the expanded private investment. This pushed the private savings–investment gap to 3.4% of GDP in FY2007 from 2.9% in FY2006.

40 years. Pakistan's exports per capita are low (Figure 5 in Appendix 3), and it continues to compete with exports from even poorer countries (e.g., rice, cotton yarn, undergarments, cotton bed linen, and other woven fabrics). Labor productivity has increased very slowly since the 1970s with an annual growth rate of only 2.6%. Unless the production and trade structure of the economy is transformed to enable it to compete effectively in global markets, Pakistan's 6%–7% real GDP growth per annum is unsustainable.

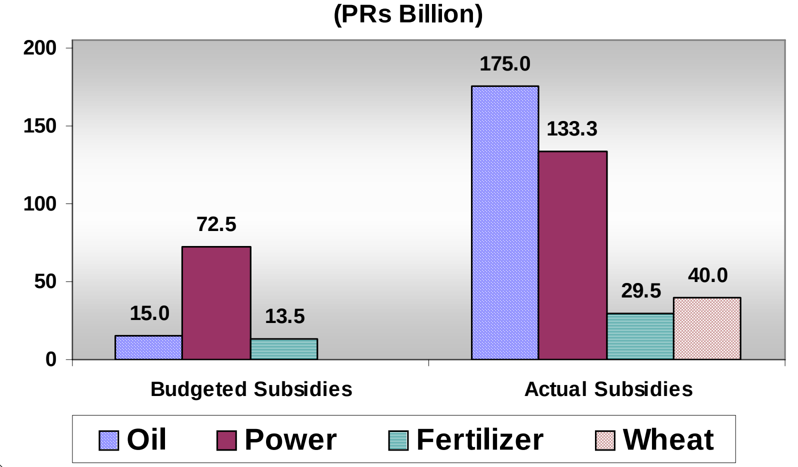
15. In summary, Pakistan needs (i) a deeper industrial base, (ii) a more productive and efficient agricultural sector, (iii) greater value creation in the service sector, and (iv) far greater export sophistication. To achieve this, Pakistan needs to address the current structural distortions, among others, in energy and agriculture sectors immediately, develop a stronger financial sector, and identify niche areas and sectors where the country can compete effectively and accelerate value creation.

B. Issues, Growth and Reform Challenges, and Opportunities

1. Immediate Distortions in Key Sectors that Perpetuate Macroeconomic Imbalances, Slow Growth and Impede Structural Transformation

16. **Untargeted Subsidies.** As a result of long-standing sector inefficiencies and the challenges described below, Pakistan now has huge subsidy needs to cover increases in the price of oil, power, wheat, and fertilizer. The unprecedented increase in the price of oil resulted in a subsidy of PRs175 billion—far above the PRs15 billion provided for in the budget. The power subsidy arising from the tariff differential and other elements rose to PRs133.3 billion—against the PRs72 billion subsidy in the budget. The subsidy on imported wheat and wheat supplied at concessional rates through the Utility Stores Corporation was in the range of PRs40 billion—no provision had been made for this in the budget. The fertilizer subsidy was PRs29.5 billion—against the budgeted amount of PRs13.5 billion. Figure 2 shows the major components of subsidies for FY2008 which amounted to PRs407.5 billion in total, almost four times higher than the budgeted amount of PRs114 billion.

Figure 2: Budgeted vs. Actual Subsidies for 2007/08 (PRs Billion)



Sources: Government of Pakistan, Finance Division 2007. *Federal Budget in Brief 2007/08*. Islamabad.
Government of Pakistan, Finance Division 2008. *Federal Budget in Brief*

17. **Weak Safety Nets.** The National Social Protection Strategy, which aims to bring social safety nets to 6.1 million households in 2012 was approved in 2007.[10] Before this, there was no overarching social protection strategy in Pakistan and a lack of direction and poor coordination on the part of individual agencies and programs. Pakistan has set up a range of schemes to help the poor, with many based on targeting (Appendix 4). Income support is offered through two cash transfer programs, Zakat and Bait-ul-Mal. However, the existing schemes suffer from four key problems: weak design (including poor eligibility criteria), poor implementation, risk of elite capture, and insufficient monitoring and evaluation. Further, the significant needs and challenges facing Pakistan require a robust safety net scheme that is based on strong data and criteria. The Government is working to improve targeting, delivery mechanisms, and monitoring through a number of initiatives. Beneficiary databases are being cleaned up and a comprehensive computerized management information system based on computerized national identity cards is being created. Developing, piloting, and expanding proxy means-tested targeting mechanisms in combination with community validation is expected to enhance the transparency and credibility of the system. Fiduciary risks are being minimized through improved financial management and the introduction of consolidated accounts at the field level to ensure effective reconciliation.

18. **Distortions in the Agriculture Sector.**[11] One of the most pressing concerns facing the Government in the short term is the adverse impact on the poor and the vulnerable of the continued rise in food prices, especially wheat, the main food staple. While Pakistan has generally been self-sufficient in wheat, the Government puts a high priority on ensuring food security and on guaranteeing adequate and affordable wheat and wheat product.[12] To attain food security, the Government has adopted a dual price policy that protects the interests of the wheat farmers on one hand, and the wheat product consumers on the other. It assures wheat producers of a support price[13] that covers their costs of production. It also provides consumers, most of whom live in the cities, with affordable prices by enabling flour mills access to subsidized wheat and assured quota allocations.[14] The Government also helps to stabilize the price of wheat and wheat products by maintaining a fair market share of total wheat production, which averaged 27% for 2000–2007,[15] for strategic reserves (for emergency purposes and to meet the wheat requirements of the poor and vulnerable) and operational reserves (to stabilize the price of wheat and wheat products). This market share is maintained through domestic

[10] Government of Pakistan. 2007. *National Social Protection Strategy.* Islamabad.
[11] Appendix 5 outlines the key production, pricing, procurement and distribution issues related to wheat in Pakistan.
[12] Wheat products, particularly wheat flour (*atta*) and bread (*roti*), are a major part of the diet, providing about 60% of protein and carbohydrate requirements. Households spend a substantial portion of their incomes on food. Wheat products represent 15.9% of household expenditure. Wheat is Pakistan's largest food grain crop, with 80% of farmers cultivating wheat and about 40% of cultivable area being devoted to wheat production. Wheat provided 38% of total crop value added in FY2007.
[13] The guaranteed minimum price or the support price accorded to wheat farmers by Government is the estimated price of wheat that would be sufficient to cover the costs of production. The support price is announced by the Government in September or October, the starting time for wheat sowing. The support price is fixed and effective for the whole country during the wheat cultivation period. The provincial food departments and directorates buy wheat from farmers at designated procurement centers, especially in harvest season months when the wheat market price decreases to the support price. The provincial government stabilizes the price of wheat by releasing this wheat during lean season months.
[14] The subsidized wheat price for flour mills is called the issue price. In theory, it is equivalent to the support price for farmers plus the incidental costs of transporting and storing the wheat. In fact, the issue price is on average about 10% lower than the actual price. This is equivalent to a subsidy from the provincial governments which absorb most of the incidental costs and part of the support price.
[15] The provincial government stabilizes the price of wheat by releasing the procured wheat especially during lean season months. Provincial food departments and directorates procure a certain volume every year to enable them to stabilize prices. The publicly announced procurement quota was 4 million–5 million tons; actual procurement averaged 3.5 million tons.

procurement, imports if there is a foreseen shortfall in production, and exports if there is a surplus.

19. To support the regulated prices and procurement activities at farms and flour mills, the Government administers the trading and marketing of wheat reserves as well as imports and exports through its Pakistan Agricultural Storage and Supplies Corporation (PASSCO), the Trading Corporation of Pakistan, and the provincial food departments and directorates. These regulatory measures are supported by state-owned storage facilities, procurement centers, and utility retail stores, as well as by easy access to credit from the SBP and commercial banks. The Government subsidy for wheat price stabilization purposes at the federal and provincial levels is substantial. The wheat subsidy on imported wheat products and those supplied at concessional rates through the Utility Stores Corporation was in the range of PRs40 billion (2.6% of the budget) for FY2008, although no provision had been made for this in the budget.

20. Under the ADB-funded Agriculture Sector Program Loan Phase II[16] (ASPL II), the Government agreed to remove the pervasive public sector interventions in the wheat market, which created disincentives for wheat producers, millers, and traders to develop an integrated food industry. Initiatives included the removal of market restrictions in trade, elimination of consumer subsidies and producer support subsidies, the divestiture and restructuring of PASSCO and provincial food departments, the closure of food directorates, and streamlined wheat reserve management. Because of the politically sensitive nature of the wheat policy and the volatile sociopolitical situation in the first half of the current decade, a phased market-based wheat policy that would lay the groundwork for a market-oriented wheat industry was deemed the most politically feasible approach. At the end of ASPL II in mid-2007, the government had reduced the gap between the support and issue prices and international prices, completed the restructuring plans for PASSCO and food departments and directorates, enabled freer movement of wheat domestically and internationally, and drawn a distinction between operational and strategic reserves.

21. The second half of 2007 was a litmus test of the Government's commitment to sustaining the phased market reforms in wheat. Because of the profit incentives that can be gained from the higher market prices for wheat and wheat products, the Government, despite its efforts to defend the public-determined prices of wheat and wheat products and its use of coercion to restrict trade and achieve its procurement targets, was powerless to stop prices from increasing. Consequently, the poor and vulnerable bore the brunt of high prices and inaccessible food as the Government's food security strategy did not put in place an effective targeted safety net measure. There are renewed interests in Government, civil society and some parts of the private sector in reverting to a greater public role in the wheat sector to ensure food security. It is essential that the investments in phased market reforms under ASPL II be ensured by accelerating the implementation of reform measures. Key policy measures that need to be brought to their logical conclusion include (i) the elimination of the consumer subsidy for wheat by moving to a market-based sale price, (ii) the elimination of the producer subsidy by moving from a support price to a market-based price for the procurement of wheat, (iii) efficient reserve management based on strategic reserves, (iv) an end to restrictions on domestic and international wheat trade, and (v) streamlining the roles of PASSCO and food departments and directorates in strategic reserve management. These need to be complemented by policies to provide targeted safety net measures for the poor and vulnerable groups and the promotion of new financial instruments and institutional arrangements to integrate farms with consumers.

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[16] ADB. 2001. *Report and Recommendation of the President to the Board of Directors on Proposed Loans to the Islamic Republic of Pakistan for the Agriculture Sector Program II*. Manila.

22. In the medium term, the lynchpin of sustainable food security is high economic growth based on economic activities that create jobs in agro-industries with high value-added and in the manufacturing and service sectors. Assured and rising incomes would be a more sustainable way for the poor to cope with food price spikes and to move out of poverty permanently. This would form the foundation for transforming subsistence agriculture into commercial and pro-poor agriculture, which would in turn finance the development of value-adding manufacturing and service sectors.

23. **Challenges in the Energy Sector.** Pakistan's energy sector is in deficit, both in energy and in financial terms. Although the country's energy resources are diverse (comprising power, oil, gas, coal, nuclear and renewable energy), energy insecurity and a power crisis persist. The sector remains institutionally fragmented and there is a lack of integrated energy planning to address the country's short, medium- and long-term energy needs. There is insufficient power generation to meet rising demands and the demand–supply imbalance reached 5000 MW in June 2008.[17] Critical investments in the generation and distribution systems have not kept pace with economic growth so available electricity is not effectively dispersed to end consumers. The transmission system is no longer a bottleneck, but the system margins and expansion program need to be effectively implemented to prevent network instability and constraints. The global oil price hike and general fiscal shortcomings have created a circular debt[18] problem in the energy sector, stopping power generation companies from reaching optimal production levels. Pakistan's sustained economic growth will be seriously affected if these twin deficits are not addressed urgently.[19]

24. Pakistan does not have an automatic electricity tariff adjustment mechanism. Regulatory tariffs have not kept up with the rising cost of operating, maintaining, and expanding the system, particularly in an environment of rising fuel costs given Pakistan's large thermal generation capacity which runs mainly on fuel oil. There continues to be a discrepancy between the tariff determined by the National Electric Power Regulatory Authority and the tariff notified by the Government. Because of fiscal constraints, the Government has not been able to disburse timely power subsidies (which cover the difference between the National Electric Power Regulatory Authority's determined tariff and the tariff notified by the Government), thereby depleting the sector of liquidity and cash flow. As a result, power distribution companies (DISCOs) have not paid off their liabilities fully for their electricity purchases, causing a working capital shortfall for the power generation companies. As a result, they cannot pay their oil and gas suppliers for fuel purchases. This spill-over has severely affected the entire energy supply chain and the inter-corporate circular debt is estimated to be close to PRs60 billion, causing an acute liquidity crisis and a deterioration of fuel stock levels at all links in the value chain.

25. A power tariff freeze from 2003 to 2007 in the wake of rising fuel prices and late payment of subsidies by the Government meant that by the end of FY2007 the DISCOs owed the Central Power Purchasing Agency (CPPA) of the National Transmission and Dispatch Company Limited (NTDC) almost PRs220 billion. It is estimated that the debt had reached about PRs240 billion by 30 June 2008, in accordance with the Annual Financial Statements of the DISCOs and NTDC.

[17] Pakistan faces a current demand of about 15,140 MW (peak-hour demand). This will rise to about 28,000 MW by 2015, 41,000 MW by 2020, and 60,500 MW by 2025 and a huge 84,800 MW by 2030.

[18] Circular debt is accumulated debt among a series of entities from, for example, the customer through the power distribution company all the way to the fuel supplier of the power generation station. The root cause has been nonpayment by the Government and its entities.

[19] Appendix 6 presents the key energy sector issues facing Pakistan.

26. Since 1992, Pakistan has been contemplating a restructuring of the power sector. The objectives of these reforms are yet to be fully achieved: (i) private investment has been attracted into the generation subsector, particularly in the mid-1990s, but it has declined in recent years (Karachi Electric Supply Company Limited's privatization has not yielded expected technical and financial efficiency results and the ex-Water and Power Development Authority DISCOs are yet to be privatized), (ii) the quality of service to the end user has been compromised significantly by power shortages (leading to riots during peak demand summer months) and by overloading of the transmission and distribution networks, and (iii) instead of being a net contributor to the national treasury, the power sector has become a fiscal burden to the tune of $2 billion a year. The successful implementation of reforms will be even more important as the Government seeks to attract large private sector participation in developing and funding the current and future power generation and system requirements. The reform agenda clearly has some way to go. The immediate needs include corporate autonomy and sector governance, electricity trading, and financial management.

27. The fiscal imbalances afflicting the power sector need to be addressed immediately and comprehensively. It is essential to determine the actual amount of the debt, to isolate it, and to develop a realistic debt restructuring plan that is acceptable to all stakeholders. It is expected that any debt restructuring plan would need to span several years. In parallel, the DISCOs should be allowed to charge cost recovery rates and the generation companies must have real and timely cost adjustments for their tariffs. The capacity and distribution bottlenecks need to be aggressively tackled. The Government is keen to address the short-term generation crisis, and to ensure sufficient funding for NTDC and the DISCOs so they can improve their transmission and distribution systems. Strategic decisions for long-term hydroelectricity generation have to be taken today.

2. Limited Financial Intermediation

28. **Progress.** Structural transformation is dependent upon an effective and efficient financial sector. The Government is committed to reforming this sector to enable it to become more competitive and a more inclusive part of the Pakistan economy. Recent bold reforms to develop the banking sector have resulted in substantial deregulation, the transformation of the banking sector from a predominantly state-owned system into a healthier market-based system primarily owned by the private sector, and the emergence of SBP as a more responsive and independent regulator. Locally incorporated private banks now control 74% of banking assets, as compared with 4% in 1992. Total banking assets (less funds held in SBP) represent 56.1% of GDP, as compared with 66.8% in India, for example.

29. **Challenges to Prudential Regulation.** In line with emerging best international practices, SBP continues to review the legal and regulatory framework for the banking sector to ensure that it enables growth and increases the depth of this sector without compromising stability. While SBP continues to systematically update its prudential regulations, it faces ongoing and emerging challenges, many of which arise from implementation of the Second Basel Accord on capital adequacy (Basel II). Many banks need to improve their risk management.

30. **Financial Sector Consolidation.** The emergence of financial conglomerates has become a feature of the financial sector in Pakistan and globally. A major features of banking sector reform in Pakistan has been the consolidation of the banking sector in order to establish fewer but stronger banks. There have been 22 bank mergers and 7 bank acquisitions since 2000, most of which have involved mergers between commercial and investment banks. Groups of affiliated financial sector entities that include a bank (hereinafter "financial conglomerates")

are becoming the norm, as banks broaden their product offerings and seek cross-selling opportunities. In addition to interests in investment banks, a number of banks also own shares in insurance companies and have interests in asset management companies and mutual funds. Some banks own shares in local banks and microfinance banks, and many may be involved in other nonbank financial activities such as leasing, advisory, and brokerage services, *modaraba*[20] management, and foreign exchange.

31. While the emergence of financial conglomerates is commercially attractive, it raises a range of issues for the regulation of the financial sector. The main risks introduced by financial conglomerates relate to conflicts of interest and potential contagion. Risks have become more difficult to monitor because financial conglomerates operate across several segments of the financial system. In the absence of proper consolidated supervision, a financial conglomerate or any of its subsidiaries or affiliates may become vulnerable to double counting of capital, large intra- and extra-group exposures, contagion problems among entities within the conglomerate, and conflicts of interest between business units within the conglomerate. There is also a risk that losses from banks will be transferred to less regulated and supervised nonbank financial sector affiliates to avoid scrutiny. Financial sector supervisors need to improve their understanding of the businesses of financial conglomerates as well as the means of accessing information and taking regulatory actions.

32. **Regulatory Fragmentation and Arbitrage.** Pakistan's existing regulatory architecture has an awkward separation of powers between SBP and the Securities and Exchange Commission of Pakistan (SECP). SBP supervises and regulates banks, development finance institutions, microfinance banks, and exchange companies, whereas SECP regulates nonbank finance companies (NBFCs).[21]

33. Under the Banking Companies Ordinance, 1962, banks are deposit-taking institutions that can perform all the functions performed by NBFCs, including investment banking, leasing, housing finance, and asset management. Banks can also perform NBFC functions by establishing separate subsidiaries, which would, however, be regulated by the SECP.

34. Due to the nascent state of the local capital market, a number of NBFCs are engaged in deposit-taking, which is traditionally regulated by banking regulators to address prudential risk concerns. For example, while investment banks traditionally perform corporate advisory services such underwriting and other capital-market-related activities, they have gradually ventured into deposit-taking and lending. They mobilize short-term funds from the general public and extend working capital and overdraft facilities to businesses. Since they are specifically prohibited from undertaking commercial banking business, they get around this restriction by issuing withdrawal slips that work like checkbooks. A recent scandal involving one of the largest investment banks led the SECP to issue a directive to this bank to cease taking deposits—the investment bank was unable to meet its obligations to depositors and institutional lenders. The deteriorating profitability of other investment banks has led them to merge into more solvent commercial banks.

35. NBFCs were previously supervised by SBP. However, because all NBFCs were incorporated as companies under the Companies Ordinance, 1984, only the SECP had the

[20] *Modaraba* is a contract in which one party provides capital to another party for the purpose of carrying on a business with the stipulation that the profit will be shared by the participating parties in the clearly specified and defined proportions agreed upon beforehand. Any loss incurred is to be borne exclusively by the capital owner.

[21] NBFCs include investment finance services (investment banking), leasing, housing finance, venture capital investment, discounting services, and investment advisory and asset management services.

power to take action against them. Thus, when off-site surveillance and on-site inspection of NBFCs by SBP highlighted irregularities, SBP had to ask SECP to take action against them under the Companies Ordinance. In December 2002, regulatory supervision of NBFCs was transferred from SBP to SECP through an amendment to the Companies Ordinance. At the time of the transfer, existing and largely single-product NBFCs serving specific market niches were allowed to offer a range of financial products. However, there was limited consolidation of NBFC activities, while banks began to make rapid inroads into this area. As a result, the market share of investment banks, leasing companies, and housing finance companies declined considerably. At the time of their transfer from SBP to SECP there were 16 investment banks, compared with 8 at present, which hold less than 1% of total financial sector assets. In addition, in a recent case where an investment bank was found to have engaged in serious malpractice and fraud, there was public confusion about SBP's oversight role since investment banks use the word "bank" in their name. This confusion has threatened the reputation of the banking industry and of SBP as its regulator.

36. **Preventing Money Laundering**. Safeguarding the financial sector from being used to launder the proceeds of criminal activities is a key priority for the Government.[22] It aims to develop and implement legal and institutional measures that will meet international standards to combat money laundering and the financing of terrorism, notably the Financial Action Task Force on Money Laundering's (FATF) recommendations on anti-money laundering and combating the financing of terrorism (AML/CFT), usually described as the FATF 40+9 Recommendations.[23]

37. To this end, Pakistan has embarked on a range of efforts, including becoming a member of the Asia/Pacific Group on Money Laundering, a regional body associated with the FATF tasked with promoting implementation of the FATF 40+9 Recommendations in Asia and the Pacific, and committed to implementing international standards for AML/CFT. At the national level, Pakistan adopted an Anti-Money Laundering Ordinance in September 2007. The ordinance provides the legal framework for AML activities, including recognizing money laundering as a criminal offense and establishing a Financial Monitoring Unit (FMU) in SBP to receive and process reports of suspicious activities. While the adoption of the ordinance is a significant milestone toward greater transparency, further improvements are needed. First, the Anti-Money Laundering Ordinance provides for a cumbersome supervisory structure consisting of a national executive committee and a general committee. The national executive committee includes relevant ministers, the SECP chairman, the SBP governor, and the director general of the FMU. The general committee includes principal civil servants from the ministries represented at the national executive committee, the SECP chairman, the SBP governor, and the director general of the FMU. While the general committee is intended to provide assistance to the national executive committee in carrying out its functions under the Anti-Money Laundering Ordinance, it is unclear how this is supposed work in practice. One national committee to develop policies and strategies for AML/CFT would be a better structure. The Anti-Money Laundering Ordinance also envisages that the director general of the FMU be supervised and controlled by the general committee. This is inconsistent with international standards and best practices as the FMU should have financial and operational autonomy.

[22] Under principle 18 of the Basel Core Principles for Effective Banking Supervision (2006) (Basel Core Principles), "supervisors must be satisfied that banks have adequate policies and processes in place, including strict 'know-your-customer' rules, that promote high ethical and professional standards in the financial sector and prevent the bank from being used, intentionally or unintentionally, for criminal activities."

[23] The FATF sets standards for global AML/CFT efforts. The FATF 40+9 Recommendations also encapsulate relevant international law instruments such as United Nations conventions and United Nations Security Council resolutions.

38. **Strengthening Payment Systems.** A well-functioning payment system is the backbone of any economy. SBP has begun implementing key payment and settlement systems reforms. However, although Pakistan has made progress in the development of electronic payments, the existing retail payment system is still largely based on checks or cash. At the retail level, banks have focused on automatic teller machines and limited internet banking. SBP would like to accelerate efforts in this area to take maximum advantage of these new technologies, unify efforts to prevent a proliferation of incompatible systems, and develop an overall and longer-term strategy for this area.

39. **Strengthening Consumer and Depositor Protection.** Pakistan has witnessed an unprecedented growth in consumer banking, which has led to a manifold increase in the grievances of consumers against bank's products and services. As such, better consumer protection is needed. An effective deposit protection scheme is also needed to ensure that depositors have continued access to their fund. This will help maintain public confidence in the banking system in the event of individual bank failures. The scheme will also protect the SBP and the Government from pressures to bail out all depositors in banks.

3. Overall Growth and Competitiveness Concerns

40. **Need for Long-Term Growth.** As noted above (paras. 11-15), Pakistan faces major challenges in a globalizing world (Appendix 3). Its contribution to global trade in high-value commodities is negligible. The experience of the newly-industrialized economies in Asia shows that robust growth needs to be sustained for at least 2–3 decades to have a significant and long-term impact on poverty reduction. With increasing links between more sophisticated markets across the region and the world, the Government needs to set some clear targets for itself, and to develop the right policies and institutions. While there have been many studies and some very good measures have been put in place by the Government, it needs to establish a clear corporate and business development plan to achieve structural transformation.

41. **Incentives for Investments.** The Government has implemented reforms to simplify cross-border trade and reduce tax rates to stimulate investment. Nevertheless, the payment of taxes and duties remains an impediment to doing business in Pakistan. Businesses need to spend about 2 months a year (560 hours) to comply with tax regulations.[24] Tax administration remains hampered by unduly bureaucratic processes with excessive scope for discretion and rent-seeking by individual staff, lack of adequate systems of financial and physical control, weak human resources, and an absence of inspection controls in customs. Discretionary powers need to be reduced and tax assessment and collection procedures that do not involve contact between taxpayers and tax officials introduced. This calls for better use of information technology and risk-based audit systems to reduce processing time, increase administrative efficiency and transparency, and raise levels of compliance.

42. **Labor Legislation**. Most surveys of business conditions in Pakistan indicate a major concern with the labor legislation. Businesses in Pakistan need to comply with from 72 to over 100 laws covering such issues as employment, working conditions, payment of wages and industrial relations. The resulting complex web of legislation and institutions increases compliance costs and decreases both employers' compliance with the laws and the employees' effective protection from employers' abuse.

[24] See World Bank. 2007. *Doing Business in South Asia 2007*. Washington D.C.

43. Figure 3 summarizes the key development problems that Pakistan faces, which the proposed AETP attempts to address.

C. ADB Operations and Lessons Learned

44. **Link Between the AETP and ADB's Past and Planned Interventions.** ADB has been involved in all the areas covered in the AETP. It has provided extensive support through technical assistance (TA) as well as through loans for: agriculture (sector reforms and investments focused on rural development and irrigation); power (largely investments in generation, transmission and distribution); financial sector reforms; and trade and export competitiveness. Appendix 7 lists all ADB-supported projects, programs and TAs in areas related to the AETP agenda during 1995–2008. Table 3 shows the links between the AETP agenda and ADB's past and planned interventions.

Table 3: Links between the Accelerating Economic Transformation Program and Past and Planned ADB Interventions

Key Areas	Past Interventions (1995–2007)	AETP (2008–2011)	Planned Interventions (2008–2011)
Agriculture	• Reforms • Agri-business development	• Reducing distortions in the short-term (subsidies; state procurement) • Targeted safety net	• Irrigation • Rural infrastructure (farm-to-market roads) • Market infrastructure
Electricity	• Sector restructuring • Transmission	• Reducing subsidies and debt overhang	• Investing in transmission and distribution
Finance	• Access • Regulatory reforms	• Strengthening supervision • Improving access	• Expanding access and outreach
Structural Transformation	• Trade • SMEs	• Economic diversification	• Full implementation
Logistics	• Roads	• Business plan for NTC	• NTC implementation

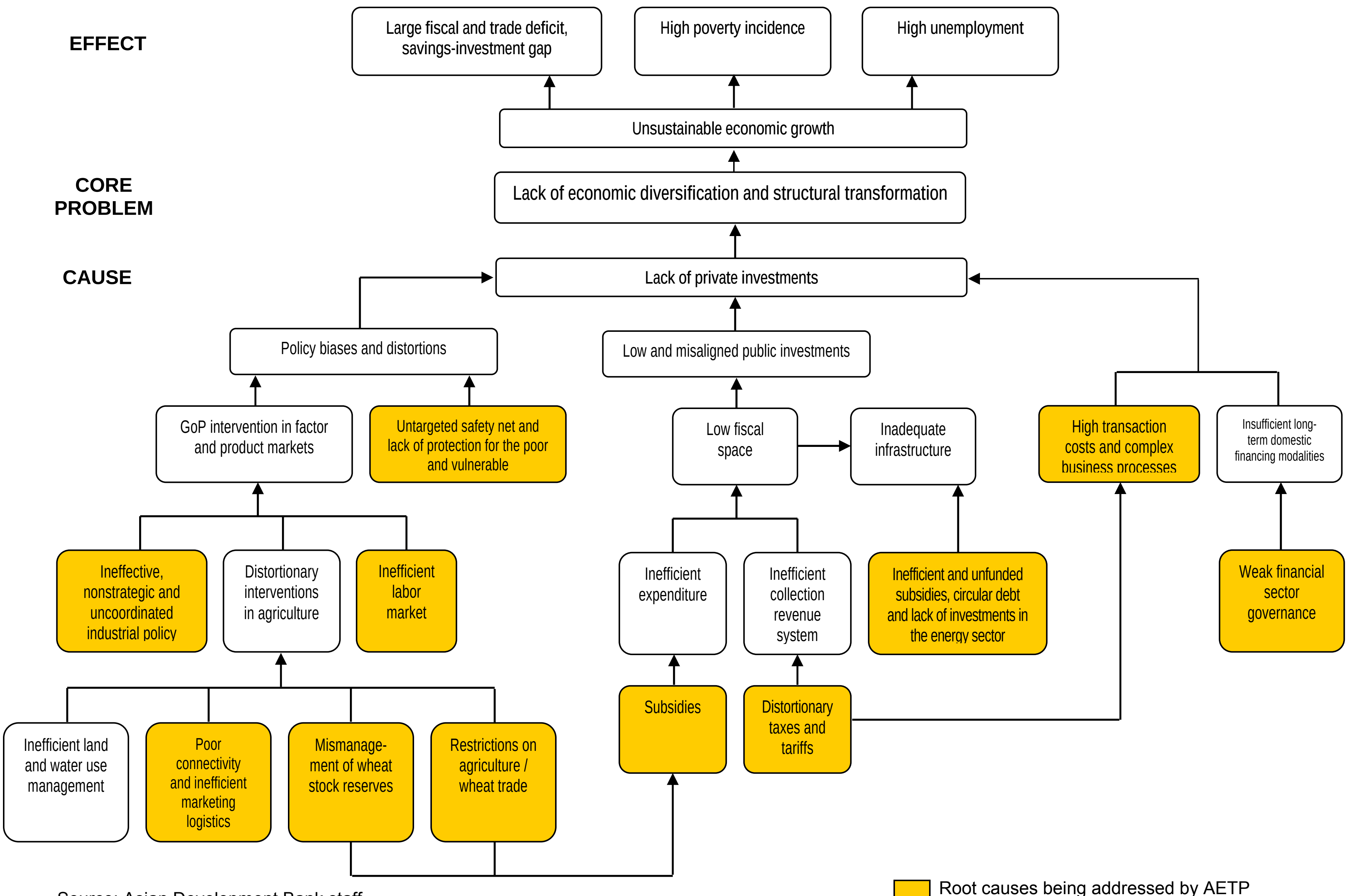
ADB = Asian Development Bank; AETP = Accelerating Economic Transformation Program; NTC = National Trade Corridor; SME = small and medium enterprise
Source: Asian Development Bank staff

45. While past ADB programs have supported reforms, there is no substantive overlap between past actions and those envisaged under the AETP. The AETP builds upon earlier reform initiatives by reinforcing critical reform measures (e.g., reductions in wheat subsidies or power sector debt restructuring). In the financial sector, a recent ADB program[25] supported the SECP and the consolidation of supervision of NBFCs. The AETP will build on this and will help Pakistan adopt a framework for consolidated supervision.

46. **Lessons Learned**. ADB's experience demonstrates that, although political disruptions may delay program implementation in difficult macroeconomic circumstances, strong Government commitment and solid support from implementing agencies can prevent a program from becoming derailed and enable it to be successfully completed. ADB's extensive and in-depth discussions with Government officials on the program design at the time of its formulation has helped to ensure strong Government ownership of previous program reforms. Similar efforts will be made in processing future programs.

[25] ADB. 2007. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan and Technical Assistance Grant to the Islamic Republic of Pakistan for the Second Generation of the Capital Market Reform Program.* Manila.

Figure 3: Problem Tree behind the Structure of the Accelerating Economic Transformation Program



Source: Asian Development Bank staff

47. At the implementation stage, the capacity of market participants and regulators will be critical in keeping reforms moving. Market participants should have market discipline and a good understanding of market operations and the virtues of regulation. Market supervisors should have the capability to evaluate the operations of market operators, establish appropriate rules, and ensure that market participants operate in a prudential manner. It is particularly important that capacity building and human resources development keep pace with policy reforms.

48. A program will yield better results if there is clear and close coordination among the government agencies involved. These agencies should collaborate on a long-term basis to ensure the sustainability and continuity of the development of a program. For example, while the Second Generation Capital Market Reform Program identified the problem of fragmented oversight over NBFCs, it did not focus on the role of SBP in addressing systemic risk concerns. One of the key lessons from this program was the need to look at the entire financial sector in addressing regulatory and supervisory gaps, regulatory fragmentation, and arbitrage concerns to enable the development of a comprehensive longer term framework. The legislative framework for the financial sector needs to be amended so it can address ongoing financial sector consolidation and reduce systemic risks more effectively.

49. The private sector needs to be involved in any reform program, since businesses are normally the major beneficiaries of such reforms. Their involvement will help to create leverage for proposed policy actions as well as to promote ADB's presence in the sector.

50. A monitoring and evaluation system and institutional mechanism must be in place to assess the progress of the policy reforms against indicators; to provide feedback on the impact of the reforms on macroeconomic stability, the competitiveness of economic sectors and potential investment areas, and reducing the insecurity of the poor and vulnerable groups; and to guide structural transformation leading to sustained industrialization.

D. External Assistance and Development Partner Coordination

51. A number of other development partners have supported macroeconomic, sectoral, competitiveness, and investment climate reforms in Pakistan (Appendix 8). In preparing the AETP, ADB has sought advice from the International Monetary Fund (IMF) and the World Bank on macroeconomic stabilization measures. To help meet the financing needs, the World Bank is working on a combination of investment and policy reform support operations to be delivered in the coming months. Other bilateral partners are supporting industrial sector and competitiveness issues. The sector agenda in AETP has benefited from ADB's past work in the relevant sectors as well as ongoing dialogue with the concerned development partners with investment or policy reform engagement.

IV. THE PROPOSED PROGRAM

A. Impact and Outcome

52. The proposed AETP will help Pakistan achieve and sustain average annual economic growth of about 8% from 2010 to 2020, through a process of structural transformation of the country's economy. The AETP will provide the fiscal and implementation support needed to enable the Government to undertake and leverage reforms. The expected outputs of the AETP are: (i) the removal of existing distortions, thereby initiating structural transformation; (ii) strengthening of financial intermediation to support structural transformation; and (iii) development and implementation of a national structural transformation strategy.

53. The proposed AETP is structured as a cluster of four subprograms over 2008–2011. Subprogram 1 attends to the urgent task of addressing the fiscal implications of the current food and energy crisis and short-term investment climate problems. It will initiate reforms that will be carried forward in the medium term. Subprograms 2–4 will build on these fiscal consolidation reforms and on analytical work and stakeholder consultation. These subprograms will support the Government to implement policies targeted at economic diversification and structural transformation. By addressing costly and inefficient subsidies in the energy and agriculture sectors, the AETP will provide fiscal space for the Government so it can finance overall development efforts. By helping to raise confidence in the banking system through a stronger regulatory environment, the AETP will mobilize financial resources and help to develop strong financial institutions that can channel investments to their most productive uses. In tandem with a new industrial policy to diversify and deepen the industrial and export base, these efforts are expected to initiate an economic transformation that will enable Pakistan to sustain high economic growth.

54. The key constraints identified in the problem tree (Figure 3) are translated into three output areas under the AETP (Figure 4, page 19). The AETP envisages immediate reforms to remove pricing, procurement, or other finance-related distortions (e.g., debt) in certain key subsectors such as wheat and electricity. Reforms are also needed in the financial sector to boost public and investor confidence. In parallel, Pakistan needs to initiate the process of structural transformation of its economy.

55. Table 4 (page 20) presents a snapshot of the principal program achievements along with results indicators for key items under each subprogram. Appendix 9 presents the Government's Letter of Development Policy, accompanied by the policy matrix for the AETP in Appendix 10, laying out the policy actions for subprogram 1 and indicative outputs and activities for subprograms 2 and 3. The activities for subprograms 2 and 3 will continue to be refined over the next 1–2 years, while the agenda for subprogram 4 (for processing in 2011) will be formulated later subject to satisfactory implementation progress. The indicators will be updated periodically, depending on implementation progress. Appendix 11 presents the IMF's macroeconomic assessment prepared at the request of ADB for the AETP.

B. Outputs and Activities

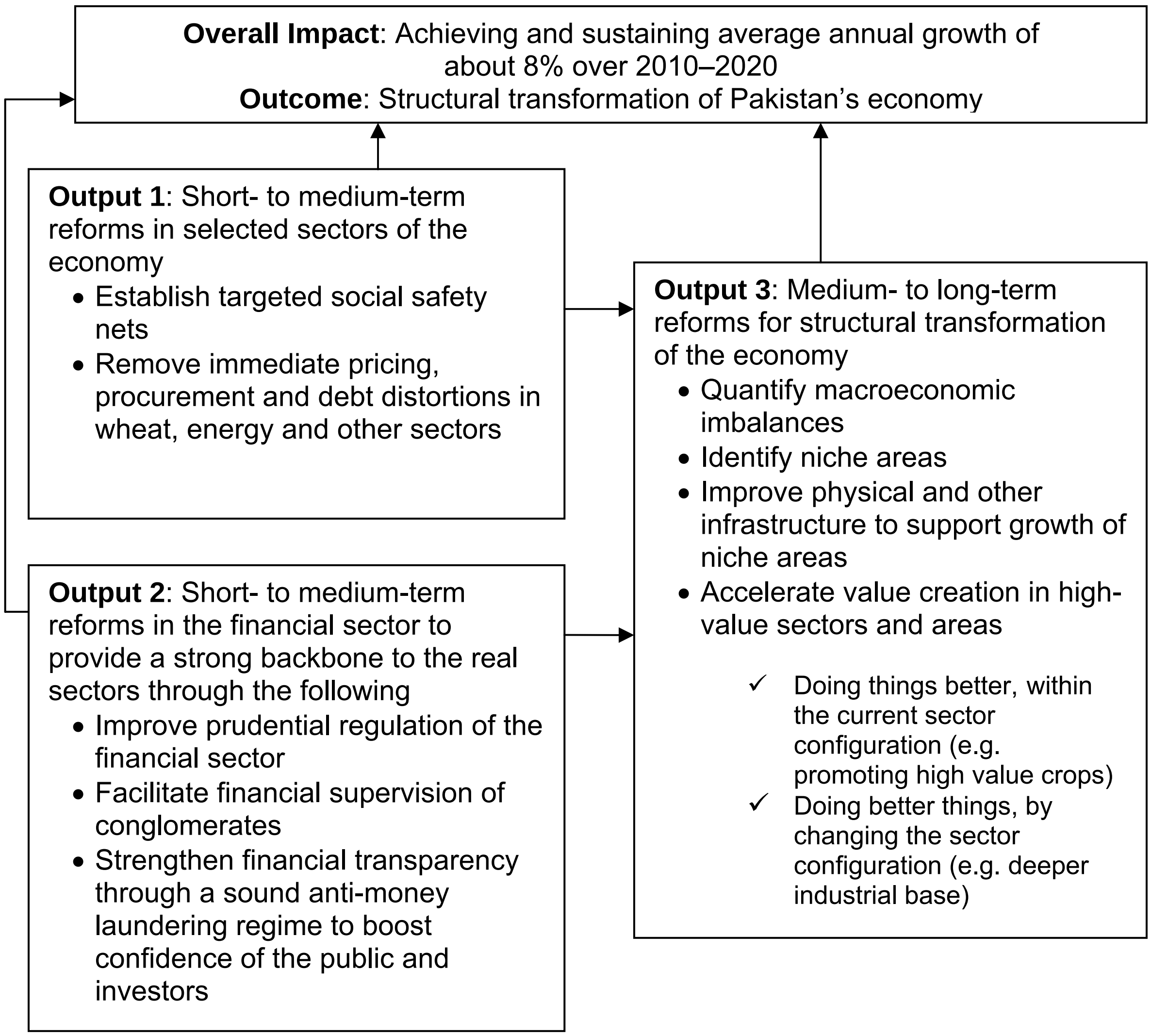
1. Remove Immediate Distortions in the Food and Energy Sectors and Protect the Poor and Vulnerable through Targeted Safety Net Programs

56. **Protect the Poor and Vulnerable.** Subprogram 1 will enhance awareness of the need to move from the current poorly targeted and inefficient subsidies in the food and energy sectors to a more targeted safety net system. The Government has set aside resources in the FY2009 budget to provide targeted cash transfers and food support for about 5 million poor and vulnerable households. The targeted population will be reached by existing and new programs. Clear criteria has been developed for selecting beneficiaries under the new cash transfer program. The application of the targeted safety nets for the poor and vulnerable households is in line with the reduction and eventual elimination of wheat subsidies, as set forth in the action plan of the Economic Coordination Committee (ECC).[26] The Government will evaluate the

[26] The ECC of the federal cabinet includes the ministers for commerce; communications; finance; food, agriculture and livestock; industries; information technology; petroleum and natural resources; ports and shipping; privatization and investment; railways; science and technology; textile industry; and water and power. It also includes, by special invitation, the special assistant to the prime minister on finance and revenue, the Planning Commission deputy chairman, the SBP governor, and the chairman of the SECP, among others. Its meetings are normally chaired by the Prime Minister of Pakistan.

safety net programs and adopt revisions, as needed, with the aim of implementing improved programs over the next 2–3 years. An existing TA[27] will be used to ensure the soundness of the program design and fiduciary transparency.

Figure 4: Rationale for Accelerating Economic Transformation Program Design



Source: Asian Development Bank staff

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[27] ADB. 2007. *Technical Assistance to Pakistan for Support to Governance Reforms in Pakistan.* Manila.

Table 4: Principal Achievements and Indicative Results Framework of the AETP

Pre-AETP Benchmark	Subprogram 1 (June 2007 to Sep 2008)	Subprogram 2 (Oct 2008 to June 2009)	Subprogram 3 (July 2009 to June 2010)	Subprogram 4 (July 2010 to June 2011)
Output 1: Eliminating immediate distortions to pave way for structural transformation				
Output 1.1: Targeted safety net programs for the poor and vulnerable				
Dedicated budget allocation of less than $200 million for safety nets	$600 million allocated for targeted safety nets	A safety net program in place with coverage for up to 7 million households	Coverage expanded to about 9 million households	Sustained coverage
Output 1.2: Market-based wheat pricing and efficient management of wheat reserves				
Support price of wheat for farmers at less than 50% of import parity (October 2007)	Support price increased from PRs425 per 40 kgs. to PRs650 (60% of import parity)	Support price increased to at least 80% of import parity	• Support and issue prices raised to the market level • Government no longer takes part in active procurement and manages only a strategic reserve of 2 months' consumption requirements	
Output 1.3: Settlement of electricity subsidies and initiating debt restructuring				
Large accumulated past power subsidies and annual subsidies spiraling to PRs133 billion ($1.9 billion) in FY2008	All past subsidies settled and new subsidies brought down to PRs88 billion ($1.3 billion) in FY2009 budget	FY2010 electricity subsidies reduced to less than 30% of previous year's level	Electricity subsidy brought down to zero by June 2010 and maintained at that level, except for lifeline tariffs[a]	
Output 2: Strengthening financial intermediation to facilitate structural transformation				
Banking credit to private sector equivalent to 27% of GDP	Benchmark level	Banking credit to private sector increased to 28.5% of GDP in FY2009	Banking credit to private sector increased 30% of GDP in FY2010	Banking credit to private sector increased to 32% of GDP in FY 2012
Fragmented supervision of financial conglomerates	An effective framework agreed upon	Financial conglomerates effectively supervised	Regulatory architecture strengthened and brought into line with international best practices	
Slow settlement of inter-bank transactions	RTGS system established	• RTGS system fully operational • Retail payment system modernized and rolled-out		
Basic legal framework for AML	Institutional framework for AML strengthened	FMU fully operational; suspicious transactions promptly reviewed and assessed		
Output 3: Structural transformation process initiated				
Pakistan product space[b] stagnating over 1985–2008	Studies launched on structural transformation and high-level steering committee set up	Structural transformation strategy and time-bound action plan adopted by cabinet	• Share of manufacturing sector increased from 19% of GDP in FY2008 to 21% in FY2012 • Share of high-value added output increased from 10% of exports in FY2006 to at least 15% in FY2012	

AETP = Accelerating Economic Transformation Program; AML = anti-money laundering; FMU = Financial Monitoring Unit; FY = fiscal year; GDP = gross domestic product; RTGS = real-time gross settlement

[a] Lifeline tariffs provide a minimum amount of electricity to the poor at lower cost, often below the cost of supply.

[b] Product space refers to the range of products that a country produces and exports.

Source: Asian Development Bank staff

57. **Adopt Market-based Wheat Pricing and Introduce an Efficient Wheat Reserve Management System.** Subprogram 1 aims to complete the establishment of market-based wheat pricing and a more efficient and transparent wheat stock reserve management system before June 2010. A more holistic approach is needed that takes into account the food security considerations facing the Government. As part of subprogram 1, the ECC has adopted a time-bound policy action plan for ensuring a market-based wheat pricing regime and an efficient and transparent reserve management system. The increase in the supply price of wheat for farmers from PRs425 per 40 kilograms to PRs650 in early 2008 was an important demonstration of the Government's commitment to implementing the action plan. This was an important step toward market-based pricing, but an automatic adjustment process needs to be put in place to increase the support price to 80% of the import price parity level and this will be pursued under subprogram 2. On procurement, as part of subprogram 2, the Government will lower its target for wheat reserves to an estimated 3 months of the national annual average consumption requirement. This is an important step, as the Government has never been able to procure more than 20% of wheat production in the past. The previous target, despite being unrealistic, exerted artificial pressures on the markets. The remaining elements of the market-based wheat policy action plan will be implemented in subprograms 2 and 3, leading in the third year to market-based pricing of the supply price of wheat and the pricing of wheat products; completion of the restructuring of PASSCO and the food departments and directorates, streamlining management of the strategic reserves; freer movement of wheat domestically; and greater engagement of the private sector in the provision of key marketing infrastructure and services. Para.56 provides the measures that will lead to more efficient, transparent and accountable safety nets for the poor and vulnerable groups, including measures that address their food insecurity.

58. **Take Measures to Address the Energy Crisis.** Specific policies to curtail sector inefficiencies are needed to address root causes and consequences of high energy prices. Although the current global and national economic outlook poses complex policy challenges, the Government has already taken key actions under subprogram 1. These include: initiating work on determining the extent of circular debt and debt overhang in the power sector, ensuring up-to-date and timely payments of the tariff differential subsidies to DISCOs, and allocating sufficient resources for energy subsidies in the budget to meet the forecast needs over FY2009. In addition, Parliamentary approval was obtained to reduce electricity subsidies through: (i) elimination of generalized sales tax subsidies for all domestic consumers and up to 500 units for commercial consumers; (ii) introduction of automatic monthly fuel price adjustments through a surcharge; and (iii) introduction of an additional surcharge to be levied on all consumers to reduce the gap between determined and notified tariffs. The settlement of the past subsidies owed by the Government will cost $1.9 billion. Addressing the circular debt and debt overhang is likely to need another $3.0 billion–$3.5 billion over 2008–2010.

2. Strengthen Financial Intermediation

59. **Improve Regulation and Supervision.** Under subprogram 1, SBP has prepared a new draft of the Banking Companies Ordinance to incorporate Basel Core Principles. Draft amendments include procedures for resolving difficulties faced by troubled banks, new powers to enable SBP to address technological changes and enforce the legal and regulatory framework more effectively, new criteria to establish or liquidate a bank, and other measures to strengthen bank governance. As part of the implementation of Basel II, SBP has increased the minimum capital requirements for banks from PRs2 billion at end-2005 to PRs4 billion by end-2007, PRs5 billion by end-2008, and PRs6 billion by end-2009 and adopted standardized and internationally accepted approaches to credit, market, and operational risks. Subsequent subprograms will help the Government to fully implement Basel II. Also under subprogram 1,

SBP has launched work on a financial sector strategy focused on banks, including reforms to the overall financial sector regulatory architecture. This strategy will be implemented over 10 years and key milestones will be identified when policy actions for subprograms 2–4 are finalized.

60. **Adopt a Framework for Consolidated Supervision of Financial Conglomerates.** Basel Core Principles provide principles for regulating financial conglomerates. Principle 24 requires that the banking supervisor have (i) the authority and capacity to evaluate all risks to the group; (ii) legal authority to review all group members; (iii) authority to set prudential standards for the group and to limit the group's activities; and (iv) access to all the group information that it requires to meet its responsibilities. In line with these principles, subprogram 1 will support cabinet approval of draft legislation to establish a regime for consolidated supervision of financial conglomerates. The draft legislation provides that SBP will be the lead regulator over all financial groups that include a bank and that it will have appropriate powers to (i) license the bank and/or holding company at the top of the group, and (ii) set out and enforce prudential standards for the group through the licensing requirements for the bank or the holding company. The draft legislation also provides SBP with greater regulatory oversight powers over parties who control banks and banking groups, and gives it the power to license, regulate, and supervise all deposit-taking institutions. Subsequent subprograms will support legislative changes and implementation of the new framework for consolidated supervision, including strengthening of regulatory capacity, and developing a strategy and related implementation plan for moving to a more functional approach to regulation to address the risk of regulatory fragmentation and arbitrage.

61. **Strengthen the Anti-Money Laundering Regime.** In line with international best practices, subprogram 1 supports cabinet approval of amendments to the Anti-Money Laundering Ordinance to strengthen the independence of the FMU. The amendments would replace the two committees that currently exercise oversight over FMU with one national committee to develop national policies and strategies, enabling FMU, the financial regulators and law enforcement agencies to concentrate on operational matters. The FMU would serve as the secretariat to this national committee. The amendments would also include transparent criteria for the appointment and dismissal of the director general of the FMU. To strengthen capacity in the fight against money laundering, the AETP will support the adoption of a national training program by the national committee for financial regulators, financial institutions, the FMU and law enforcement agencies. Subprograms 2 and 3 will implement the policy measures adopted under subprogram 1.

62. There is a current ADB TA for $1.5 million that will provide substantial capacity building and training, including the establishment and early operations of the FMU.[28] This TA provides about 32 person-months of international consultant inputs and 30 person-months of national consultant inputs as well as support for workshops and other training activities. The TA will contribute substantially to the efforts of the authorities and the work envisaged for the AETP.

63. **Enhance SBP Autonomy and Governance.** Subprogram 1 will help to develop a proposal for a new State Bank of Pakistan Act that will grant greater independence to SBP and

[28] "Strengthening the anti-money laundering regime in Pakistan", a subproject under ADB. 2007. *Technical Assistance to Pakistan for Support to Governance Reforms in Pakist*an. Manila. (TA 4922-PAK).

enhance its accountability according to international standards and best practices. This law is expected to be enacted within the AETP implementation period.

64. **Strengthen Payment Systems.** SBP has established a new real-time gross settlement (RTGS) system for wholesale transactions. This is a milestone in strengthening payment systems in Pakistan. In addition, SBP has also introduced a centralized online system for retail payments. Subsequent subprograms may review and update this system, including possible platforms for electronic and cell-phone-based transactions and addressing issues of privacy and security.

65. **Strengthen Consumer Protection for Depositors and Borrowers.** As part of efforts under subprogram 1, SBP has established a dedicated consumer protection department to deal with consumer grievances and put in place an appropriate policy and regulatory mechanism to safeguard consumer interests. In addition, a Consumer Protection Law is being drafted, which is expected to be enacted during subsequent subprograms. This law is expected to address such issues as transparency, confidentiality, availability of statements, account servicing, protection against fraud, unfair contracts and lending practices, methods of debt collection, and arbitrary penalties. It will be based on international standards and best practices.

66. Under subprogram 1, a concept paper has been developed to help finalize a deposit protection law as well as to establish a deposit protection scheme to protect small depositors in case of a bank failure. The most important consideration for depositors is that their money will be safe and available when they need it.

3. Develop and Implement a National Structural Transformation Strategy

67. **Medium to long-term product diversification and structural transformation.** Subprogram 1 will set the stage for an effective, strategic, and well-coordinated industrial policy. Policy setting and identification of implementing institutions will begin under subprogram 1 and analytical work on industrial policy structures and institutions will be carried out, to be supported by subsequent subprograms. This analysis will be based on a systematic understanding of what economic subsectors need and how they may be feasibly enhanced by specific sector development policies.

68. This policy analysis will have a special focus on public–private sector interaction. It will focus on feedback and consensus building in (i) institutions for public–private coordination of strategies and investments, and (ii) structural transformation policies carried out by the public sector. Two current ADB studies will support the AETP: one, supported by TA,[29] will undertake an in-depth analysis to identify the potential to diversify production and increase productivity in light of the country's technological and social capabilities; the other, supported by a TA loan,[30] will develop a strategic framework for new business development in key areas in the context of the heavy public sector infrastructure investments along the National Trade Corridor (NTC). Under subprogram 1, a high-level steering committee reporting to the prime minister or the cabinet has been established to lead work on Pakistan's structural transformation. The committee will prepare a work program to guide the preparation of a structural transformation strategy, a reform and investment program, and an execution plan. The committee will also

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[29] ADB. 2008. *Technical Assistance to Pakistan for Competitiveness and Structural Transformation in Pakistan*. Manila.

[30] ADB. 2005. *Report and Recommendation of the President to the Board of Directors on a Proposed Technical Assistance Loan and Technical Assistance Grant to the Islamic Republic of Pakistan for Infrastructure Development.* Manila.

agree on the involvement and responsibilities of various parties involved in the design and implementation, including those of ADB.

69. **Adopt Measures to Facilitate Investments.** Under subprogram 1, the Government has taken several short-term measures to improve the investment climate. It has introduced risk-based customs inspection with facilities for e-filing and payment of duties. This has subsequently been extended to sales taxes. The Government has also introduced a pioneering program to support the development of the automobile industry, with the goal of increasing its share of GDP from the current 2.8% in FY2006 to 5.6% in FY2012.

70. As indicated in the policy matrix (Appendix 9), future subprograms will help the Government to simplify labor laws and promote e-governance to improve delivery of public services. It will also help to identify key sectors, prepare and implement development programs, streamline the rules of business, and restructure some key ministries and agencies, based on the recommendations of the structural transformation studies.

C. Special Features

71. The proposed AETP is premised on three key principles. First, Pakistan needs to address certain economic distortions in the short term, specifically by reducing and eventually abolishing inefficient subsidies and targeting them to benefit the poor and vulnerable. Second, Pakistan needs to deepen financial intermediation and increase financial sector stability and soundness. Third, Pakistan needs to diversify its economy and increase the share of industry from the current level of 26% of GDP and to increase the share of manufacturing with high value-added. In parallel, it needs to increase agriculture productivity and make its services sector produce greater value.

72. It is estimated that Pakistan will need more than $1.6 billion to transition from the inefficient subsidy schemes to a targeted cash transfer and food safety net program in the first year of AETP, and about $3 billion to resolve the accumulated debt in the electricity sector. The AETP will help Pakistan to address the ongoing food and energy crisis in a systematic manner. Subprogram 1 is also one ADB's first responses to its developing countries' needs in the food crisis, first announced by the President at the ADB Annual Meeting in May 2008 and contained in the Board information paper *ADB's Response to the Food Crisis*.[31]

73. Structural transformation of an economy of the size and nature of Pakistan's cannot take place quickly or through rigidly prescribed conditions. To achieve the principles laid out in para. 71, the AETP sets out a 4–5 year design and implementation period, and a cluster structure of four subprograms that will provide flexibility to meet evolving circumstances. It sets out short-and medium-term actions, with changes to come beyond the program period. The AETP will only tackle the policy issues, with a large number of procedural and process-related changes taking place in parallel to the proposed reform measures.

D. Financing Plan

74. As noted in para.72, the costs associated with the reforms under the AETP (which includes increases in subsidies as a result of price increases in food and oil) are significant in the short term, and can go up to $5 billion in FY2009–FY2012 to expand the social safety nets. The Government has requested that subprogram 1 and subprogram 2 each be designed to

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[31] ADB. 2008. *ADB's Response to the Food Crisis.* Manila.

provide $500 million, with subprogram 1 to be submitted for ADB approval in September 2008 and subprogram 2 before the end of June 2009. For subprogram 1, two loans are proposed—a loan of $300 million from ADB's ordinary capital resources (OCR) and a loan of $200 million equivalent from the Asian Development Fund (ADF). Subject to reform progress and availability of resources, subprograms 3 and 4 are each envisaged to be $400 million–$500 million. Thus, the overall amount for the AETP is estimated to be in the range of $1.8 billion–$2 billion.

75. The OCR loan will have a 15-year term, including a grace period of 3 years, an interest rate to be determined in accordance with ADB's London interbank offered rate (LIBOR)-based lending facility, a commitment charge of 0.15% per annum, and such other terms and conditions as set forth in the draft loan agreement. The Government has provided ADB with (i) the reasons for its decision to borrow under ADB's LIBOR-based lending facility on the basis of these terms and conditions; and (ii) an undertaking that these choices were its own independent decision and not made in reliance on any communication or advice from ADB.

76. The ADF loan will have a term of 24 years, including a grace period of 8 years, an interest rate of 1.0% per annum during the grace period and 1.5% thereafter, and other terms and conditions as set forth in the draft loan agreement.

E. Implementation Arrangements

1. Program Management

77. The Ministry of Finance (MOF) will be the Executing Agency for the AETP. The Ministry of Industries and Production; Ministry of Commerce; Ministry of Food, Agriculture, and Livestock; Ministry of Water and Power; State Bank of Pakistan; Planning Commission; Federal Board of Revenue; Engineering Development Board; and the Pakistan Bait-ul-Mal[32] will be the implementing agencies.

78. The secretary of finance will steer the AETP. The financial management arrangements within MOF have been assessed as adequate. MOF's accumulated experience in implementing a large number of program loans demonstrates its competence and capacity to carry out financial management of the AETP effectively. ADB will monitor program implementation closely to ensure that envisaged outputs and outcomes will be achieved.

2. Implementation Period

79. To ensure reform continuity as well as the predictability of support, the AETP will be structured as a program cluster of four single-tranche subprograms to be implemented approximately between June 2007 and July 2011.

(i) Subprogram 1 (covering reforms from June 2007 to September 2008) addressing food and energy crisis, supporting short-term investment climate measures, and paving way for medium-term structural transformation;
(ii) Subprogram 2 (October 2008 to June 2009) furthering reforms for structural transformation;
(iii) Subprogram 3 (July 2009 to June 2010) expanding reforms to enhance private sector participation in key sectors; and

[32] Pakistan Bait-ul-Mal is a semi-autonomous organization established within the Ministry of Social Welfare and Special Education pursuant to the Bait-ul-Mal Act, 1991.

(iv) Subprogram 4 (July 2010 to June 2011) marking completion of the initial phase of structural transformation.

80. The loan of $500 million will become available following satisfaction of subprogram 1 policy actions and after loan effectiveness. The loans for subprograms 2–4 will be processed subject to adequate progress of reforms and the Government's continued commitment to the reform agenda.

3. Procurement and Withdrawal Procedures

81. Loan proceeds will be used to pay for items procured in ADB member countries, other than the items specified in the negative list of ineligible items (Appendix 12) and imports financed by other bilateral and multilateral sources. The proceeds of the program loan will be disbursed in accordance with the provisions of ADB's simplification of disbursement procedures and related requirements for program loans. Loan proceeds disbursed against imports will require a certificate from the Government stipulating that the value of the total imports of Pakistan, minus its imports from nonmember countries, ineligible imports, and imports financed under other official development assistance, is equal to or greater than the amount of the loan expected to be disbursed during a particular year. ADB reserves the right to audit the use of loan proceeds to verify the accuracy of the Government's certification.

4. Anticorruption Policy

82. ADB's *Anticorruption Policy* (1998, as amended to date) was explained to and discussed with the Government. Consistent with its commitment to good governance, accountability, and transparency, ADB reserves the right to investigate, directly or through its agents, any alleged corrupt, fraudulent, collusive, or coercive practices relating to the AETP. To support these efforts, relevant provisions of ADB's *Anticorruption Policy* are included in the loan regulations. To mitigate the risk of corruption in the implementation of targeted subsidies, ADB will provide support under an ongoing TA (footnote 27) to put in place good fiduciary systems and requirements for the safety net programs. The TA will include 3 international person-months and 12 national person-months of fiduciary expertise. In addition, monitoring and evaluation expertise will help to improve the safety net programs based on outcomes and lessons.

5. Counterpart Funds

83. The Government shall ensure that the local currency generated from the proceeds of the OCR loan shall be used first, to support the adjustment costs of reforms to be initiated and implemented under subprogram 1, and second, to finance expenditures for the Government's general development purposes. The Government shall ensure that the local currency generated from the proceeds of the ADF loan shall be used to support the poor and vulnerable households under the two targeted social safety net programs set forth in output 1 of subprogram 1.

6. Program Performance Monitoring and Evaluation

84. The economic reform unit in MOF and SBP have established a performance evaluation system for the AETP, which includes a database on the status of policy measures and program indicators based on the policy matrix. They will take the lead in monitoring the implementation of the AETP and its impacts and outcomes, and submit reports to ADB twice a year on program implementation, including accomplishment of the measures set forth in the development policy letter and policy matrix. They will be proactive in gathering data, updating performance

indicators and proposing revisions as needed to ensure that data compiled provide useful guides to management decision-making by policy makers. Policy advisors may be placed within MOF and SBP to assist in monitoring and evaluation. ADB will keep track of program implementation through regular reviews and progress reports throughout implementation. Based on these reviews, modifications and improvements will be considered. The results framework in Table 4 and the design and monitoring framework in Appendix 1 identify the targets by which attainment of the outputs will be measured. In addition, each subsequent subprogram will include an appendix reflecting a summary assessment of the performance of each subprogram.

V. TECHNICAL ASSISTANCE

85. The proposed TA will help the Government to design and implement the reform agenda for subprograms 2–4. The components of the TA are aligned with the principal areas of the AETP and include support for implementing structural transformation and financial sector development. The design for this TA takes into account existing TAs and will be supplemented by a subproject from ADB's ongoing governance TA cluster (footnote 27), financed by the Department for International Development of the United Kingdom. This subproject will focus on the design and implementation of targeted safety net programs for the poor and vulnerable, gradual elimination of wheat and energy subsidies, and restructuring of the electricity sector debt. Supplementary Annex C presents the full details of this TA. In addition, an ongoing TA will support Pakistan's anti-money laundering efforts (footnote 28).

86. The TA is estimated to cost $1,040,000 equivalent. ADB will provide $800,000 on a grant basis from its TA funding program. The Government's contribution of $240,000 equivalent will cover office accommodation, training and workshop facilities and counterpart support. Procurement of goods under the TA will be in accordance with ADB's *Procurement Guidelines* (2007, as amended from time to time).

87. The Ministry of Finance will be the Executing Agency for the TA and will help coordinate the work of the TA with the implementing agencies. For the financial sector component, the work will be coordinated and supervised directly by the concerned regulatory agencies. The TA will be implemented over a period of 2 years starting in October 2008 and running until September 2010. The TA is estimated to require about 15 person-months of international consulting services and 30 person-months of national consulting services. All consultants will be selected on an individual basis in accordance with ADB's *Guidelines on the Use of Consultants* (2007, as amended from time to time). The impact, outcome and scope of the TA, outline terms of reference, and cost estimates are in Appendix 13.

VI. PROGRAM BENEFITS, IMPACTS, ASSUMPTIONS, AND RISKS

A. Benefits and Impacts

88. The AETP will provide significant benefits and will have a positive impact on the poor. Appendix 14 presents the summary poverty reduction and social strategy prepared for the Program. First, the immediate outcome of AETP, particularly under subprogram 1, will be to help Pakistan overcome the short-term exogenous shocks of spiraling food and fuel prices and meet the immediate and large fiscal needs. Second, it will help the Government move away from inefficient and untargeted subsidies to a targeted safety net program for the poor. Beginning with about 2 million households immediately, and expanding to cover 5 million households during the 2008-2009 fiscal year if the safety net program implementation is smooth, the AETP could potentially target up to 9 million households. In parallel, the AETP will

also assist the Government in embarking on a medium term reform agenda. As such, third, the AETP will raise public confidence in the banking system through a depositor protection scheme, and stronger financial intermediaries that are better able to mobilize and allocate resources and risks. Fourth, the AETP will open the way forward for structural transformation, and in the process, it will help cut transaction costs for businesses (e.g., by reducing red tape in tax payments) and improve the investment climate. Fifth, the AETP framework will enable ADB to sustain policy dialogue on structural reform in sectors where ADB has been actively involved through past and current investments.

B. Risks and Mitigating Measures

89. While some of the risks of the AETP are political and outside of its scope, the financing will mitigate a range of others, including the following:

(i) **Interest group resistance.** This is likely, as those affected by reforms in the short-term may resist. The Government is adopting a good communication strategy to articulate the long-term and country stability interests that are behind the reforms. Further, the program cluster nature of the AETP ensures prior actions by the Government before financing is provided.
(ii) **Weak capacity.** This is a generic concern, which is elevated in case of complex reforms. Adequate design and implementation support is being mobilized under AETP through technical assistance.
(iii) **Global food and fuel crisis.** The measures under AETP are predicated on there being a global recovery. Yet, the program cannot determine global events, although it can help cushion Pakistan against some exogenous shocks.
(iv) **Lack of policy coordination**. The AETP will demonstrate the clear benefits of product diversification, industrialization, processing and value creation and will therefore help build consensus. ADB's current analytical and design work on transformation is supported by well-known institutions, which will bring credibility to the reforms and help build momentum.

90. The risk of *not* supporting Pakistan's safety net programs and longer-term economic transformation is also high. In the absence of timely reforms, the Government's budget would continually be burdened by costly and inefficient subsidies, leaving fewer resources for development financing, the financial sector would be vulnerable to systemic risks, and investors would be vulnerable to market fraud and misconduct. Without meaningful structural transformation, growth may once again be stalled and macroeconomic stability disrupted, returning the country to the cyclical pattern observed in the past. High and persistent fiscal, current account and investment deficits could lead to unsustainable levels of public debt, adversely affecting the country's macroeconomic environment, constraining investment and economic growth, and aggravating poverty.

91. The underlying assumptions for the AETP include

(i) strong and sustained leadership and commitment to reforms,
(ii) development partner coordination, and
(iii) open dialogue with the private sector and other key stakeholders

VII. ASSURANCES

92. In addition to the standard assurances, the Government has given the following assurances, which are incorporated in the legal documents.

(i) The policies adopted and actions taken under subprogram 1, as set forth in the Development Policy Letter and the Policy Matrix, will be in effect for and beyond the duration of subprogram 1.
(ii) The Government will keep ADB informed of policy discussions with other multilateral and bilateral aid agencies that may have implications for the implementation of subprogram 1 and will provide ADB with an opportunity to comment on any resulting policy proposals. The Government will take into account ADB's views before finalizing and implementing any such proposal.
(iii) The Government shall ensure that the local currency generated from the proceeds of the ADF loan shall be used to support the 5 million poor and vulnerable households under the two targeted social safety net programs set forth in output 1 of subprogram 1.

VIII. RECOMMENDATION

93. I am satisfied that the proposed program cluster and loans would comply with the Articles of Agreement of the Asian Development Bank (ADB) and recommend that the Board approve

(i) the program cluster to the Islamic Republic of Pakistan for the Accelerating Economic Transformation Program;

(ii) the loan of $300,000,000 to the Islamic Republic of Pakistan for the first subprogram of the Accelerating Economic Transformation Program from ADB's ordinary capital resources, with interest to be determined in accordance with ADB's London interbank offered rate (LIBOR)-based lending facility; a term of 15 years, including a grace period of 3 years; a commitment charge of 0.15% per annum; and such other terms and conditions as are substantially in accordance with those set forth in the draft Loan Agreement presented to the Board; and

(iii) the loan in various currencies equivalent to Special Drawing Rights 122,888,000 to the Islamic Republic of Pakistan for the first subprogram of the Accelerating Economic Transformation Program from ADB's Special Funds resources with an interest charge at the rate of 1.0% per annum during the grace period and 1.5% per annum thereafter; a term of 24 years, including a grace period of 8 years; and such other terms and conditions as are substantially in accordance with those set forth in the draft Loan Agreement presented to the Board.

Haruhiko Kuroda
President

10 September 2008

DESIGN AND MONITORING FRAMEWORK

Design Summary	Performance Targets/Indicators	Data Sources/Reporting Mechanisms	Assumptions and Risks
Impact Sustained high economic growth	Real GDP growth sustained at 8% per year over 2010–2020 Manufacturing sector's share of GDP increased to 30% by 2020 High-value added output[a] share of exports increased to 40% by 2020 Banking sector credit to private sector expanded to 42% of GDP by 2018	National income accounts SBP	**Assumptions** • Strong Government commitment • Private sector responds positively to policy reforms **Risks** • Resistance from vested interest groups
Outcome Initiate structural transformation of Pakistan's economy	Manufacturing sector share of GDP increased from 19% in FY2008 to 21% by FY2012 High-value-added output's share of exports increased to at least 15% by FY2012 Banking sector credit to private sector expanded to 32% of GDP by FY2012	National income accounts SBP	**Assumptions** • Ongoing support and ownership by implementing agencies • Development partner support for reforms and close coordination **Risks** • Weak absorptive capacity of implementing agencies

Design Summary	Performance Targets/Indicators	Data Sources/Reporting Mechanisms	Assumptions and Risks
Outputs **A. Immediate distortions removed to initiate structural transformation** 1. Targeted safety net programs designed and rolled out for the poor and vulnerable households	1. Proxy means-tested targeted safety net program coverage expanded to over 5 million households	Ministry of Finance	**Assumptions** • Government is committed to carrying out the policy reforms • Private sector dialogue is effective • Development partners support the program and there is close coordination • Financial stability **Risks** • Global food insecurity intensified • Political instability • External vulnerabilities • Policy coordination risks • Heightened security risks
2. Wheat subsidies reduced and eventually eliminated; wheat procurement made competitive	2. Market-based pricing for farmers and flour millers adopted by 2010	Ministry of Food, Agriculture, and Livestock	
3. Past liabilities during FY2008, including all power subsidies, settled and debt restructuring plan implemented	3. Electricity subsidy brought to zero by June 2010, and maintained at that level, except for lifeline tariffs[b]	Ministry of Water and Power and Ministry of Finance	
B. Financial intermediation strengthened to support structural transformation 4. Prudential regulation and supervision strengthened	4. New Banking Act enacted and implemented by 2009	SBP	
5. Autonomy and governance of the SBP strengthened	5. SBP Act enacted and implemented by 2009	SBP	
6. National payment systems strengthened	6. RTGS and online payments systems fully operational by 2010	SBP	
7. Consumer and depositor protection strengthened	7. Consumer Protection Law and Deposit Protection Law enacted and implemented by 2010	SBP	
C. National structural transformation strategies designed and implemented 8. National structural transformation strategy developed and implemented	8. Index of sophistication of exports increased from 4,500 in 2006 to 5,000 by 2011	Ministry of Industries	
9. Measures adopted to facilitate investments	9. Average number of days for customs clearance reduced from 33 days in 2006 to 15 days in 2011	Federal Board of Revenues and Ministry of Commerce	

Activities to be completed by 25 August 2008	Inputs
1.1.1. Safety net cover for up to 5 million poor households provided for through allocation of PRs41 billion in FY2009 budget[c] 1.1.2. Clear criteria developed for selecting beneficiaries of cash transfers through the Benazir Income Support Program 1.2.1. Time-bound action plan adopted by ECC for market-based pricing and reserve management[d] 1.2.2. Support price of wheat for farmers increased from PRs425/40kgs to PRs650/40kgs 1.3.1. Parliamentary approval obtained to reduce electricity subsidies through: (i) elimination of generalized sales tax subsidies for all domestic consumers and up to 500 units for commercial consumers; (ii) introduction of automatic monthly fuel price adjustments through a surcharge; and (iii) introduction of an additional surcharge to be levied on all consumers to reduce the gap between determined and notified tariffs. 1.3.2. Work on estimation of power sector debt overhang and circular debt initiated 1.3.3. All past electricity subsidy payments (PRs133 billion for FY2008) fully settled, and PRs88 billion allocated in the FY2009 budget to partially cover the difference between determined and notified tariffs (for FY2009) 2.1. Draft of a new Banking Act prepared by SBP, aligning it with international best practices 2.2. Higher minimum capital requirements for banks raised by SBP as part of Basel II implementation 2.3. Work on a 10-year financial sector strategy launched by SBP, to broaden and diversify financial markets while developing supportive financial safety nets, safeguards for consumer protection and effectively fighting against money laundering and financial crimes 2.4. Cabinet approval obtained for legislative amendments to enable SBP to better manage systemic risks by: (i) adopting a consolidated supervisory framework, allowing SBP to be the lead supervisor of financial groups and conglomerates[e] in compliance with Basel Core Principle 24; and (ii) transferring the licensing, regulation and supervision authority of deposit-taking institutions to SBP 2.5. Cabinet approval obtained for amendments to strengthen the anti-money laundering legal framework[f] incorporating international standards and best practices 2.6. Financial Monitoring Unit established and operationalized, with the SBP providing interim budget support and administrative oversight 2.7. SBP has launched work on a new Central Bank Act that provides for greater autonomy and accountability of SBP in its monetary and financial policies, effective regulation and supervision of financial institutions under its oversight, and clarity in the role of SBP in financial safety net and lender of last resort functions 2.8. Payments Systems and Electronic Funds Transfer Act (2007) enacted 2.9. Real-time gross settlement system launched 2.10. Centralized online system for retail payment systems established	• AETP loans: $500.00 million equivalent • AETP TA: $800,000 • TA Loan 2178-PAK Infrastructure Development (NTC study): $3 million • TA 7054-PAK Competitiveness and Structural Transformation: $350,000 • TA 4922-PAK Support to Governance Reform subproject, Strengthening Anti-Money Laundering Regime: $1.5 million • TA 4922-PAK Support to Governance Reform subproject, Strengthening Financial Sector Governance: $870,000 • TA 4922-PAK Support to Governance Reform subproject to strengthen the fiduciary governance of the targeted safety net programs for the poor and vulnerable, gradual elimination of wheat and energy subsidies, and restructuring of the electricity sector debt (for $900,000)

2.11. Consumer Protection Department established in SBP and work launched on a Consumer Protection Law 2.12. Concept paper and draft Law on Deposit Protection Scheme prepared and consultations launched with stakeholders 3.1. High-level steering committee[g] established (reporting to the prime minister/the cabinet) to lead work on Pakistan's structural transformation 3.2. All preparatory steps finalized for the studies on structural transformation 3.3. Automobile Industry Development Program adopted (to accelerate the share of this segment from 2.8% of GDP in FY2006 to 5.6% by FY2012) 3.3. Risk-based customs inspection introduced and an e-filing and payments systems adopted for customs and sales tax	

AETP = Accelerating Economic Transformation Program; ECC = Economic Coordination Committee; FY = fiscal year; GDP = gross domestic product; NTC = National Trade Corridor; PRs = Pakistan rupees; SBP = State Bank of Pakistan; TA = technical assistance

[a] The top five most sophisticated manufacturing products were (i) fabrics, woven of continuous synthetic fibers; (ii) medical instruments and apparatus excluding electro medical; (iii) other outdoor sports materials; (iv) fabrics, woven of discontinuous synthetic fibers; (v) stockings, knitted or crocheted, not elastic.

[b] Lifeline tariffs provide a minimum amount of electricity to the poor at lower cost, often below the cost of supply.

[c] Through expansion and strengthening of the Bait-ul-Mal Food Support Program and establishment of the new Benazir Income Support Program.

[d] The action plan will address (i) elimination of wheat subsidies through the support price of wheat for farmers; (ii) elimination of operational reserves while maintaining strategic reserves at 2 months of annual average national consumption requirements by June 2010; (iii) removal of administrative restrictions on domestic wheat trade; (iv) completion of restructuring of PASSCO and the provincial food departments and directorates; (v) implementation of a targeted safety net program for poor and vulnerable households; and (vi) divestment of government ownership in unused warehouses, storage facilities and other market infrastructure. The action plan shall be implemented over the period between subprograms 1 and 3.

[e] A financial conglomerate includes any group of legal entities whose exclusive or predominant activities is banking and at least one other activity in the financial sector.

[f] Among other things, the amendments will (i) provide for a single national committee to oversee and provide policy guidance for AML efforts, instead of two committees, as at present; (ii) ensure the financial and operational autonomy of the Financial Monitoring Unit (FMU); (iii) provide that the FMU shall act as the secretariat for the national committee; and (iv) set out transparent criteria for the appointment and dismissal of the head of FMU.

[g] The steering committee's deliberations and strategy formulation will be supported by ADB TA on growth diagnostics and structural transformation, and the business investment potential of the National Trade Corridor.

PAKISTAN: FISCAL NOTE

1. **Summary of the Fiscal Situation**: At the heart of Pakistan's unstable macroeconomic situation today is a looming fiscal imbalance. The fiscal deterioration during fiscal year 2007/08 has been serious enough for then incumbent (now resigned) Finance Minister to announce in a press conference after taking over that the fiscal deficit could rise to 10% of GDP if no mitigating measures were taken. The Government has since then taken a few measures to restrain the blooming imbalance through allowing a steady (but insufficient) rise in domestic oil prices since 1 March, undertaking a small adjustment in the electricity tariff, cutting down of the Public Sector Development Program (PSDP), and freezing of supplementary grants to government departments. Based on the provisional figures for the fiscal year 2007/08, the fiscal deficit rose to 6.5% of GDP, thus breaching the 4% of GDP fiscal deficit ceiling mandated under the Fiscal Responsibility Act of 2005. The Government continued to run a revenue deficit whereas it had committed in the Act to eliminate this deficit by the 2007/08 fiscal year. The fiscal situation, if not addressed, will have a profound impact on overall macroeconomic stability and growth prospects of the country. This Note summarizes the key aspects of the fiscal challenge and explains underlying reasons for the recent deterioration.

2. **Contextualizing the Fiscal Position**: Having run unsustainable fiscal deficits in the range of 6-7% in the late 1990s, the Government undertook stabilization measures to contain expenditure and improve revenues supported initially by a Poverty Reduction and Growth Facility (PRGF) of the IMF approved in 2001. Large capital inflows in the post September 11, 2001 situation provided additional space to the Government to consolidate and improve its internal fiscal balance while maintaining robust levels of development spending. By 2003/04, the fiscal deficit had come down to 2.4% of GDP. The deficit rose to 4.3% of GDP in 2005/06 contributed by additional public spending on relief and rehabilitation in the aftermath of the October 2005 earthquake, higher subsidy on account of the rise in international oil prices, and rising development expenditure. This level of deficit was maintained in fiscal year 2006/07 on account of a precipitous increase in interest payments and continued expansion in development expenditure. The deficit jumped to 6.5% of GDP in 2007/08 as total expenditure rose sharply to 21.3% of GDP, underpinned by an increase in current expenditure to 17.5% of GDP. Total revenues on the other hand fell to 14.7% of GDP in 2007/08 from 14.9% in 2006/07, while the tax to GDP ratio stagnated at 10.1% of GDP (Table 1).

Table 1: Summary of Fiscal Position (% of GDP)

	2004/05	2005/06	2006/07	2007/08*
Total Revenue	**13.8**	**14.2**	**14.9**	**14.7**
Tax Revenue	10.1	10.6	10.2	10.1
Non-tax Revenue	3.7	3.6	4.7	4.6
Total Expenditure	**17.2**	**18.5**	**19.2**	**21.3**
Current Expenditure	13.3	13.6	14.9	17.5
Development Expenditure	3.9	4.8	4.9	3.8
Fiscal Deficit	**3.3**	**4.3**	**4.3**	**6.5**

Source: Economic Affair's Wing, Finance Division, Government of Pakistan. 2008. *Pakistan Economic Survey 2007-08.* Islamabad.

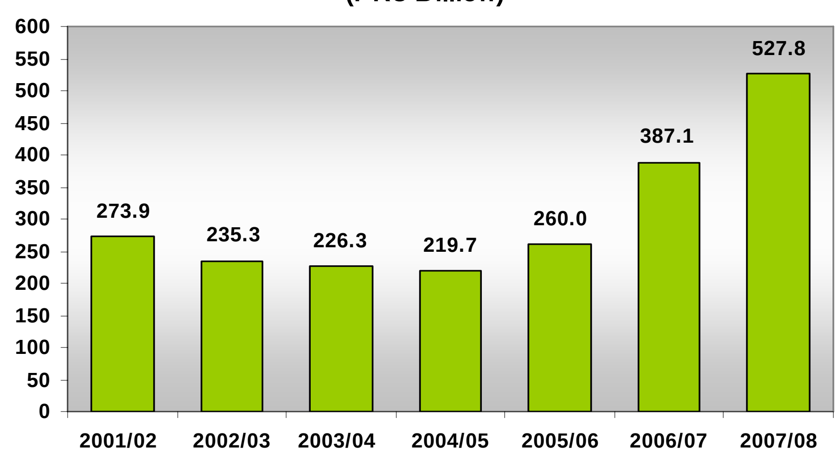
* Provisional

3. **What Explains the Recent Fiscal Deterioration?** The fiscal deficit in fiscal year 2007/08 shot up to 6.5% of GDP from 4.3% of GDP in the previous period, exceeding the targeted deficit of 4% of GDP for the year in a major way. In absolute terms, the fiscal deficit in 2007/08 was 81% more than the corresponding deficit in the last fiscal year. Why has this happened? In a nutshell, there has been a major overrun of public expenditure that has

outpaced a significantly decelerated revenue collection. The fiscal issue, therefore, is both on the expenditure and the revenue side. To start from the expenditure side, there are three key factors explaining the high overrun: large increase in interest payments; bloated oil, energy, and food subsidies; and rising development expenditure.

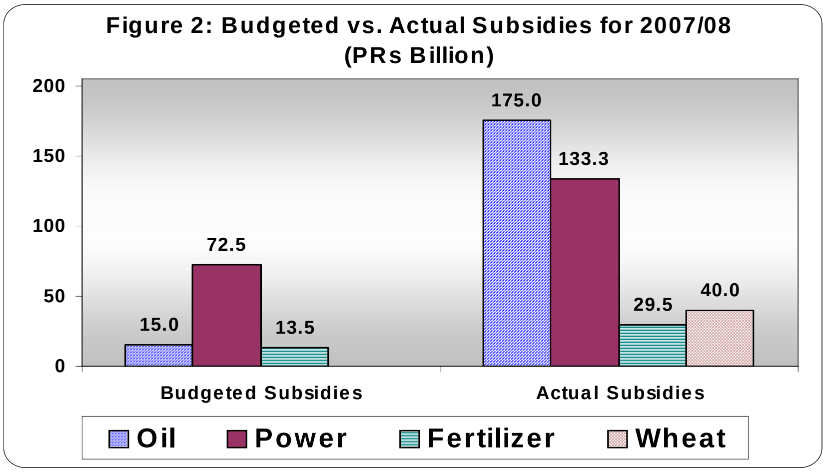
3.1 **Large Increase in Interest Payments:** Having witnessed modest growth in recent years following consolidation of the total debt situation, interest payments on public debt leaped by almost 49% during 2006/07 on the back of lumpy payments made on maturing high interest bearing Defense Saving Certificates (DSCs) issued by the Government in the late 1990s (Figure 1). In fiscal year 2007/08, interest payments continued their upward rise to reach PRs528 billion – surpassing the budgeted amount by a significant margin of 21%. The lumpy interest payments will continue for the next two fiscal years and will continue to put pressure on the budget. Aside from the issue of lumpy DSCs, interest payments remained high on account of the growing level of absolute debt, both domestic and foreign, that increased by over 10% in 2006/07 and another 16% by end March 2007/08, as a result of the large fiscal and current deficits.

Figure 1: Interest Payments (PRs Billion)



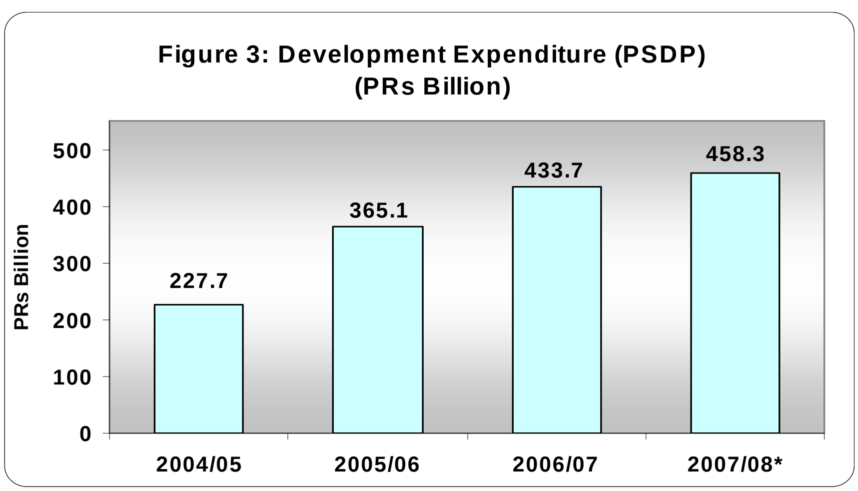
Source: Economic Affair's Wing, Finance Division, Government of Pakistan. 2008. *Pakistan Economic Survey 2007-08.* Islamabad.

3.2 **Bloated Oil, Energy, and Food Subsidies:** Subsidies included in the federal budget for 2007/08 have been sharply exceeded and the actual total subsidy level is significantly above the budgeted amount. Altogether the total subsidy level in 2007/08 touched PRs407.5 billion—almost four times more than the budgeted subsidy level of PRs113.9 billion (Figure 2). The major subsidy heads are four: oil, power, wheat, and fertilizer. The unprecedented increase in international oil prices resulted in an actual subsidy of PRs175 billion – far above the PRs15 billion subsidy provided for this head in the budget. The power subsidy arising from the tariff differential and other heads likewise rose to PRs133.3 billion –against the PRs72.5 billion subsidy in the budget. The wheat subsidy on imported wheat and that supplied at concessional rates through the Utility Stores Corporation was in the range of PRs40 billion whereas no provision had been made for this in the budget. The revised actual fertilizer subsidy of PRs29.5 billion is PRs16 billion more than the budgeted amount.



Sources: Government of Pakistan, Finance Division 2007. *Federal Budget in Brief 2007/08*. Islamabad.
Government of Pakistan, Finance Division 2008. *Federal Budget in Brief 2007/08*. Islamabad.

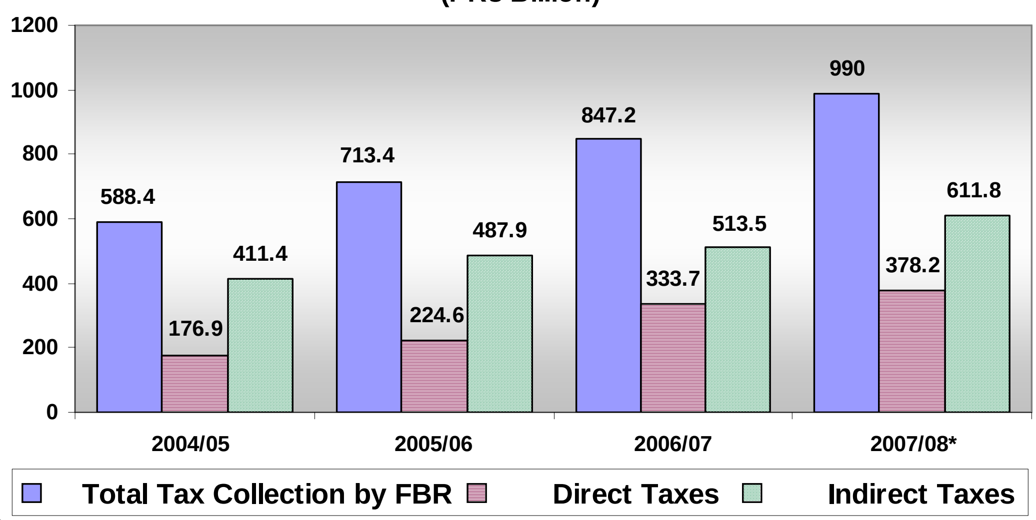
3.3 **Rising Development Expenditure**: Development expenditure has increased consistently in recent years, more than twofold as percentage of GDP from 2.2% in 2002/03 to 4.9% in 2006/07. In absolute terms, development expenditure in 2006/07 was about 19% higher than the previous fiscal year (Figure 3). At the start of fiscal year 2007/08, being an election year, a record PSDP of PRs520 billion was announced in the budget that was 20% higher than the actual development expenditure in 2006/07. With the fiscal pressure imposed by interest payments and rising subsidies, the PSDP was subsequently reprioritized to concentrate on fast moving projects and financing for projects that had not yet been started was suspended. As a result, the size of the PSDP came down by about PRs62 billion in 2007/08. Going forward, the PSDP will need to be maintained at a level that is consistent with the overall fiscal position of the Government and availability of external financing. In the current tight fiscal environment un-helped by the high and rising subsidies, protecting spending for important infrastructure and social sector projects has become a key challenge.



Source: Economic Affair's Wing, Finance Division, Government of Pakistan. 2008. *Pakistan Economic Survey 2007-08.* Islamabad.

3.4 **Tax Revenue Slippages:** In 2006/07**,** on the back of strong direct tax collections that grew by 49%**,** there was a 19% increase in total tax collection by the Federal Board of Revenue (FBR) over the level of the last fiscal year (Figure 4). But the tax performance in 2007/08 was affected by the slowing down of economic activity and the FBR tax revenue target of PRs1.025 trillion, 21% higher than last year, was missed by PRs25 billion. Total tax collection by FBR grew by 16.9% in 2007/08 as direct tax collection slowed, compared to its level last year, but still grew at a rate of 13.4% over the previous fiscal year. But, as percentage of GDP the total tax collection by FBR[1] fell to 9.4% in 2007/08 from 9.7% in 2006/07. Contributing to this jaded tax performance is a decline in corporate profitability and political disturbances and the law and order situation resulting in closing down of businesses on several occasions in the latter half of 2007 in major cities. Total tax revenues consequently stagnated as percentage of GDP at 10.1% in 2007/08 and 10.2% in 2006/07.[2]

Figure 4: Tax Revenue - Federal Board of Revenue (FBR) (PRs Billion)



* Provisional

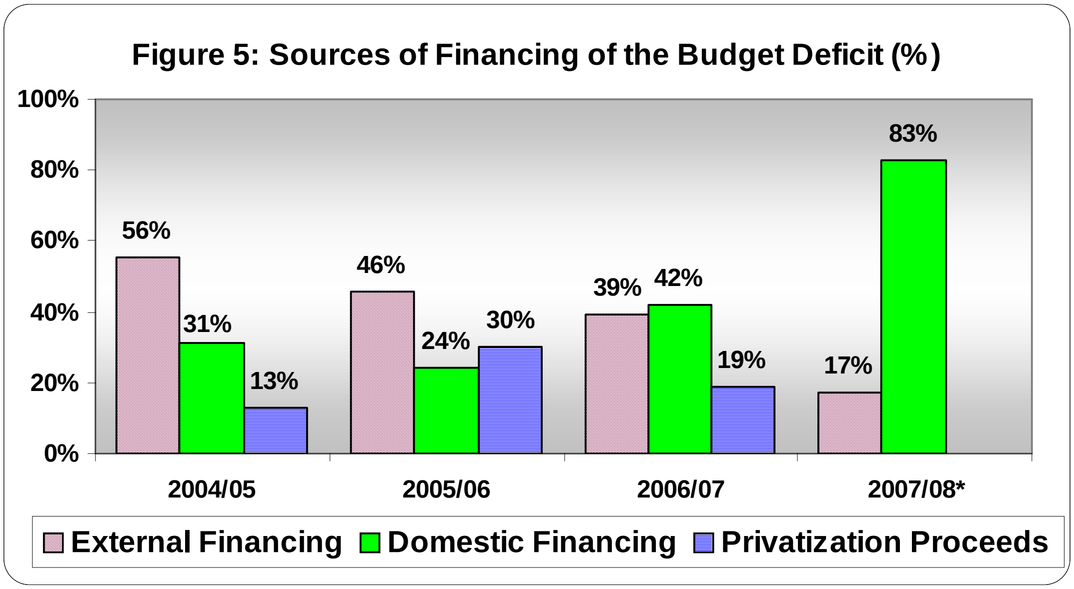
Source: Economic Affair's Wing, Finance Division, Government of Pakistan. 2008. *Pakistan Economic Survey 2007-08.* Islamabad.

4. **Financing of the Fiscal Deficit:** Large external capital inflows between 2004/05 and 2006/07 financed a significant part (47% on average) of the fiscal deficit (Figure 5). These inflows allowed the Government to contain its reliance on the domestic banking system and non-bank sources for financing of the deficit. However, external inflows slowed down significantly and financed only 17% of the fiscal deficit in 2007/08. The result was that the Government's dependence on the banking system[3] increased dramatically to finance 83% of the deficit, of which major chunk was borrowed from the State Bank of Pakistan (SBP).

[1] Provincial governments' collected taxes and surcharges on gas and oil are not included in the tax collected by Federal Board of Revenue (FBR).

[2] Total federal Government's tax revenue includes tax collection by FBR, provincial governments' collected taxes and surcharges on oil and gas.

[3] From 1 July 2007 to 14 June 2008, Government sector borrowing for budgetary support from State Bank of Pakistan increased to PRs652 billion, whereas, the scheduled banks owed PRs179 billion to the Government on the specified date. Therefore, net Government sector borrowing for budgetary support from the banking system was at PRs473.1 billion compared to only PRs163.2 billion in the same period last year.



Source: Economic Affair's Wing, Finance Division, Government of Pakistan. 2008. *Pakistan Economic Survey 2007-08.* Islamabad.

5. **Economy Wide Impacts of the Fiscal Imbalance**: Unabated public borrowing from the banking system could ultimately also crowd out part of private sector credit and hurt private investment and growth. Public sector investment is already going down as manifested in the slashing of the PSDP on account of the squeezed fiscal space –this will also impact private investment and growth. The fiscal deficit is also main reason behind a rapid accumulation of debt. As mentioned before, domestic debt grew by 15.8% in the first nine months of 2007/08 compared to an average growth of 9.5% in past three years. At end March 2008, foreign debt also increased by 17.2% compared to a 7% average in the past three years.

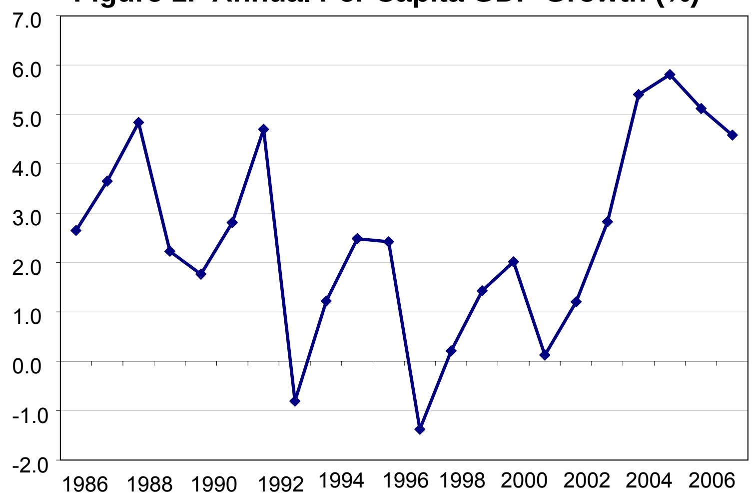
6. **Concluding Remarks:** Pakistan's fiscal problems in 2007/08 are predicated not only on rising expenditures but also on stagnating revenues. A strategy to improve the fiscal situation will thus need to rest not only on expenditure containment but also concrete steps to strengthen revenue mobilization. On the expenditure side, leaving aside the non-discretionary interest payments, the Government needs to make a strategic resource allocation decision regarding the extent to which it wants to continue to allow expenditure on subsidies to erode and crowd out the PSDP. The level of subsidy this fiscal year is approximating the (now curtailed) size of the PSDP and this has implications for public investment for strategic development projects at the federal and provincial government levels. On the revenue side, serious efforts are required to enhance the tax base and bring the agriculture and services sectors in the tax net while eliminating ad-hoc tax exemptions and rationalizing the burden of taxes on the manufacturing sector. The experience of the current year with falling capital inflows that has complicated the financing of the deficit only serves to bring in the limelight the challenge and need for raising domestic revenues.

ECONOMIC TRANSFORMATION IN PAKISTAN – WHAT IS IT AND WHY IS IT NEEDED?

I. Macroeconomic situation

1. Pakistan has registered an average growth rate of 5.5% during 1960-2007. However, in per capita terms, and due its relatively high population growth, Pakistan's performance has been less successful, and between the mid 1980s and the early 2000s, the country's per capita growth rate showed a marked downward trend (Figure 1). Since 2001, however, this trend has shifted and it has improved substantially. Policy makers' objective is to maintain this good performance in the medium term.

Figure 1. Annual Per Capita GDP Growth (%)



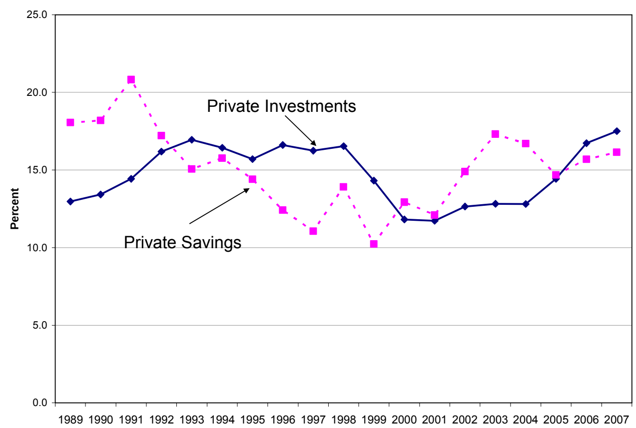
GDP = gross domestic product
Source: *World Development Indicators*. World Bank online database, 30 April 08.

2. Achieving this objective, however, is not easy, as the economy faces two problems. One refers to the recent macroeconomic performance. During the last few years, there has been an accelerating erosion of the country's macroeconomic stability. Growth has relied on expansionary private and fiscal sectors and a contractionary external sector. This makes the current growth model unsustainable. The second problem refers to the underlying path of structural transformation of the economy. It is such that it is very difficult to transit to a higher and sustainable growth path along the lines of the successful East and Southeast Asian economies. Nevertheless, while challenging, the situation is not irretrievable.

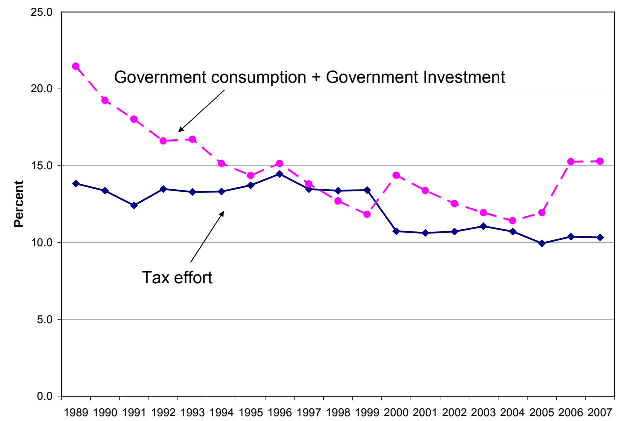
3. The past three years have been beset by deficits in the private, public and external sectors. Figure 2 shows these macroeconomic imbalances. In the private sector, private savings have been unable to keep up with growing private investment during the recent high growth years. In the government sector, the tax revenue effort has stagnated and deteriorated as government (both current and investment) spending has increased, partly spurring the current high growth. This has led to a serious fiscal deficit problem. These two deficits naturally have led to large external current account deficits. Indeed, exports plus net factor income from abroad (the latter made up mostly of remittances from overseas workers less foreign debt interest payments) have fallen as percent of GNP in recent years as imports have increased substantially due to the country's high growth.

Figure 2. Macroeconomic imbalances (% of GNP)

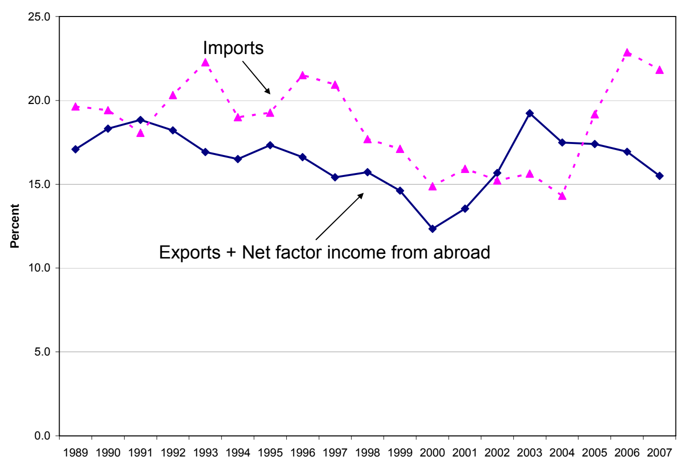
2.A. Private savings and investment



2.B. Tax efforts and government expenditure



2.C. (Exports + NFIA) and Imports



Source: ADB. 2007. *Key Indicators 2007*. Manila.

4. This analysis indicates that Pakistan's main macro challenges in the short to medium term are:

(i) To reduce the fiscal deficit by rationalizing spending and increasing the tax effort (rather than cutting vital public expenditures in social and economic services). Efforts must be directed toward reorienting poorly targeted subsidies and bloated public sector expenditures, and raising revenues by broadening the tax base meaningfully. This will free fiscal resources.

(ii) To reduce the growing and large current account deficit. Ideally, this should be done by increasing exports (in particular their quality) and by reducing non-essential/luxury consumer imports. It is also hoped that the financing of the significant current account deficit will rely in the future less on volatile 'hot money' (portfolio flows) and loans, and more on foreign direct investment and productive grants/aid;

(iii) To increase private savings so that they finance to a larger extent private investment. Private savings will only grow if income per capita grows significantly, and if the share of consumption (about 70% of GDP) declines.

II. The Need to Industrialize

1. Why?

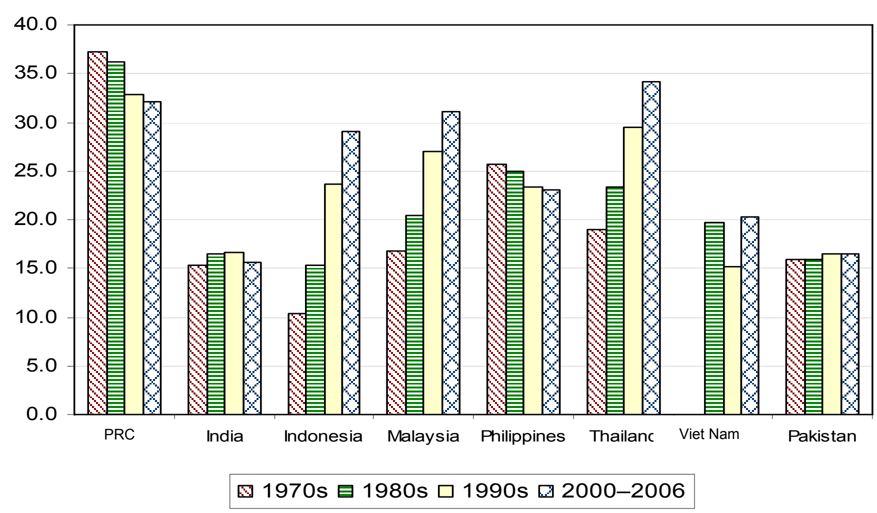
5. In the medium to long-term macroeconomic stability is a necessary, but certainly not a sufficient condition, for a country's development. The latter consists in the upgrading and diversification of the production and export structures. Only the countries that succeed in this endeavor manage to achieve high and sustainable growth rates, and ultimately develop.

6. The development literature is filled with empirical evidence and examples that show that successful development in a country like Pakistan entails passing through different stages, where the essence is the transfer of resources from the less productive sectors of the economy (agriculture in general) to the more productive sectors (industry and services in general). At one point, manufacturing (and industry in general) must take the lead in the growth process, as this sector is characterized by increasing returns to scale. Likewise, development is accompanied by technological and scale upgrading of the products produced in the economy, especially in the manufacturing sector (as the successes of People's Republic of China [PRC], Japan, the Republic of Korea and Taipei,China the show). Finally, the literature also shows that the successful countries enter a phase of fast export growth during which they manage to upgrade their export structures significantly.

2. Low industrialization and technological upgrading in Pakistan

7. Despite Pakistan's relatively good growth record over the last decades, its industrialization achievement lags significantly behind that of other countries, especially those in East and Southeast Asia. Pakistan's manufacturing output share in GDP is much lower than that of PRC, Indonesia, Malaysia, the Philippines, Thailand and Viet Nam. Moreover, the size of this sector has barely changed in decades (during the last few years it has increased and it is already close to 20%) (Figure 3).

Figure 3. Manufacturing Output Share (% of GDP)

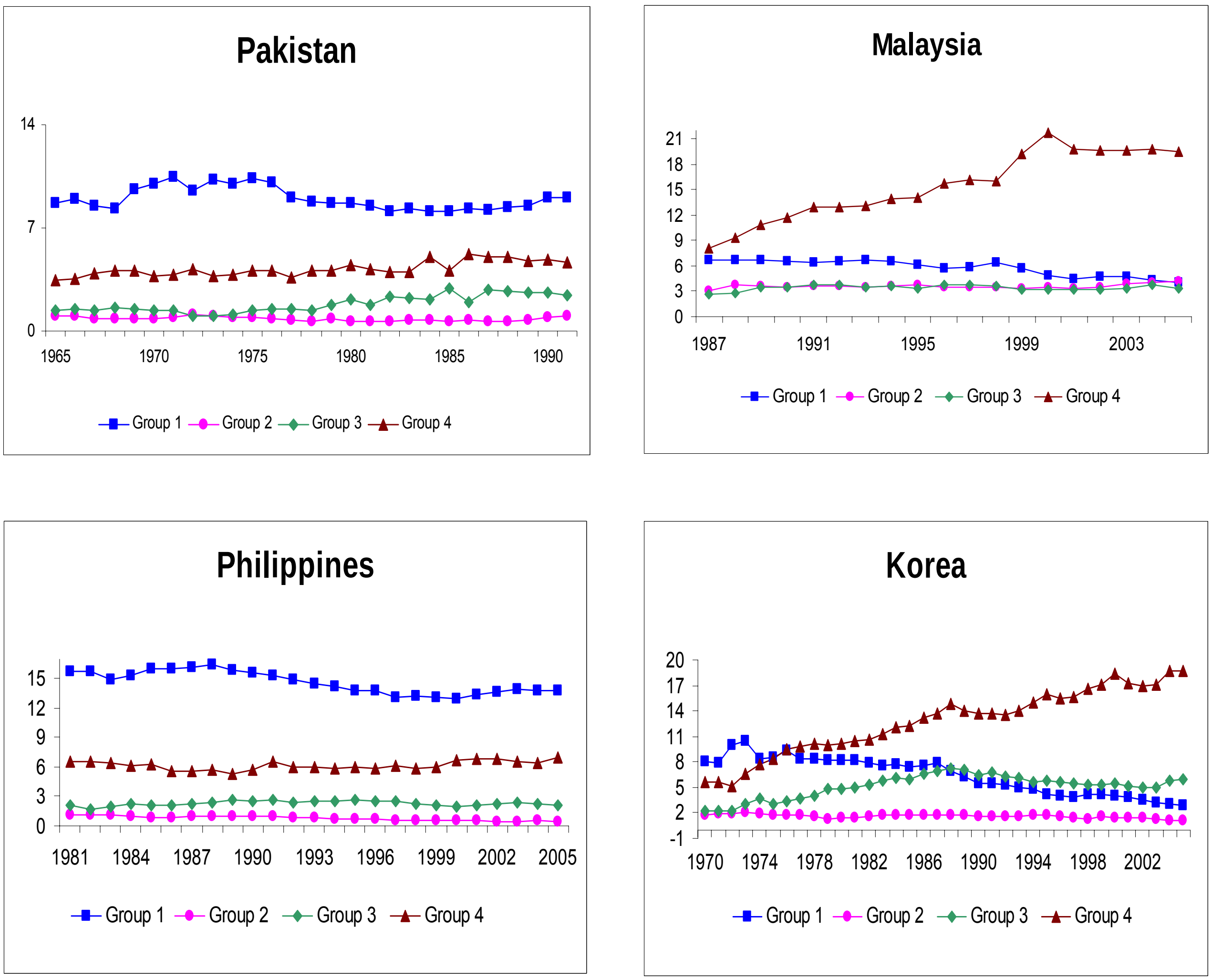


GDP = gross domestic product; PRC = People's Republic of China
Source: *World Development Indicators.* World Bank online database, 30 April 2008.

8. In terms of technology and scale, Pakistan's manufacturing is still dominated by products at the lower end (in terms of technology level) of the spectrum. Figure 4 provides the shares in

GDP of the different manufacturing branches. The have been divided into four groups, from the lowest technology and scale level to the highest: group 1 consists of those branches with the lowest technology and scale level, e.g., food and beverages, footwear, furniture; group 2 consists of plastic, rubber, etc.; group 3 consists of glass products, iron and steel, etc.; and group 4 electrical and non-electrical machinery and transport equipment. The Figure shows that Pakistan's manufacturing sector is still dominated by products that belong to group 1, unlike Korea and Malaysia whose manufacturing sectors are dominated by high-tech and scale products (group 4). In the case of Pakistan, group 4 takes only about 5% of GDP.

Figure 4. Shares of manufacturing groups in GDP based on technology and scale (%)



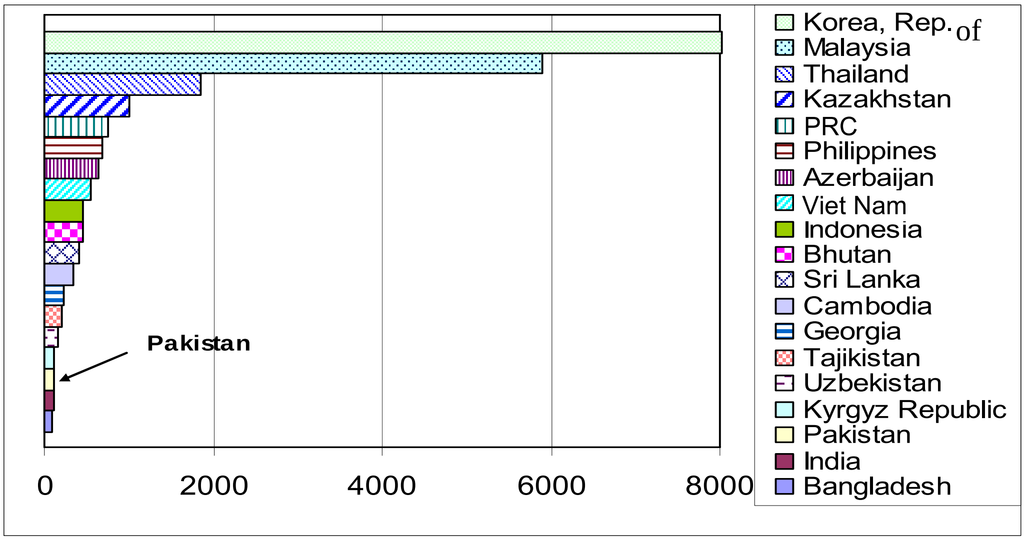
Source: Staff estimates

9. Summing up, Figures 3 and 4 above indicate that Pakistan's manufacturing sector is significantly smaller than that of the successful Southeast Asian countries and that it needs substantial product upgrading.

3. Low export performance and sophistication

10. Pakistan's export performance also lags behind. Its exports per capita are very low, about $110 (Figure 5), and even correcting for income per capita, the country's exports per capita are smaller than what "they should be."

Figure 5. Exports Per Capita in 2006, Various Asian Countries (US Dollar)



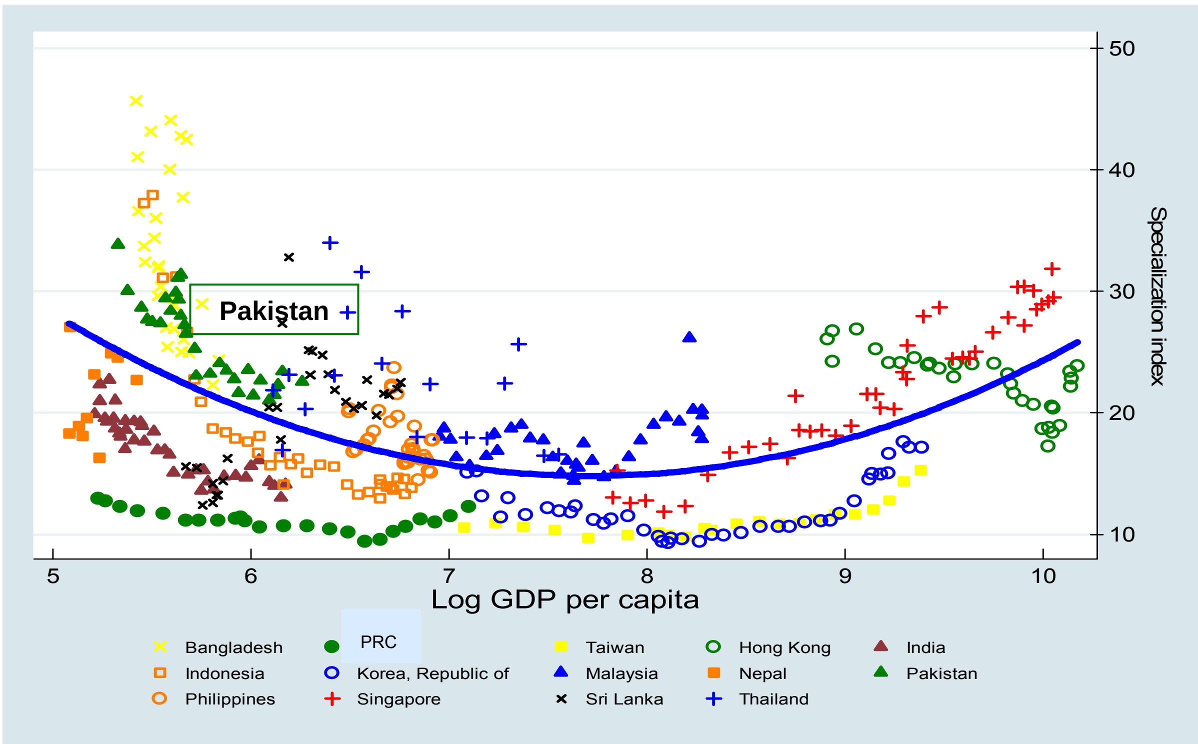
PRC = People's Republic of China
Source: *World Development Indicators*. World Bank online database, 30 April 2008.

11. As noted above, Pakistan's manufacturing structure is tilted toward low technology and scale products. Given this, it is likely that the manufacturing structure will also be skewed toward the same type of products. The question is whether it is possible for countries like Pakistan to move up in the development ladder. Standard trade theory seems to imply that indeed it is possible. This theory explains trade and production structures of a country based on its relative endowments of physical and human capital, labor, and natural resources, plus the quality of institutions. These variables determine countries' relative costs and the specialization pattern. An implication of comparative advantage is specialization. It is a country's specialization in the products in which it has comparative advantages what raises the productivity of the economy. In the standard theory, changes in the export basket are regarded as a passive consequence of changing factor endowments, and, therefore, any attempt to reshape the production pattern beyond the one set by the factor endowments is likely to fail and, even, to impede growth.

12. However, recent research examining the patterns of sectoral concentration and diversification in a cross-section of countries finds a statistically robust U-shaped relationship between specialization and per capita GDP. It is found that as poor countries get richer, sectoral production becomes more diversified. This diversification process continues until relatively late in the development process, and, only after a country's income level reaches a threshold level, production patterns start to become more concentrated. The intuition behind this idea is that for countries to be able to manufacture advanced products, they must have mastered the production of a relatively wide range of other products. This learning process provides them with the necessary capabilities (e.g., production knowledge). This finding has a significant implication for the development strategy for poor countries, since it suggests that economic diversification

should stand at the center of their development strategy. Figure 6 shows the specialization index and per capita GDP of 14 Asian countries. Given its income level, Pakistan is still in the diversification stage and far below the threshold income level where countries' production structures start concentrating. For Pakistan, economic diversification is needed to bring the economy to a higher income level.

Figure 6. Specialization Index of Developing Countries: Manufacturing Value Added



GDP = gross domestic product; PRC = People's Republic of China
Source: Staff estimates.

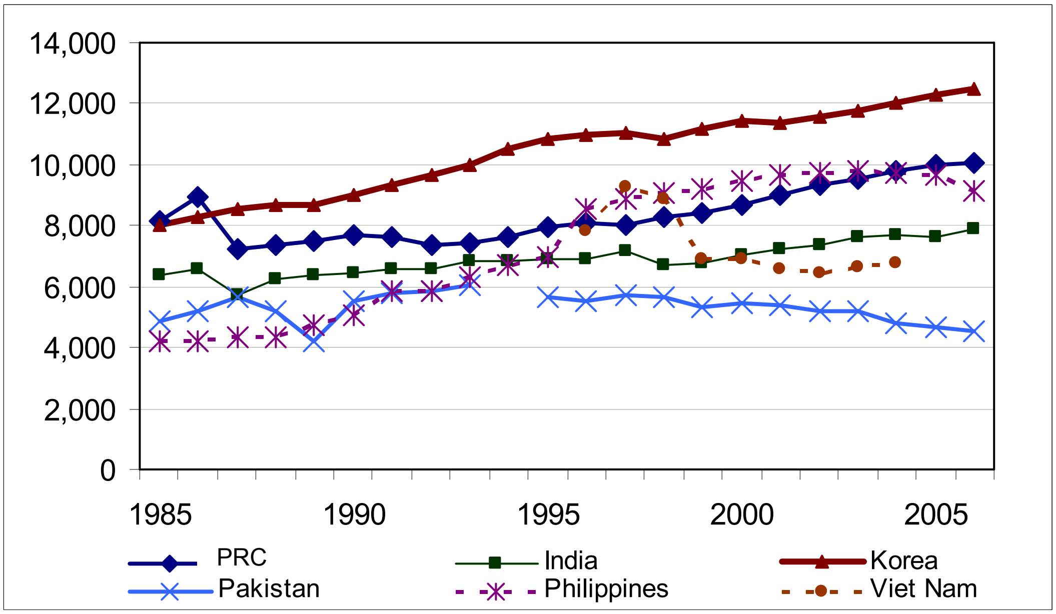
13. This finding has led to the development of a new dynamic theory of trade by focusing on the idiosyncratic elements of specialization patterns. A key argument is that not all goods are alike in terms of their consequences for economic growth performance; and that the current export composition of a country can determine subsequent growth of that country. Specializing in some products will bring higher growth than specializing in others.

14. To show that some traded goods are associated with higher productivity levels than others and that countries exporting higher productivity goods can perform better, we constructed a quantitative index or export commodity score, denoted *PRODY*, that ranks traded goods in terms of their implied productivity. *PRODY* is constructed as a weighted average of the per capita GDPs of the countries that export a product. In the second step, we construct the income/productivity level that corresponds to a country's export basket, denoted *EXPY*, by calculating the export-weighted average of the different *PRODY* of that country. *EXPY* shows the implicit level of sophistication of a country's exports.

15. Figure 7 shows the evolution of EXPY for a group of countries, including Pakistan. The results clearly show that Pakistan's *EXPY* has not improved, and the value has even decreased

since the mid 1990s. Overall, it remains low compared with those of the other countries. For example, India's *EXPY* in 1985 was 32 percent higher than Pakistan's; by 2006 it was 74 percent higher. This means that Pakistan is stuck into the export of products being exported by poor countries.

Figure 7. Export Sophistication: Pakistan and Other Asian Countries



PRC = People's Republic of China
Source: Staff estimates.

16. Why has the sophistication of Pakistan's export basket stagnated? This can be seen by analyzing the *PRODY* measure. Table 1 ranks exports (products with a share of at least 1% in the export share) at the SITC 5-digit level according to *PRODY* in 2005, and shows the share of these products in total exports. The table shows the top 17 exports (according to *PRODY*), which account for over four fifths of total exports. Pakistan's exports are heavily concentrated on garments and textiles. The highest *PRODY* is in "Fabrics, woven of continuous synthetic fibres" with a value of 16,060. This value is approximately in the middle of the *PRODY* scale. The highest *PRODY* value, at 31,288, corresponds to "weighing machinery" (obviously produced by developed countries). Pakistan does not export (in many cases the share is literally zero) products with a *PRODY* above 16,000. However, if one takes into account Pakistan's level of development, this is quite an acceptable degree of export sophistication. The problem is that after the share of "Fabrics, woven…." peaked at about 10-11% in 1990 and 1995, it declined to 2.09% in 2005. On the other hand, the share of "Linens and other furnishing art. Of textile, Other cotton fabrics, woven, bleached, dyed, etc." in total exports, with a much lower PRODY value of 3,604 in 2005, increased from 11% in 1982 to 23% in 2005-2006. In other words, Pakistan has moved into the low end textile and garment products, and this explains the overall low value of *EXPY*.

Table 1: Pakistan's Exports Ranked by PRODY (SITC 5-digit level) and Share (%) in Total Exports

Commodity	PRODY	PRODY (%) in 2005	1982	1985	1990	1995	2000	2005	2006
Fabrics,woven of continuous synthetic fibres	16060	7.2	0.10	3.06	10.11	11.33	8.88	2.09	1.15
Medical instruments & app.exc.electro medical	14254	5.3	2.49	4.06	2.80	2.44	2.10	1.72	1.51
Other requisites for outdoor sports	10476	6.3	3.50	3.81	3.83	4.24	3.71	2.77	2.80
Fabrics, woven of discontinuous synthetic fibres	6142	0.3	0.19	0.01	0.00	0.01	0.01	0.23	1.72
Stockings, etc., knitted or crocheted not elast.	5662	1.9	0.00	0.00	0.73	1.85	0.77	1.58	2.01
Other made up textile articles, n.e.s.	5348	2.9	0.90	1.44	0.58	0.45	1.07	2.50	2.28
Womens, girls & infts outer garmts, not knitted	3884	3.1	4.84	6.50	6.27	3.69	3.05	3.66	4.22
Mens and boys outer garments, not knitted	3772	5.4	2.30	2.88	4.47	5.02	7.26	6.61	6.52
Outer garments knitted, not elast. Nor rubber	3670	6.2	0.72	0.95	7.03	6.77	8.29	7.88	8.89
Under garments knitted, not elast. Nor rubber	3632	6.7	2.29	2.74	5.19	8.22	9.19	8.52	9.62
Linens and other furnishing art. Of textile	3604	18.5	11.28	14.58	12.68	12.11	18.56	23.84	23.10
Other cotton fabrics, woven, bleached, dyed, etc	3116	9.0	16.28	14.81	11.30	11.79	10.73	13.48	12.03
Men's/boy's under garments, not knitted/crochet.	3003	0.8	3.04	3.84	4.62	3.77	2.74	1.21	0.90
Flour of wheat or of meslin	2410	0.5				0.00	0.09	0.98	1.10
Other cotton fabrics ,woven unbleached	2284	3.3	14.79	13.80	10.11	11.57	7.69	6.65	6.76
Leather of sheep and lamb skins	718	0.0	2.48	2.62	1.14	0.62	0.32	0.26	0.23
Leather of goat and kid skins	460	0.1	5.37	5.52	4.05	2.68	1.39	1.10	1.13
	Total	77.5	70.55	80.63	84.91	86.59	85.86	85.08	85.97
	EXPY	4643.9	4642	4864	5539	5681	5441	4644	4536

Note: The second column provides the percentage contribution in 2006 of the *PRODY's* score of each product to Pakistan's *EXPY*.

4. Product space

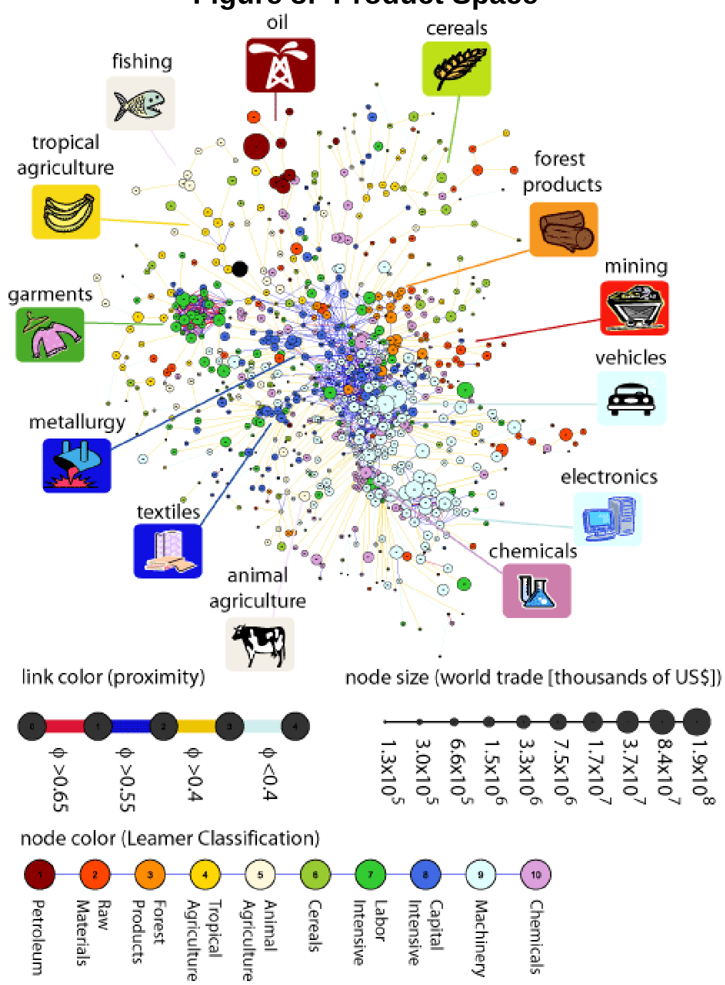
17. Given the analysis of Pakistan's exports, the next question should be: can Pakistan upgrade its exports? Producing new goods is quite different from producing more of the same good. Each product involves highly specific inputs such as knowledge, physical assets, intermediate inputs, labor training, infrastructure, property rights, regulatory regimes, and so on. The exact set of assets and capabilities required is unique for each product, but this set can be an imperfect substitute for the set of capabilities needed to produce another good. To every pair of goods, there is an associated notion of "distance between them": if the goods require highly similar inputs and endowments, then they are said to be 'closer'; but if the products require

totally different capabilities, then they are said to be 'farther' apart. The probability that a country will develop the ability to produce one good is related to its installed capabilities in the production of similar products for which the currently available capabilities can be easily applied and transferred.

18. Given the varying degree of specific assets between products, the speed of structural transformation depends on the density of the "product space" (i.e., the range of products being produced) near the area where each country has developed its productive capabilities. This means that the country's current production structure can determine future productivity of the economy. If the specific capabilities used in the production of a country's basket can be applied to the production of products with higher productivity, then the country can easily diversify by shifting to rich-country products. Thus, the structural transformation of a country is path-dependent, and, hence, justifies government interventions in shaping the production structure for the future development of the economy.

19. By using a network representation methodology, it is possible to construct the *product space* in which node size represents world trade, node color shows the product classification and link color indicates a range in the proximity values (Figure 8).

Figure 8: Product Space



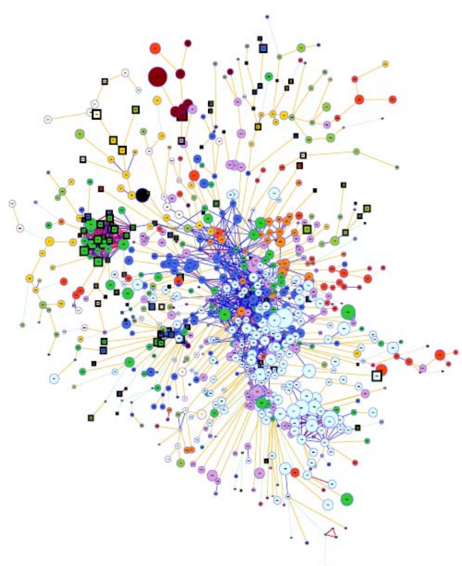
Source: Hidalgo, C., B. Klinger, A-L. Barabasi, and R. Hausmann. 2007. "*The Product Space Conditions the Development of Nations*." *Science* 317: 482-87.

20. Given the product space, which is common for all countries, one can analyze how the specialization pattern of a country can be changed over time. Products exported by a country with a revealed comparative advantage greater than unity are shown with squares (■). Comparing changes of positions of the squares in the product space, we can analyze how the production structure or specialization pattern of a country has been evolved. Figure 9 shows the product space for Pakistan, Malaysia, PRC, and India in 1985 and 2000.

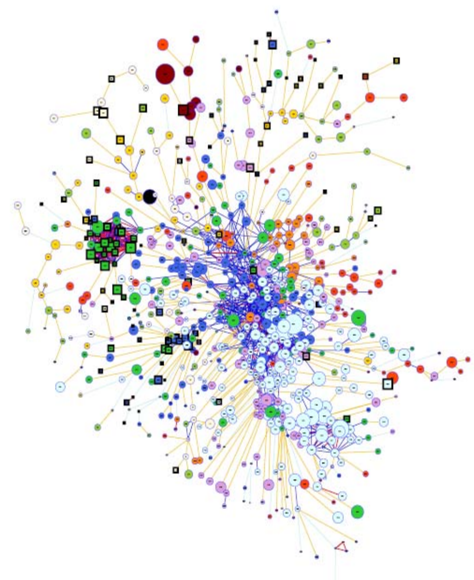
Figure 9. Production Structure in 1985 and 2000
Pakistan, Malaysia, People's Republic of China, and India

Pakistan

1985

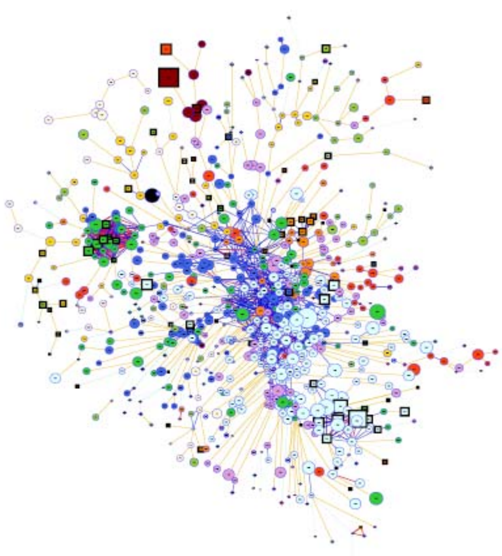


2000



Malaysia

1985



2000

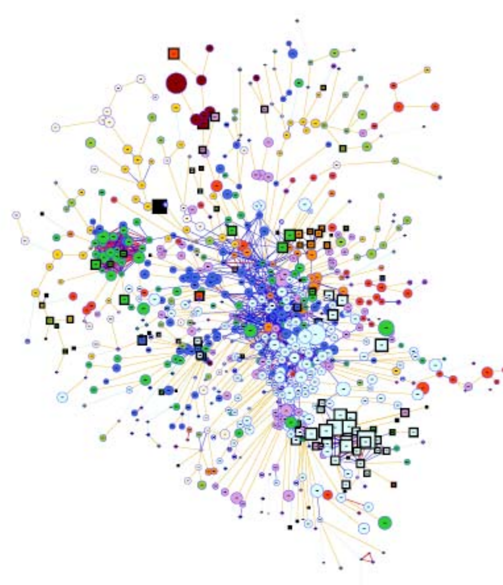
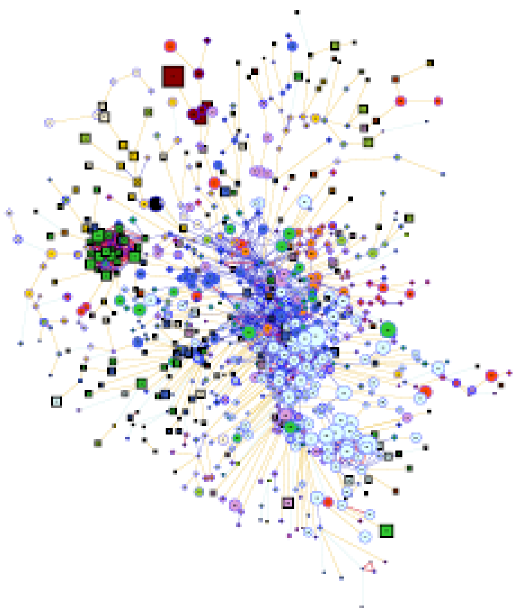


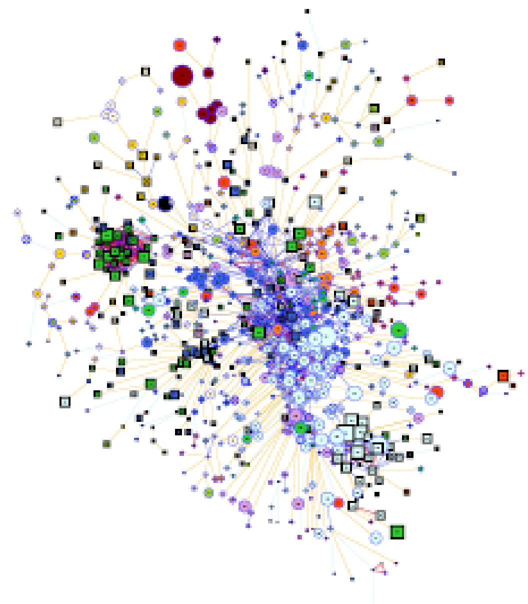
Figure 10. Specialization Patterns in 1985 and 2000

<u>People's Republic of China</u>

1985

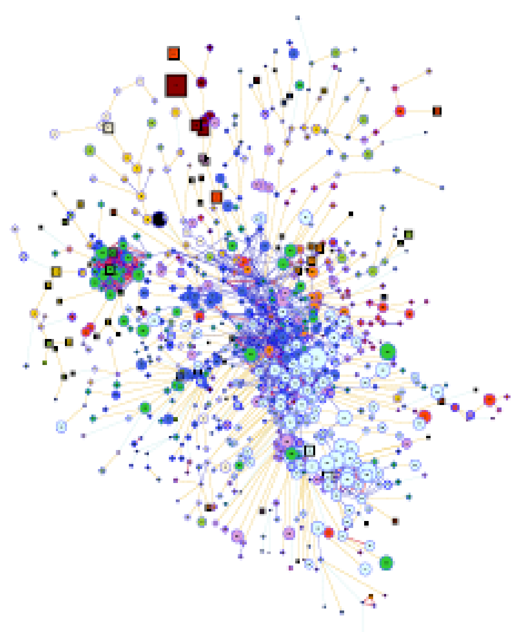


2000

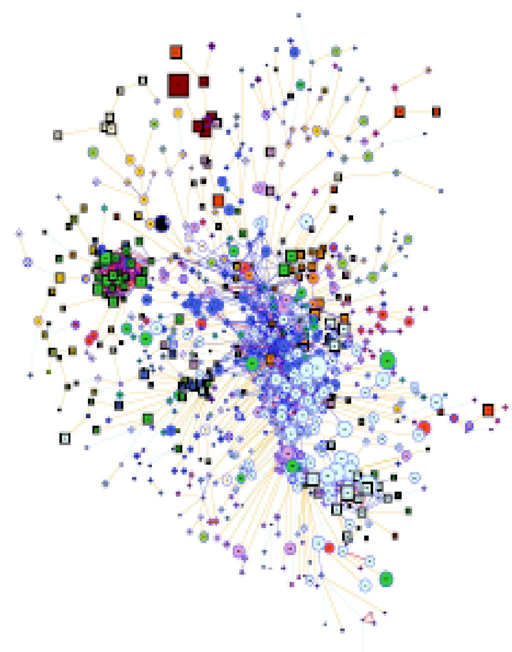


<u>India</u>

1985



2000



Source: *The Product Space and the Wealth of Nations*: http://www.nd.edu/~networks/productspace/

21. The figure shows that Malaysia has shifted its product structure from textiles in 1985 to electronics in 2000, and that it has started producing some products located in the dense area of the product space. This implies that Malaysia will easily be able to upgrade its production structure to products of higher productivity in the future. The PRC and India have also successfully upgraded their production structure. By contrast, Pakistan's production structure remains almost same in 2000 as in 1985. Pakistan has concentrated on low productivity garments and textiles, and cereals, and has failed to upgrade.

22. The speed at which countries can transform their productive structure and upgrade their exports depends on the path determined by their current production and export structures. Pakistan's problem is that it has specialized in products that require assets and skills specific to lower productivity products, and which do not help in order to move to higher productivity goods.

III. Policy Options

1. The Potential for Industrialization, Product/Technological Upgrading and Product Space

23. Our previous discussion indicates that there is a clear need to plan and implement policies that will bring out and facilitate innovation and growth in the industrial, manufacturing and high productivity sectors of agriculture, services and industry. How to achieve this poses a significant challenge, and is actually the key to successful economic development. The analysis above points some directions on how to do this. Even if the low-tech group 1 (see Figure 4) dominates Pakistan's domestic manufacturing, the high-tech group 4 has the second highest share. This means that there are sectors that may provide dynamism for the manufacturing sector to take off.

24. Table 2 provides a breakdown of Pakistan's manufacturing sectors in the 1970s, 1980s and 1990s. Low-tech sectors like food and beverages, textiles and apparel dominate the manufacturing sector. However, their share is decreasing and these sectors are being partially replaced by higher-tech sectors, especially industrial chemicals, electrical machinery and transport equipment. This gives Pakistan a golden opportunity to increase its dynamism and innovation, so that high productivity and value-added are acquired in these sectors through proper economic incentives, infrastructure, specific inputs and institutional/legal setups (to be discussed in III.2).

Table 2: Pakistan Manufacturing Branches (%)

	1970s	1980s	1990s
Food and beverages	30.45	30.94	22.89
Textiles	27.78	18.14	25.06
Apparel, leather, and footwear	2.04	2.37	2.80
Wood and wood products	0.26	0.39	0.37
Paper and paper products	1.61	1.15	1.54
Printing and publishing	1.22	1.06	2.00
Industrial chemicals	11.20	14.29	15.50
Petroleum and coal products	5.27	6.01	3.26
Rubber and plastic products	1.80	1.80	1.42
Non-metal mineral products	4.43	7.75	7.76
Basic metals	3.06	6.20	5.13
Metal products	1.62	1.06	0.81
Non-electrical machinery	1.84	2.14	2.09
Electrical machinery	3.31	3.26	5.43
Transport equipment	2.99	2.89	3.05
Others	1.11	0.55	0.88
Total	100.00	100.00	100.00

Source: Staff's calculations based on data from United Nations Industrial Development Organization Industrial Statistics International Standard Classification Revision 2 (2005).

25. Pakistan needs to rethink its export promotion policy and think in two possible dimensions. One is to grow within existing products. Pakistan can export more of the same, or upgrade quality within products. The suitability of this dimension depends on how much room there is to upgrade quality within the existing basket, and how sophisticated that basket is. In the case of Pakistan, the income elasticity of demand for exports (a proxy for non-price or quality competitiveness) is very low, close to zero. This indicates that when foreign income increases by 1%, Pakistan's exports increase very little if at all. Why? Because Pakistan exports inferior goods. This means that there is plenty of room for overall quality upgrading, as foreigners do not perceive, in general, Pakistan's exports as of high quality. Remember (Table 1) that even within textiles, Pakistan seems to be moving down the development ladder. The question is how to improve, and to solve this problem Pakistan's public and private sectors must draw a plan. A second strategy is to grow through more of the same. Table 1 above showed that Pakistan already has made inroads into some high-tech export products like woven fabrics of continuous synthetic fibers, medical instruments and apparatus, and some requisites for outdoor sports. Although the export shares of these groups have decreased in the 2000s, perhaps proper policies could lead to an increase in exports of these products and make them more competitive in the world market. This is also a feasible strategy given that Pakistan's EXPY is relatively high given its level of income: Pakistan can grow within the existing export basket.

26. A third possibility is to move from existing products into new products. If Pakistan's actual export basket were in a central part of the product space, then there would be an apparent and obvious path toward new products. However, this is not the case, as we saw above. Pakistan's exports are largely textiles, and most likely the current export package is intensive in capabilities that are not easily redeployed to alternative –more sophisticated, products. In this case, there is not an obvious path to other parts of the product space, and a "jump" to a new part of the space is necessary. This requires conversations with both public and private sectors in order to jointly identify these sectors. For example, the Ministry of Commerce has published targeted new export products that the Government would want to promote, namely, engineering goods, pharmaceutical products, carpets, gems and jewelry, Japonica (high value-added) rice, meat and fruits and vegetables. Feasibility studies will be needed to see if these sectors are viable and whether the proper infrastructure, specific inputs, institutional/legal setting and economic incentives (discussed in III.2) are in place for these exports to take off and gain world market share. Box 1 provides an example of how Singapore decided to venture a few years ago into biotechnology.

Box 1. Building the Biotechnology Industry in Singapore

After making significant strides in electronics, engineering and chemicals, Singapore is now turning biotechnology into its next manufacturing pillar, and is making huge investments to nurture its development. In the middle of 2003, the Government opened Biopolis, a S$500 million research park that provides facilities for biotechnology activities and provides legal and laboratory support services. This first class facility is envisioned to create an atmosphere of inspiration and creative thinking. It features, for instance, a S$33 million high tech airconditioning system which is planned to cool even open-air parks. Besides providing physical infrastructure, government initiatives also include research grants and tax incentives, funding startups, as well as education programs and scholarships to develop the workforce. A chief executive of a life sciences consulting firm predicts that government initiatives, in addition to already established pharmaceutical companies in the country, would allow manufacturing output to reach S$12 billion by 2005.

The country's national policy of attracting foreign talent is contributing to the effort, particularly in training the workforce. Some top scientists in molecular biology, cancer research, and neurology are already based in Singapore, and the government encourages long-term assimilation into the society. The country's attractiveness to researchers is also helped by a strong intellectual property rights regime and a well-developed health care industry.

The government recognizes the risks involved, such as the long period before investment returns are realized (if at all) and the threat of workers trained in its facilities to seek better opportunities elsewhere, notably the US, Europe, and Australia. But it is determined to move ahead as the changing economic environment calls for it.

Source: Wong, Douglas, "Singapore's Research Heaven Lures Scientists," *Financial Times*, Jan. 24, 2003 issue.

2. Growth Diagnostics and Industrial Policy

27. Undertaking the policy work discussed above requires a growth diagnostics approach. Obviously, industrialization and technological upgrading cannot occur without increases in productive investments and capital formation in the proper sectors, especially since productive capacity and technology are embodied in capital goods. The growth diagnostics approach aims at identifying the binding constraints in the economy that prevent investment and growth in potentially productive and dynamic sectors of the economy and, ultimately, industrialization.

28. Bottlenecks or constraints to investment and industrialization in the productive sectors may involve general problems such as poor infrastructure, poor energy generation, bureaucratic impediments, difficulties and delays in setting up and undertaking entrepreneurial and innovative activities, as well as political/economic instabilities.

29. But the binding constraints may also take the form of lack of economic incentives for investment and innovation/technological and scale improvements in dynamic sectors. The lack of incentives may be in the form of:

- (i) lack of specific inputs (such as specialized infrastructure – e.g., IT-related infrastructure for computer-dependent sectors) and institutional/legal structures to facilitate specific economic sectors (such as the lack of public institutions to cater to the specific technical and regulatory needs of, for example, medical diagnostics – e.g., there should be institutions catering to the training, certification of good quality of the technicians and equipment, and legal institutions and procedures in case of charges of erroneous diagnoses).
- (ii) lack of human capital and specialized skills needed for specific sectors (e.g., the lack of qualified engineers or software experts due to brain drain and/or lack of training/education facilities).
- (iii) lack of technical, R&D and technological investments and support for potentially dynamic industries.
- (iv) absence of (or distorted) economic incentives given to productive entrepreneurial, as well as innovative and activities with the potential to be technologically upgraded.

30. All these possible constraints should be looked at in order to come up with policy suggestions for manufacturing expansion and product upscaling. Section III.1 has identified possible potential and promising sectors. But it will take time to come up with a plan for manufacturing expansion, product diversification and sectoral upgrading until all the above possible binding constraints are sufficiently studied and analyzed. Box 2 provides an example of how India and South Korea approached the implementation of an industrial policy program with significantly different results.

Box 2. Industrial Policy in Korea and India

Jacobsson and Alam (1994) provide an example that shows that the correct implementation and design of a successful industrial policy program requires not only a dose of creativity and experimentation, but also some clear guiding principles that combine a carrot to promote investments in nontraditional areas with sticks to wed out investment projects that fail.

Both India and Korea started producing hydraulic excavators (equipment used to remove soil and stones) in the 1970s. Both countries protected these infant industries by restricting imports of finished hydraulic excavators. Technology was imported through licenses. Protection was supplemented by requirements for local component inputs, which became more stringent over time. Despite these initial similarities, the development of the hydraulic excavator industry differed substantially in the two countries, and the way India and Korea promoted their infant industries contrasts sharply.

By the late 1980s the two Korean excavator manufacturers, Samsung and Daewoo, were producing more than ten times the annual production of Larsen and Toubro, the largest Indian excavator manufacturers. Moreover, the Korean manufacturers had designed and developed their own excavators, which were competitive enough to be exported starting in 1987. By contrast, none of the Indian manufacturers had introduced an excavator based on their own design and none was in any position to export.

Two aspects of government policy in these countries are crucial in explaining this difference in industry performance. First, although both governments guided private investment decisions in the industry, the Korean government recognized the importance of economies of scale. It limited the Korean industry to two firms and allowed them to expand production capacity and exploit production economies. The Indian government, by contrast, encouraged a large number of firms to enter the industry and limited their individual production capacities in the belief that this would foster competition in an otherwise protected market. Second, the Korean government managed to instill a sense of competition and dynamism in its two producers by announcing a credible program of time-bound protection. Indian protection was not time-bound. This impending liberalization of the industry was the main factor driving the Korean firms to formulate a clear strategy for developing an internationally competitive design for excavators and an export marketing plan. The cases of India and Korea reinforce the critical role that greater openness after a limited period of protection plays in developing competitive infant industries.

31. Finally, it is important to stress the importance of having appropriate institutions in place to interact with the private sector and learn what new activities are being considered and what public action is required for them to successfully emerge. Box 3 summarizes the characteristics of these institutions.

Box 3. Institutions for Industrial Policy

According to Rodrik (2004), the following are the basic elements of an institutional architecture of institutions for industrial policy: (i) Place political leadership at the top; (ii) Set up coordination and deliberation councils; and (iii) Set up mechanisms of transparency and accountability. And he proposes ten design principles for the formulation of industrial policy: (i) Incentives should be provided only to “new” activities; (ii) There should be clear benchmarks for success and failure; (iii) There must be a built-in sunset clause; (iv) Public support must target activities, not sectors; (v) Activities that are subsidized must have the clear potential of providing spillovers and demonstration effects; (vi) The authority for carrying out industrial policies must be vested in agencies with demonstrated competence; (vii) The implementing agencies must be monitored closely by a principal with a clear stake in the outcomes and who has political authority at the highest level; (viii) The agencies carrying out promotion must maintain channels of communication with the private sector; (ix) Optimally, mistakes that result in “picking the losers” will occur; and (x) Promotion activities need to have the capacity to renew themselves, so that the cycle of discovery becomes an ongoing one.

SOCIAL PROTECTION AND SAFETY NETS IN PAKISTAN

1. The National Social Protection Strategy which aims to bring social safety nets to 6.2 million households in the next five years was approved by the Government of Pakistan (the Government) in 2007.[1] Pakistan's existing safety nets include: (i) cash transfers (Zakat, Pakistan Bait-ul-Mal's Food Support Program, and conditional cash transfers); (ii) Old-age income security (pension for Government employees, employees old age benefit institutions); (iii) other employment-based programs (Workers Welfare Fund, programs through various foundations); (iv) Micro credit and NGO programs (Pakistan Poverty Alleviation Fund, Khushhalibank, Rural Support Programs etc); (v) Public works Programs; (vi) food based programs (Tawana Pakistan Mid-day school meals); (vii) wheat subsidy; and (viii) social security programs (pension - old age, survivor and disability and benefits to formal sector workers).

2. Prior to the 2007 Strategy, there was no overarching social protection strategy in Pakistan. It obviously led to lack of direction and poor coordination on the part of individual agencies and programs working in this area. The absence of a social protection strategy could also explain the low and irregular budgetary allocations for the purpose. Public spending on key safety net programs is only 0.5% of the GDP. This is low by international standards and inadequate to meet existing needs. It is hard to assess the effectiveness of these programs in addressing poverty and vulnerability given a lack of monitoring and supervision system, any third party verifications, and feedback loops for self-correction and learning. Organizations implementing safety net programs are involved in multiple activities not part of their core competency (running schools, hospital, training centre etc.) hence thinly spreading limited resources and providing no synergies between agencies and program. There is no systematic targeting and beneficiaries are selected on the basis of administratively determined criteria. Ad hoc selection process of beneficiaries, distribution system and discretion of the government functionaries leaves room for leakage of funds. All this has reduced the effectiveness of the programs and lowered their credibility in public eye.[2]

3. Pakistan offers income support through two cash transfer programs, *Zakat* and *Bait-ul-Mal*. *Zakat*, managed by federal Ministry of Religious Affairs, Zakat and Ushr, is a State-based option for Muslims to meet their charitable obligations through a deduction once a year at the rate of 2.5 per cent on the value of certain financial assets.[3] It applies only to *Sunni* Muslims and others can choose not to be included in the scheme and make their zakat privately. Pakistan Bait-ul-Mal (PBM) is a semiautonomous organization within the Ministry of Social Welfare and Special Education. Bait-ul-Mal's objectives as stated in the Bait-ul-Mal Act are to provide financial assistance to destitute and needy widows, orphans, invalid, infirm and other needy persons. Unlike Zakat, Bait-ul-Mal benefits are open to all regardless of creed. Also, unlike Zakat, the funds are entirely controlled by public servants. It has offices at provincial and district levels that are closely linked to, but not part of provincial administrations.

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[1] Government of Pakistan. 2007. *National Social Protection Strategy*. Islamabad.

[2] Draft Social Protection Strategy for Pakistan Presentation by Dr. Pervez Tahir Chief Economist, Planning Commission, Government of Pakistan, at the Workshop on Social Protection in South Asia 17-19 May 2006, Colombo, Sri Lanka

[3] A Central Zakat Council appointed by the Federal Government provides policy guidance and general superintendence and control over Zakat funds. The Central Zakat Council allocates funds to the provinces roughly in proportion to their population.

4. Bait-ul-Mal's main programs of direct assistance to individuals are the Food Support Program,[4] Individual Financial Assistance, National Centres for Rehabilitation of Child Labour, Vocational Training Institutes, Tawana Pakistan (school feeding program) and building of homes. It also gives grants to NGOs to provide institutional support for orphans, the disabled and abandoned and destitute women, and the aged. It also provides some grants for water supply. In the past, it has also completed a housing development for the poor in Sindh.

5. The PBM programs face problems of poor targeting, fragmentation, duplication, inadequacy, poor monitoring and sustainability.[5] The government has laid out its strategy to deal with these issues in the National Social Protection Strategy. The Vision of the Strategy is to develop an integrated and comprehensive social protection system, covering all the population, but especially the poorest and the most vulnerable. The Core Instruments proposed by the Strategy include expanding the coverage of cash transfers using conditional cash transfers (CCTs) supplemented with unconditional transfers (through the Food Support Program (FSP) and Zakat) among others. PBM is undertaking efforts to improve targeting, delivery mechanisms and monitoring through a number of initiatives. They are in the process of cleaning-up their database and creating a comprehensive computerized Management Information System based on relatively authentic Computerized National Identity Cards (CNIC). Developing, piloting and expanding proxy means tested targeting mechanism in combination with community validation is expected to enhance transparency and credibility of the system. Fiduciary risks are being minimized through improved financial management and introduction of consolidated accounts at the field level to ensure effective reconciliation.

6. The Government has announced the launch of a new cash transfer program in addition to the already existing program of Zakat, Bait-ul-Mal, and provision of food items at subsidized rates through the existing and expanded network of government-run Utility Stores. The new program, named after the former Prime Minister of Pakistan, is called *"Benazir Income Support Program"*. For this purpose, the Government has allocated an amount of PRs34 billion to be raised to PRs50 billion in the future. The program entails provision of a cash grant of PRs1000 per month to each qualifying household to be selected through a means tested program based on the CNICs. Relying on this system will require the Government to address the coverage issues of the CNIC database. Additional TA will be required to develop systems for the new scheme.

7. Despite challenges, it is clear that the Government not only has existing safety nets but also intends to improve their coverage and targeting. The programs are expected to target more than 5 million households. They have also substantiated their intentions by allocating substantial amounts in the budget. Subject to improving systemic issues, the programs have a significant scope and need for expansion. World Bank is working with the Ministry of Social Welfare and PBM to improve targeting of their existing programs. UN has fielded a joint mission to asses the situation and propose immediate and medium to long-term measures in the wake of recent food crisis.

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[4] Its largest program that provides PRs2400-3000 a year for persons whose income is less than PRs4000/month. The program guidelines require that assistance be provided to needy individuals following an order of priority. Meeting the criteria does not guarantee receiving the benefit as each district has a quota of recipients that it cannot exceed.

[5] Asian Development Bank. 2004. TA 4155 PAK: Social Protection Strategy Final Report Vol. 1.

TOWARDS A GROWTH INCLUSIVE AND SUSTAINABLE FOOD SECURITY POLICY AGENDA FOR PAKISTAN: A BRIEFING NOTE

I. The Wheat Economy

1. Wheat is the basic staple food of Pakistan. Wheat is the major Rabi (winter season) crop sown in October-December and is harvested in March to early May. It provides 70% of total production of food crops, occupies 37% of total cropped area, and generates 39% of the value added of major crops. Production, which has been increasing since the 1990s, averaged yearly at 20.1 million tons from 2000-2007. Of this total, Punjab's share was 80%, followed by Sindh at 12%, NWFP at 5% and Balochistan at 3%. In 2007-2008, the government projected a bumper crop of 23.5 million tons.

Table 1: Wheat Production and provincial share, 2000-2007 (000 tons, (%)

Year	Punjab	Sindh	NWFP	Balochistan	Pakistan
2000-07	16,060 (80)	2,409 (12)	1,003 (5)	602 (3)	20,075 (100)

Source: Agriculture Statistics of Pakistan; ADB staff estimates

2. Table 2 shows the supply and demand situation for the period 2000-2007. Pakistan is marginally sufficient, with most of the produce (roughly 65-75%) being kept by wheat farmers for household consumption, feeds, and seeds. Domestic wheat consumption is supplied largely through the marketable surplus (mainly from Punjab) and partly through imports. Wheat is also exported but mainly to Afghanistan. In 2007-2008, government projected a huge bumper stock and decided to export some of the produce. The registered export volume though may be underestimated because of the largely unrecorded exports to the porous borders between Pakistan and its neighboring countries, Afghanistan and Central Asia, estimated at about 1-2 million metric tons.

Table 2: Wheat Balance, FY2000-FY2008, average million metric tons

	Opening Stocks	Prod'n	Imports	Total Supply	Food Use	Feed Use	Other Use	Total Domestic Use	Exports	Per capita consumption (kg/yr)	Pop'n (million)
FY2000-FY2007	1.9	20.5	0/73	23.1	20.0	0.18	0.85	21.0*	0.25	129.8	153.9
FY2008, Original Revised	 2.3 0.5	 22.5 20.5	 1.5 2.5	 26.3 23.5	20.9	0.2	0.9	 22.0 23.5	0.13	130.5	160.1

Total domestic consumption is computed to include the projections of wheat flour that is sold to Afghanistan. Afghanistan is considered as the fifth" province of Pakistan when it comes to wheat consumption.
Source: FAO crop statistics, MINFAL

II. Wheat - A Political Commodity

3. The government accords highest priority to providing wheat products at affordable prices to its consumers, mainly urban consumers. In the Household Income and Expenditure Survey of 2004-05, household expenditure's share on wheat products is 15.9%, the second highest in the basket of 17 major food items, with the first being fresh milk at 17.4%. The response of governments in the past and in the present has been to intervene on one hand at the farmer level, specifically by guaranteeing wheat farmers with a price that would at least cover his costs

of producing wheat, and on the other, at the consumer level by ensuring an affordable price through subsidized wheat price and quota allocations accorded to the flour mills. The market share of government procurement to total wheat production averaged at 27% for the years 2000-2007. The surplus provinces, Punjab and Sindh, provided 70% and 10%, respectively, of the marketable surplus. Deficit provinces, NWFP and Balochistan, provide insignificant procurement shares, while the federal government's wheat marketing arm, PASSCO, averages at around 20%.

4. To support the regulated prices and procurement activities at the farm and flour mill levels, the government through its PASSCO, Trading Corporation of Pakistan, and the provincial Food Departments/Directorates, administers the trading and marketing of the wheat reserves or buffer stock as well as the import and export of the commodity. These regulatory measures are supported by state-owned storage facilities, procurement centers, and utility retail stores, as well as easy access to credit from the State Bank of Pakistan and commercial banks. Tables 3 and 4 provide indicative amounts of Government subsidies for wheat price stabilization purposes at the federal and provincial levels. Overall, the budget support for performing this role is substantial.

Table 3. Estimates of Provincial and Federal Subsidies PRs Million

Year	Provincial Subsidy	Federal subsidy	Total subsidy
1990-91	1,988	762	2,750
1991-92	1,831	2,175	4,006
1992-93	1,325	2,148	3,473
1993-94	2,760	354	3,114
1994-95	1,890	1,449	2,339
1995-96	3,169	6,648	9,817
1996-97	5,173	5,761	10,934
1997-98	2,443	4,119	6,562
1998-99	9,375	-	9,375
1999-00	6,045	923	6,968
2000-01	5,502	1,054	6,554
2001-02	5,940	2,335*	8,275
2002-03	6,671	6,479*	13,150
2003-04	1,962	10,500	12,462

Sources: MINFAL, Food Department, Punjab.

Table 4: Provincial Subsidy on Domestic Wheat, PRs Million

Year	Punjab	Sindh	NWFP	Balochistan	All Provinces
1998-99	5,117	1,184	2,387	687	9,375
1999-00	2,698	860	1,731	756	6,046
2000-01	3,035	907	620	940	5,502
2001-02	4,190	1,071	294	385	5,941
2002-03	4,600	1,382	447	242	6,671
2003-04	245	1,108	613	-	1,962
2004-05	1,429	n.a.	596	n.a.	
2005-06	3,919	n.a.	n.a.	n.a.	

n.a.- not available
Source: MINFAL, Wheat Section

5. Table 5 reflects the cost recovery and the estimated per capita subsidy for Punjab for the period 2000-2006. The Punjab Food Directorate essentially covers only 48% of its costs of performing the wheat price stabilization function; the rest are in the form of federal and provincial budget support. The main beneficiaries of the subsidy are the urban consumers. An urban resident gets a food subsidy that is more than 3.5 times higher than that received by an average poor consumer.

Table 5: Cost Recovery Share and Per Capita Food Subsidy

	Procure-ment (million tons)	Domestic price (PRs/40 kg)	Actual incidental expenses (PRs/m ton)	Rate of subsidy (PRs/m ton)	Recovery rate (%)	Provincial subsidy (PRs m)	Subsidy/ person (PRs/person)	Subsidy/ urban consumer
Ave, 2000-06	2.5	252	1,211	686	47.6	1,884	26	74

Source: Ministry of Food, Agriculture, and Livestock

6. Flour mills, especially the inefficient ones, also benefit from the subsidy (Table 6). Not only are they provided an assured amount of wheat flour at subsidized rates, but in the case of the inefficient flour mills located in the deficit districts, these also get transportation subsidy as the Food Departments cover the transport of the wheat flour from the surplus to the deficit areas.

Table 6: Provincial Subsidy Released to Flour Mills, 000 tons

Year	Punjab	Sindh	NWFP	Balochistan	Pakistan
2000-01	2.802	1.030	0.900	0.430	5.162
2001-02	2.091	0.429	0.189	0.144	2.853
2002-03	3.242	0.609	0.237	0.209	4.297
2003-04	2.422	0.679	0.294	0.226	3.621
2004-05	2.719	0.882	0.281	0.204	4.086
2005-06	1.111	0.231	0.230	0.101	1.673
Avg 00-06	2.398	0.643	0.355	0.215	3.615

Source: Ministry of Food, Agriculture and Livestock, Wheat Section

7. Compared to the market and import price of wheat flour, the issue price was lower than the market and import price levels, except for 2005-2006 (Table 7).

Table 7: Ratio of Issue Prices to Market Prices and Import Prices PRs/Tonne

Year	Issue Price (IP)	Market Price (MP)	Import Price (IPP)	Ratio of IP to MP	Ratio of IP to IPP
2000-01	7,500	8,136	10,522	0.92	0.71
2001-02	7,500	7,842	11,437	0.96	0.66
2002-03	7,500	8,339	11,486	0.90	0.65
2003-04	8,750	9,848	12,550	0.89	0.70
2004-05	10,000	11,273	12,924	0.89	0.77
2005-06	10,625	11,130	9,730	0.95	1.09

Source: Ministry of Food, Agriculture and Livestock

III. Towards a Phased Market-Based Wheat Policy: 2005-2007

8. Under the ADB-funded Agriculture Sector Program Loan Phase II (ASPL II), the government agreed to remove the pervasive public sector interventions in the wheat market which created disincentives for wheat producers, millers, and traders to become efficient and develop an integrated food industry. These measures included the removal of market restrictions in trade, elimination of consumer subsidies and producer support subsidies, the restructuring and divestiture of PASSCO and provincial food departments and closure of food directorates, and a streamlined role in wheat reserve management. Because of the politically sensitive nature of the wheat policy and the volatile sociopolitical situation in the first half of 2000s, a phased market-based wheat policy was deemed as the most politically feasible to achieve. The key elements of the phased market-oriented wheat policy are:

- Five-year phased policy reform of reducing the operational reserves to equate to the strategic reserves by 5th year. Strategic reserves assumed to be equal to 1 million tons
- Implement a price band: lower limit is the support price to farmers, and the upper limit is the price accorded to consumers. Within the price band, allow the private sector to undertake trading activities to farmers, flour mills, and consumers.
- No restrictions of wheat trade at intra- and inter-provincial levels.
- No restrictions of import and export of wheat. Enable private sector to engage in external trading. The Government imports only when domestic consumer price moves above it and private sector is not forthcoming.
- There was agreement that support price would move toward the export parity level, while the consumer price would move to the import parity price level. Price stabilization function would be only performed through management of strategic reserve.
- Blanket consumer subsidy will be removed. Instead, a targeted food safety net will be developed for the poor and vulnerable.
- PASSCO and food departments are to be restructured.
- Agriculture Pricing Commission (APC) changed to Agriculture Policy Institute (API) which, among others, would also monitor the pricing movements and provide policy advice through good technical analysis.

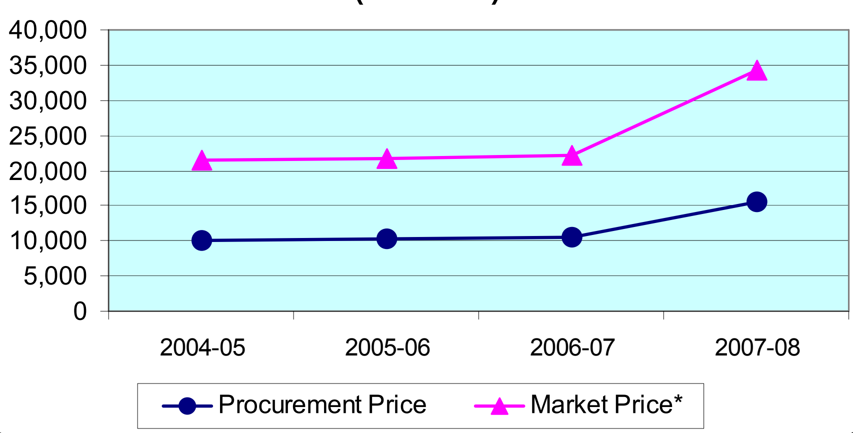
9. The environment during 2005-2007 was an opportune time to put in place the phased market-based wheat policy reform agenda as there were no major internal e.g., major drought, floods, political change came in latter part of 2007 and did not have an effect on the wheat situation, etc.) or external shocks that would have resulted in disruptions of the food supply and demand conditions. These “normal” conditions enabled the federal and provincial government to try out more private sector participation in the trading and marketing aspects, particularly the domestic and external trade activities. Farmers also had the opportunity of more market options, government (at GMP price or procurement/market-based price) and private sector). Prices received by consumers were fairly stable. Urban incomes were also rising, thus reducing the consumption for wheat products and increased demand for livestock products. Local government’s coercive measures to meet procurement targets were also minimized. More importantly, consensus building between federal and local governments on the phased market-based wheat policy resulted in agreements on the implementation of the policy.

10. At the end of ASPL II in mid-2007, the gap between the support and issue prices with their international price parity levels was decreasing; the restructuring plans for PASSCO and

food departments/directorates were completed, there were no domestic and international restrictions in wheat trade, and operational reserves were being reduced gradually.

11. Figure 1 plots the support price of wheat with the market price in Rawalpindi, a proxy indicator of the export parity price at Afghanistan border for the years of the ASPL II implementation from 2004-2007. It is noticeable that the support price has moved much closer to the market price especially during the ASPL II years when the phased wheat market-based policy was introduced (starting 2005). The price differential between the support and the market price in 2004-2005 was PRs1,469 per tonne; the gap decreased to PRs863 per tonne in 2005-2006, or a 59% decline in price gap. By 2006-2007, the price differential between the support and market price was just PRs298 per tonne. However, at the height of the wheat price upsurge beginning in mid-2007 (which also coincided with the completion month of ASPL II) and during the political uncertainty, the average price difference jumped to PRs3,125 for the months July 2007-May 2008. There is a need to safeguard the policy commitments of Government to remove the support and issue prices for wheat and wheat flour, respectively.

Figure 1: Support and Market Prices, 2004-2008 (PRs/tonne)



* Rawalpindi market price as proxy to Afghan border price for wheat
Source: Ministry of Food, Agriculture, and Livestock, Government of Pakistan

12. The remaining agenda that will need to be followed through are found in the following Table:

Table 8: Unfinished Agenda of ASPL II

Policy Condition	Compliance Status
Eliminate consumer subsidy for wheat and move to market-based sale price for wheat	Substantially complied in the sense that measures have been taken to reduce the operational reserves and move toward a phased targeted food subsidy
Eliminate producer subsidy by moving from a support price to a market-based price for the procurement of wheat, except for the losses that may accrue from the minimum strategic reserves of wheat	Substantially complied in the sense that farmers are given more leverage to sell their produce at the market price and not at the GMP. Besides, the government was already purchasing the operational and some of the strategic reserves at market price.

Policy Condition	Compliance Status
Closure of the provincial Food Directorates in Food Departments of Sindh, NWFP, and Balochistan, and commence process of divestiture Complete implementation of restructuring of provincial Food Departments, including the upgrading and leasing of storage facilities	Waiver; moved instead toward restructuring of Food Departments Plans were completed but were not implemented
Implementation of restructuring of PASSCO completed and end budgetary support, subsidies and exclusive preferential credit for PASSCO except for costs of managing the strategic wheat reserve	Waiver

IV. Present Situation- Challenging Global and National Political Economy Landscape

13. The newly installed government faced several problems when it assumed power in late 2007.

- Global Food Insecurity through Food Price Hikes: Among the most pressing problem facing the new government is the rising food prices, especially the main staple, wheat. A confluence of global factors resulted to this phenomenon: high food demand and changing food consumption patterns, increasing energy prices which encourage shift in production land use from food to alternative biofuel, increased land cultivation for feeds, and structural neglect in agriculture investments.
- Mismanagement of stock reserves: From the viewpoint of the public at large, the rising wheat (flour/atta) price is perceived largely as the gross mismanagement of the wheat situation by previous government. The main problem was that the government's issued price for wheat flour per 20 kgs was too low (PRs425/24 kgs) vis-à-vis the market price (PRs625/40 kgs), resulting in increased leakages and corruption, not to mention the huge subsidy cost incurred by the government (about PRs4.4 billion as consumer subsidy). Traders, flour millers, and households near the borders of Afghanistan benefited from the low price of wheat flour, but not the poor consumers. Further, because of the higher price hike of coarse rice and maize which are used for animal feed, livestock farmers substituted coarse grain and maize with more wheat use. About 1 million tons of wheat was diverted to animal feed. In the end, the previous government had to import 1.7 million tons at already high global prices, resulting in another fiscal burden of about PRs50 billion.
- Increased competition between public and private sector players: To some extent, farmers benefited from the high wheat prices. The private sector was quite effective at purchasing from farmers. The Food department of Balochistan for example, could only purchase 2 MT out of their procurement target of 20 MT.
- Tight Supply for FY2009: The present and newly installed government is thus under great pressure to act due to the very tight supply situation: Opening stocks for May 2008 were down to 0.2 million tons. Latest estimates of wheat production are down to 22.8 million tons. Requirements for 2008-2009 are 23 million tons, meaning that strategic reserves is just 0.5 million tons, 0.5 million tons short from the desired strategic reserves. Some argue that the strategic reserves of 1 million tons may be low as this was an outdated estimate when population of Pakistan was below the 100 million mark.

- Poor and vulnerable affected most by the wheat price hike: An ADB study (2008) on the impact of price increases on Pakistan's poverty situation concluded that a 10% price hike in wheat prices would result in an additional 7.05 million poor Pakistanis (in 2004-05, the number of poor was 33.35 million), at 20%, the number of additional poor would more than double at 14.7 million, and at 30%, an additional 22 million. The study also noted that subsidy for the old and new poor would involve a hefty sum ranging from PRs18,537.61 million (or 0.29% of GDP) if there were a 10% increase in the food prices, to as much as PRs83,203.69 million, or 1.28% of GDP, if the food price increases were 30%.

14. The second-half of 2007 when global food prices increased dramatically and global food reserves dwindled to low levels, thus became the litmus test on Government's commitment to sustain the phased market reforms in wheat. Because of the strong profit incentives to be gained from higher prices for wheat and wheat products, the Government, despite its efforts to defend the public-determined prices of wheat and wheat products and its use of various coercive methods to restrict domestic trade and achieve its procurement targets, was powerless with the interplay of market forces. The poor and vulnerable bore the brunt of high food prices and inaccessible food as the Government's food security strategy did not have an effective targeted safety net measure in place. The government also mismanaged its stock reserves.

15. High wheat prices, increased global food price volatility, and heightened market uncertainty are projected in the medium-term. There is thus popular pressure on the new government to revert to increased public role in the wheat sector as the way for ensuring food security as demonstrated by recent policies of government:

- Increased imports from 1 million tons to 2.5 million tons. But these will be coursed by Trade Development Authority through PASSCO and the food departments.
- Due to fiscal pressure the food departments were also instructed not to provide wheat at subsidized rate to millers. Punjab has agreed to provide 50,000 MT from Punjab flour mills at the price of 365 PRs/40kg (for one month only) these will be traded by private traders- According to FD this measure will expose local millers to competition.
- All provinces have imposed ban on inter province and inter district wheat movement especially during the duration of the procurement by the food department- Baluchistan province has applied this measure in 3 surplus district for 15 days but the measure was lifted due to political pressure. In addition the measure did not help as FD could only procure 10% of the target of 20,000 MT for this year.
- Punjab has again restricted inter-provincial wheat trade movement. NWFP cannot access cheaper PFD wheat, but mainly PASSCO's more expensive wheat.
- Exports of wheat were discouraged: (i) federal level – issuance of a wheat export duty of 35%; (ii) coercive measures to stop wheat exports to higher-priced AFG market
- GMP or support price increased twice: (i) from PRs450/40 kg to PRs625/40 kg, which is still below the open market of PRs700/40 kg. The amount was still not sufficient to account for the rising input prices, especially fertilizers.

16. It is essential that the investments in ASPL II of laying down the phased market reform in the wheat policy be sustained and its implementation be accelerated. Key policy measures that will need be brought to their logical conclusion are the: (i) elimination of consumer subsidy for wheat and movement to market-based sale price for wheat, and (ii) elimination of producer

subsidy by moving from a support price to a market-based price for the procurement of wheat, (iii) efficient management of the strategic reserves, (iv) non-restrictions of domestic and international wheat trade, and (v) streamlined roles of PASSCO and food departments/directorates on strategic reserve management. These should be complimented with policies that provide targeted safety net measures for the poor and vulnerable groups, and measures that promote new financial instruments and institutional arrangements for the effective and efficient integration of the farms with the consumers through appropriate provision of private sector-run market infrastructure and services.

V. Key Desirable Features of a Policy Agenda for Sustainable Food Security

17. **Towards a common understanding of the meaning of food security:**

- Food security as defined in the World Food Summit (Rome 1996) is a situation "when all people, at all times have physical and economic access to sufficient, safe, and nutritious food and to meet their dietary needs and food preference of an active and healthy life."
- Food security is measured in terms of (i) physical access to food (or availability), economic access to food, and biological utilization of food (food absorption). Many studies note that in Pakistan, physical availability of food (including wheat flour) may not be the main issues, but rather consumers are constrained by poverty or their low incomes that in turn, impedes their ability to use the food adequately for a balanced proper nutrition.

18. **Appropriate direction of Food Security Policy:**

- In the short-term, food security should safeguard the food availability and accessibility of the poor and vulnerable. For farmer producers, a guaranteed minimum price (but indexed on both costs of production and the export parity level) may be needed to enable farmers to reap some of the economic gains of wheat price hikes.
- In the medium-term, food security cannot be sustained through provision of consumer and producer subsidies. Measures that enhance economic activities and job creation would be a more sustainable basis for the poor to cope with food price spikes. Further, higher productivity of the food producing sector and its integration to a more efficient and effective integration of the food supply chain are required instead of distortionary price supports. Specifically, farmers need to be equipped with access to (i) high yielding seed varieties, modern technology and agronomic practices and secured water supply and land use rights; as well as (ii) access to accurate information on market conditions, market infrastructure, and institutional arrangements that effectively link them to the domestic and global market. With these, the farmers can make the right choices and to realize profits from evolving global trading system.

19. **In the Pakistan context**

- **Immediate and priority focus** of the Government should be to ensure the food availability and access of wheat flour especially for the poor and vulnerable groups. Key agenda for action are-

- Build up the strategic reserves through a more cost-effective and market-oriented reserve stock management system.
- Develop and implement a targeted food safety net program with a time-bound exit strategy.

- **The medium-term (1-5 years) agenda- building blocks for structural transformation from low-based food to integrated food supply chains: T**he Government should lay the policy, institutional, and investment reform measures that will develop a market responsive wheat/food supply chain network. The key agenda for action are-
  - Productivity-enhancing and efficient land and water-use management measures at the farm level
  - Policy reforms and infrastructure investments that efficiently link the food-producing farming sector with the domestic and global food supply chain.

Box 1: Proposed Food Security Policy Agenda for Pakistan

Outcome: Improved food security at a reduced budgetary cost to Government

Two-Pronged Agenda:

- **Towards a more cost-effective wheat reserve stock management. The price stabilization mechanism will be a win-win solution for wheat consumers and farmers.**

  1. Support and issue price of wheat raised to the market level
  2. Remove operational reserves and cap strategic reserves to 2 months of wheat consumption requirements
  3. Remove domestic restrictions on wheat trade
  4. Divestment of unused government-owned storage and warehouse facilities
  5. Restructuring of PASSCO and the provincial food departments and directorates

- **Towards a More Targeted and Effective Safety Net for the Poor and vulnerable groups-**

  1. Clear criteria developed for selecting beneficiaries of targeted cash transfer program for the poor
  2. Evaluate safety net program and adopt revisions
  3. Provide budget allocation for income support for up to 9.5 million households in 2010.

ENERGY SECTOR: A BRIEFING NOTE

I. Introduction

1. One of the major challenges facing Pakistan is its current energy crisis that is intense, costly and multidimensional. Pakistan's energy sector is marred with twin deficits – technical/energy and financial/fiscal – and prevailing power shortages underscore urgent attention to prevent serious derailment of economy. Electricity sales rose 40% in the five years ending 30 June 2007, while generation capacity remained practically stagnant. It is estimated that the system lacks about 5000 MW to cover peak demand with acceptable reliability. With demand expected to grow at 7-8% per year in the medium-term, current plans for capacity additions need to be revised upward to eliminate shortages. On the financial front, the sector needs significant fiscal support - estimated at US$2.0 billion for FY2008 (close to 20% of the projected operating revenues and 1% of GDP) to cover the revenue deficit.

2. The energy insecurity and the poor electricity service have been identified as major constraints to the country's sustained economic growth and, hence, it's ability to alleviate poverty. The fiscal imbalances have created an inter-corporate circular debt problem, impeding the power generation companies to reach optimal production levels. Currently the financial health of sector power entities is precarious caused by delayed and partial implementation of necessary and agreed reforms. Tariffs must keep up with costs (of operating, maintaining, and expanding the system) particularly in an environment of rising fuel costs given Pakistan's large thermal generation capacity. In the power sector, distribution companies have not been able to charge cost recovery rates whereas the generation companies and independent power producers (IPPs) have had real cost adjustments for their tariffs. The deficit amount is covered by the Government as a subsidy to the electricity customers, which under the current fiscal regime is not sustainable.

3. Technical constraints are a limiting factor in evacuation and dispersal of generated power to the end customers. Transmission and distribution losses for the national system stand at a quarter of net generation as the power supply chain is over-loaded, under-invested, and under-maintained. For 2006-07, every 1% reduction in technical losses would have brought additional revenue of some PRs4.3 billion (US$68 million) into the system at prevailing tariffs.

II. Issues and Opportunities

4. The fiscal issues are a primary cause of sector deterioration, and its severity is also negatively affecting the overall fiscal position of the national budget. The power subsidy payments budgeted and to be paid by the Government, have reached unsustainable levels due to sharp increase in the international oil prices. This is accentuated as Pakistan's domestic production, catering for 25% of country's needs, is also linked to the international oil prices. Consequently, the power sector subsidies, the differential between the National Electric Power Regulatory Authority determined and Government notified tariff, has grown substantially by more than 400% (from the budgeted PRs25 billion to actual PRs133 billion) during FY2008, primarily by high fuel price for thermal generation. The delayed subsidy payments by the Government has led to insufficient capital (cash) in the power sector, making the power distribution companies (DISCOs) unable to pay their liabilities including purchase of electricity as well as limiting maintenance, augmentation, and expansion funding. This cash shortfall has spilled into power generation companies, rendering them unable to pay for the fuel deliveries. The next link─oil/gas producers─are being partially paid by the fuel distribution companies. As a

result, a serious circular debt problem has emerged between the power utilities, fuel suppliers and the engineering industry.

5. This circular debt situation has created acute liquidity crisis as well as deterioration in fuel stock levels. This has been continuing over the past few years resulting in a serious debt overhang of PRs220 billion as of end FY2007 between the DISCOs and the Central Power Purchasing Agency (CPPA) of the National Transmission and Dispatch Company Ltd (NTDC). It is estimated that the debt overhang has now swelled further during FY2008. Weak governance has resulted in inefficient utility operations, power theft, illegal power supply, reduced billing and collection, and non-payment of arrears. Financial sustainability can only be achieved once tariff is rationalized, subsidies are phased out and balance sheets of the entities are cleaned. Poor business practices have contributed to the build up of the financial crisis which has significant repercussions on the country's economy. Water and Power Development Authority (WAPDA) is at the center of a public sector circular debt problem, in which state firms and government ministries have failed to pay power bills, while WAPDA has failed to meet obligations to them and to private sector creditors.

6. Since 1992, Pakistan has undertaken power sector restructuring. The objectives of sector reforms are yet to be fully achieved: (i) private investment has been attracted into the generation sub-sector but after a high in the mid-l990s, there has been a persistent low in recent years (Karachi Electric Supply Company's privatization has not borne results yet and the ex-WAPDA DISCOs are yet to be privatized), (ii) quality of service to the end-user has been compromised significantly by power shortages (during peak demand summer months, power riots have been witnessed) and by over-loading of the transmission and distribution networks, (iii) sector financial strength has not been achieved and instead of being a net contributor to the national treasury, the sector creates a fiscal burden to the tune of $2 billion/year. The successful implementation of reforms becomes even more important as the Government seeks to attract large private sector participation in developing and funding the current and future power generation and system requirements in Pakistan. The reform agenda clearly has some way to go. The immediate steps include corporate autonomy and sector governance, electricity trading, and financial management, among others.

7. Therefore ADB's assistance should address the fiscal sector imbalances as the first priority to ensure sufficient liquidity in the sector and to curtail the current circular debt issues. It is essential to determine the actual amount of the debt overhang, isolate it, and develop a practical debt restructuring plan acceptable to all stakeholders. It is expected that an implementation of the debt restructuring plan would span several years. Parallel to addressing the fiscal aspects, the current technical short-comings need to be aggressively tackled. Currently the Government is moving rapidly trying to address the short-term generation crisis, and ensuring sufficient funding for NTDC and the DISCOs for improvements in the transmission and distribution systems. There are needs in terms of knowledge products and financing of basically all technical areas of the power sector, but most importantly the Government need to ensure that the fiscal energy sector matters are appropriately addressed to eliminate substantial energy sector subsidy requirements.

8. Energy security is becoming a major concern globally, second to food security. This is clearly recognized by the country's Medium Term Development Framework (MTDF). The sector remains institutionally fragmented, lacks integrated energy planning to analyze/develop a consolidated action plan and address the country's energy needs in short, medium and long term. The sector is managed by the Ministries of Petroleum & Natural Resources, Water & Power, Planning & Development, Environment, Transport and Communications, and Pakistan

Atomic Energy Commission. There are separate regulatory bodies for oil & gas and electric power. No single ministry or regulatory body has over-arching responsibility and accountability for energy.

9. An integrated model interlinking the different components of the energy chain is necessary for effective analysis and evaluation of the different options. Such a model will show whether the current practice of transporting imported oil upcountry for power plants after adding the economic cost of transportation, i.e. the impact on the overstretched road infrastructure is a lower cost option than building the power plants at the port and transmitting bulk power at high voltage. Similarly it would help the country's economic managers in allocating scarce resources such as natural gas or answer questions being raised on subsidizing Compressed Natural Gas (CNG) as replacement for gasoline and its impact on refinery economics and the government's budget. Given the strong link between the petroleum and the power sub-sectors the pricing regime of petroleum products impacts the cost of power and the different subsidies and concession the Government provides to consumers for social considerations or for the industry to maintain its competitiveness. Industry in Pakistan is currently disadvantaged, compared to its counterpart in other countries, by the energy tariffs which have built in cross subsidies from the industrial to domestic and agricultural consumers.

10. An integrated look will help develop a least cost approach to energy policy and pricing and minimize the cost of subsidies. Once true economic costs and benefits are established, issues such as pricing of peak power or using captive power can be effectively addressed. The viability of alternate energy and premium, if any, that the country should pay for diversifying sources to reduce supply risk, can be rationalized. An empowered and effective link between the planners and those who implement these plans will ensure improved information for decision making, realistic planning and faster implementation of projects. It should lead to faster and timely response to changes in domestic and geopolitical realities. The country needs to start thinking in terms of energy rather than gas, oil, coal and electricity. This is necessary to make the MTDF and Vision 2030 goal of Energy Security, which means ensured energy availability at lowest possible cost, a reality.

11. Under Pakistan Accelerated Economic Transformation Program, ADB's assistance will focus on addressing the fiscal imbalances in the power sector, complemented by integrated planning approach to the sector, which ADB is assisting through an under implementation Advisory Technical Assistance.

III. Program Components related to the Energy Sector

12. Following extensive discussions with the Government it was mutually agreed that the Program would address the major fiscal areas related to the power sector. These specific areas incorporated in subprogram 1 include:

- Parliamentary approval obtained to reduce electricity subsidies through: (i) elimination of generalized sales tax subsidies for all domestic consumers and up to 500 units for commercial consumers; (ii) introduction of automatic monthly fuel price adjustments through a surcharge; and (iii) introduction of an additional surcharge to be levied on all consumers to reduce the gap between determined and notified tariffs.
- Work on estimation of power sector debt overhang and circular debt initiated.

- All past electricity subsidy payments (PRs133 billion for FY2008) fully settled, and PRs88 billion allocated in the FY2009 budget to partially cover the difference between determined and notified tariffs [for FY 2009].

13. The component focuses on actual payments of funds and timing of cash flows, ensuring that power sector remains liquid to pay its current obligations and invest in system maintenance, expansion and augmentation. This is true for the current portion of the subsidy payments and the immediate future requirements. Furthermore, the approach establishes the actual amounts of the circular debt and debt overhang. After the amounts have been established, the Government is in a position to address subsequent financial issues and undertake least cost system expansion through an integrated energy planning.

IV. Outcome of the Energy Sector Components

14. The objectives in terms of ADB's energy sector components in the Program are (i) to transparently establish the subsidy requirements arising from current subsidy policies and decisions and ensure that these requirements are fully funded through national budget and duly paid to respective agencies/companies, and (ii) establish the non-sustainability of subsidy requirements and subsequently move towards automatic fuel cost pass-through mechanisms on a timely basis, wherein tariff levels closely matching the actual cost of supply, and focus on limited and targeted subsidies. The policy dialog with Government related to both the objectives has been positive in achieving these objectives. The Government has already initiated requisite steps in the right direction including provision of adequate subsidies, measures to rationalize tariffs and move towards monthly adjustment of tariffs through the recently approved Finance Bill 2008.

15. In terms of direct outcome, it is expected that all subsidies would be paid by MOF to the DISCOs, leading to a healthy liquidity position in DISCOs to allow them to fully pay for the electricity purchases from CPPA/NTDC. In turn, this would make CPPA capable of fulfilling its financial obligations with the generation companies, who again would be able to settle with the fuel suppliers. The short to medium term result would be the elimination of the circular debt. More important the power generating companies will be able to procure sufficient fuel stocks to run the plants at their maximum levels, which would increase supply by at least 1500 MW.

16. The success in attracting private investment to a certain extent depends on financial strength of the contracting public sector. Fully addressing both the circular debt position and the debt overhang issue would result in an increased attractiveness by potential buyers of energy sector companies. The current account deficit could be reduced by increased FDI, and privatization of energy sector companies, both in the power and gas sub-sectors, would be a good source of funds provided the fiscal position is made transparent and sustainable. The expected outcome is fiscal neutrality within the energy sector, which would lead to increased ability of the Government to present additional energy sector entities to the market and increased interest from potential investors to purchase these entities. It is also expected that the price obtained for the entities would increase from the elimination of the circular debt and actual timely subsidy payments by MOF.

V. Continuation of the Energy Sector Components

17. In the past the Government has been able to address fiscal deficits and imbalances in the energy sector, through interventions and assistance of multilateral institutions. This positive experience leads to a continued focus on these two areas dealing with continuous payment of

subsidies, as required, and make adequate allocations in future national budgets. Accordingly, these two actions are imbedded in subsequent subprograms to ensure continuation of fiscal discipline and subsequent tranches would not be released without complying by these two disbursement requirements.

18. In terms of the debt overhang, a debt restructuring plan must be developed and implemented through the Program period. By the consideration of subprogram 2 the debt restructuring plan should be approved and implementation should have started. By consideration of subprogram 3 it is expected that implementation of the debt restructuring plan is well underway towards closure.

19. To address the current technical shortcomings in the sector, the Government would be required to contract for electricity supply from new generation stations running on fuel oil. By subprogram 2 the Government should have undertaken the calculations of the future subsidy requirements taking into account the current tariff and subsidy policies, and arrive at its impacts on the national economy. ADB remains Pakistan's largest development partner in Energy Sector and has strong presence (through investment projects and analytical and project preparatory assistance) across the power supply chain in the country. ADB is simultaneously addressing the sector inefficiencies and remains committed to address sector inefficiencies.

ADB PROJECTS IN AREAS RELATED TO AETP AGENDA 1995-2008

Table 1. Loans to Pakistan in Areas Related to AETP Agenda 1995-2008

No.	Loan No. and Title	Loan Amount (US$ million)	Year of Approval
A. Agriculture Sector Reforms and Investments		**502.0**	
1	L1467: Bahawalpur Rural Development	38	1996
2	L1877: Agriculture Sector Program II	123	2001
3	L1878: Agriculture Sector Program II	225	2001
4	L1879: Agriculture Sector Program II (TA Loan)	2	2001
5	L2134: Sustainable Livelihoods in Barani Areas	41	2004
6	L2171: Agribusiness Development	31	2005
7	L2234: Federally Administered Tribal Areas Rural Dev't	42	2006
B. Power Sector Reforms and Investments		**926.0**	
1	L1807: Energy Sector Restructuring Program	300	2000
2	L1808: Energy Sector Restructuring Program	50	2000
3	L1809: Capacity Enhancement in the Energy Sector	5	2000
4	L2286: Renewable Energy Development Sector Investment Program	105	2006
5	L2287: Renewable Energy Development Sector Investment Program	10	2006
6	L2289: Power Transmission Enhancement Investment Program	226	2006
7	L2290: Power Transmission Enhancement Investment Program	10	2006
8	L2396: Power Transmission Enhancement Investment Program – Subproject 2	220	2007
C. Trade and Competitiveness; Investment Climate		**1,057.0**	
1	L1680: Trade, Export Promotion and Industry Program	300	1999
2	L1681: Modernization of Customs Administration	3	1999
3	L1682: Institutional Support for the Trade Regime	3	1999
4	L1683: Institutional Strengthening of the Board of Investment	1	1999
5	L1796: Small and Medium-Size Enterprise Trade Enhancement Finance	150	2000
6	L2066: Small and Medium Enterprise Sector Development Program	152	2003
7	L2067: Small and Medium Enterprise Sector Development Program (Project Loan)	18	2003
8	L2178: Infrastructure Development	25	2005
9	L2230: TA Loan – Rural Enterprise Modernization	5	2006
10	L2270: Private Participation in Infrastructure Program – Subprogram 1	400	2006
D. Finance Sector Reforms		**1,738.0**	
1	L1371: Financial Sector Intermediation Loan	100	1995
2	L1576: Capital Market Development Program	250	1997
3	L1577: Capacity Building of the Securities Market	5	1997
4	L1805: Microfinance Sector Development Program – Program Loan	70	2000

No.	Loan No. and Title	Loan Amount (US$ million)	Year of Approval
5	L1806: Microfinance Sector Development Program – Project Loan	80	2000
6	L1955: Financial (Nonbank) Markets and Governance Program	260	2002
7	L1957: Strengthening Regulation, Enforcement and Governance of Nonbank Financial Markets	3	2002
8	L1987: Rural Finance Sector Development Program – Program Loan	225	2002
9	L1988: Rural Finance Sector Development Program - Project Loan	25	2002
10	L2291: Improving Access to Financial Services (Phase I) Program	300	2006
11	L2292: Improving Access to Financial Services (Phase I) Program	20	2006
12	L2340: Second Generation of Capital Market Reform Program	400	2007

Table 2. TAs in Areas Related to AETP Agenda 1995-2008

No.	TA No. and Title	TA Amount (US$)	Year of Approval
A. Agriculture Sector Reforms and Investments		**2,750,000.0**	
1	TA3229: Agriculture Sector Program	350,000	1999
2	TA3383: Integrated Pest Management	500,000	1999
3	TA4058: Agribusiness Development	700,000	2002
4	TA4367: Balochistan Rural Dev’t and Drought Mitigation	600,000	2004
5	TA4587: Agribusiness Dev’t Project Implementation Support	150,000	2005
6	TA 4723: National Agriculture Sector Strategy	450,000	2005
B. Power Sector Reforms and Investments		**9,650,000.0**	
1	TA3409: Capacity Building of the National Electric Power Regulatory Authority	1,000,000	2000
2	TA3502: Support for Privatization of Karachi Electric Supply Corporation	1,000,000	2000
3	TA3502: Restructuring the Gas Sector	1,000,000	2001
4	TA4130: Institutional Capacity Building of the National Transmission and Dispatch Company Limited	600,000	2003
5	TA4610: Operational Support to the Office of the Energy Advisor	150,000	2005
6	TA4665: Power Transmission Enhancement	500,000	2005
7	TA4852: Formulation of Strategy for Development and Utilization of Coal Reserves at Thar and Badin	150,000	2005
8	TA4870: Establishment and Commencement of Operations for the Central Power Purchasing Authority	950,000	2006
9	TA4876: Power Distribution Enhancement Multitranche Financing Facility	900,000	2006
10	TA4881: Renewable Energy Policy Formulation and Capacity Dev’t of the Alternative Energy Dev’t Board	800,000	2006
11	TA4982: Integrated Energy Model	2,000,000	2007
12	TA7060: Sustainable Energy Efficiency Dev’t Program	600,000	2008

No.	TA No. and Title	TA Amount (US$)	Year of Approval
C. Trade and Competitiveness; Investment Climate		**3,500,000.0**	
1	TA3183: Monitoring the Socioeconomic Impact of the Trade, Export Promotion and Industry Program Loan	150,000	1999
2	TA3558: Institutional Strengthening of Export Promotion Bureau (TA Cluster)	800,000	2000
3	TA3835: Small and Medium Enterprise Dev't Program	800,000	2002
4	TA4300: Supporting Coordination of the Small and Medium Enterprise Sector Development Program	250,000	2003
5	TA4635: Support of Infrastructure Investments	150,000	2005
6	TA4861: Supporting the Private Participation in Infrastructure Program	1,000,000	2006
7	TA 7054: Competitiveness and Structural Transformation in Pakistan	350,000	2008
D. Finance Sector Reforms		**8,165,000.0**	
1	TA2393: Capital Market Development	865,000	1995
2	TA2812: Interest Rate Management of National Savings Scheme	100,000	1997
3	TA2825: Capital Market and Insurance Law Reform	100,000	1997
4	TA2865: Restructuring of Public Sector Mutual Funds	800,000	1997
5	TA2937: Rural Microfinance	600,000	1997
6	TA3559: Enhancing Capital Market Depth for Preparing Capital Market Development Program II	150,000	2000
7	TA3650: Institutional Strengthening of the State Bank of Pakistan	450,000	2001
8	TA3696: Capacity Building for Capital Market Development and Corporate Governance	600,000	2001
9	TA4260: Strengthening Secured Transactions	500,000	2003
10	TA4668: Private Participation in Infrastructure Sector Development Program	1,000,000	2005
11	TA4894: Improving Access to Financial Services	2,000,000	2006
12	TA4956: Supporting Second Generation of Capital Market Reform Program	1,000,000	2007

DEVELOPMENT PARTNER MATRIX

ADB Portfolio	ADB Strategy/Activity	Other Development Partners Programs
Agriculture & Natural Resources	Strategic focus on promoting a sustainable, modern, and diversified agricultural production and marketing system focused on key value chains for improved competitiveness, as well as improved institutional environment for private sector investment. Supporting policy and institutional reforms in the water sector, and rehabilitation and upgrading of existing infrastructure for irrigation, drainage, and flood protection. Ongoing support for agriculture sector reforms aimed at facilitating a progressive increase in agriculture productivity and profitability. Assistance for barrage rehabilitation and on-farm water management in Punjab. Support for integrated rural development through area development projects in regions with high incidence of rural poverty, including in Malakand and Punjab and NWFP *barani* areas, and the Federally Administered Tribal Areas (FATA). Support for a coastal area development project in Sindh and agribusiness development. Ongoing assistance for developing a national agricultural sector strategy.	**Australia:** Strengthening agriculture sector interaction with commercial and research institutions in Australia. Technology development for rice and heavy stubbles. Supporting adoption of raised bed technology in Pakistan's irrigated maize and what cropping system. **Department for International Development (DFID):** Support for the Rural Support Programs Network (RSPN) for action and policy research to inform government policies for poverty reduction, devolution and to strengthen the capacity of rural support programs for working with the rural poor and local governments. **European Union (EU):** Support for a national project to enhance livestock productivity by reducing losses from animal diseases. Integrated area development project in Balochistan and Azad Jammu and Kashmir. **Food and Agriculture Organization (FAO):** Improving livestock and dairy productivity, small ruminant husbandry, feed availability, and sustainable use of rangelands in Balochistan. Development of marketing potentials of high value crops fisheries and livestock products through value addition for export and agribusiness development. Agriculture rehabilitation activities in the cyclone affected areas in Sindh. **International Fund for Agriculture Development:** Community development project in Azad Jammu and Kashmir. Agriculture development in Federally Administered Tribal Areas (FATA). Rural development project in Dir district of North West Frontier Province (NWFP). Village development in rain-fed areas of Punjab. Agriculture and rural development in Northern Areas. **Islamic Development Bank:** Water management and agriculture development in Chagai district of Balochistan. **Japan:** Canal system rehabilitation in Punjab. **Switzerland:** Supporting integrated natural resource management in designated forest areas.

ADB Portfolio	ADB Strategy/Activity	Other Development Partners Programs
		United Nations Development Program (UNDP): Support for addressing salinity in Punjab. Area development project in Balochistan. Support for innovative agricultural production techniques, training on post-harvest processing for farmers, and developing market linkages for farmers through area development programs. Support for establishment of mini-dams and irrigation channels through area development programs. Mass awareness program for water conservation at household, farm and industrial levels. **United States Agency for International Development (USAID):** Support for a market-driven agriculture development project implemented by FAO in collaboration with Balochistan's Department of Agriculture. **World Bank:** Water sector management and institutional reforms in Punjab. Rehabilitation of irrigation infrastructure at Taunsa Barrage in Punjab. On-farm water management in Sindh and NWFP to improve quality and equity of irrigation service delivery. Strengthening rural infrastructure and services in Azad Jammu and Kashmir. Supporting rural poverty reduction through the Pakistan Poverty Alleviation Fund with a focus on rural infrastructure and microfinance.
Energy	Strategic focus on supply of energy to meet national requirements through assistance from both public and private funding sources. Activities supported through ADB's assistance include power generation, transmission, and distribution facilities and systems. Support also includes energy sector reforms and capacity development of key agencies. On the demand side, ADB proposes to focus on supporting energy efficiency activities to address the issues of the high electricity usage per capita. Support for energy sector projects being provided through ongoing multitranche financing facilities (MFF) include those for renewable energy development and power transmission. Technical assistance is also being provided for policy formulation and capacity building for renewable energy, restructuring of the gas sector, and establishment of the Central Power Purchase Agency.	**Germany:** Erection of electrical substations in various cities and towns. Financing hydropower feasibility studies. **Global Environment Fund:** Supporting utility scale wind production. **Japan:** Support for load dispatch system upgradation. **People's Republic of China:** Support for Chashma Nuclear Power Project. Assistance for hydropower station in Gilgit, Northern Areas. **World Bank:** Focus on ensuring a competitive and efficient power sector providing affordable electric power; increased access to electricity in rural areas; efficient and competitive oil, gas and petroleum industries supported by effective Government regulation. Planned support for power transmission and distribution.

ADB Portfolio	ADB Strategy/Activity	Other Development Partners Programs
Finance & Trade	Strategic support for deepening of reforms in the equity and capital markets, diversification and innovation of financial services and products, development of infrastructure finance, public-private partnerships, and strengthening of regulatory and supervisory regimes to improve access to financial services to support inclusive growth. Application of technologies to lower transaction costs, and expand outreach and access to financial services will also be supported under programs including pilot mobile banking models. Ongoing assistance includes a private participation in infrastructure development facility, an access to financial services program, and a program to support second generation reforms for capital markets development.	**DFID:** Supporting tax administration reforms. Supporting microfinance services for poor women and policy dialogue on access to financial services. **EU:** Technical assistance to address trade related issues and building capacity for international trade negotiations. **International Fund for Agriculture Development:** Supporting outreach and innovation in microfinance services. **Switzerland**: Assistance to strengthen microfinance sector's responsiveness to the poor and building institutional capacities of microfinance actors. **USAID:** Supporting micro loans and financial services in Sindh, Balochistan, and FATA. Providing assistance for enterprise development activities. Supporting competitiveness related studies and activities. **World Bank:** Ongoing support through Pakistan Poverty Alleviation Fund (PPAF) for microfinance. Support for a tax administration reform program. Ongoing technical assistance for banking sector development.

DEVELOPMENT POLICY LETTER
OF THE GOVERNMENT OF PAKISTAN

SYED NAVEED QAMAR
Minister for Finance, Revenue, Economic Affairs & Statistics

ISLAMABAD

8 September 2008

D.O.No.F.1(34)EF(C)/2008.

Dear President Kuroda:

The Asian Development Bank (ADB) is a principal development partner of the Islamic Republic of Pakistan. The Government and the people of Pakistan value the role played by ADB in Pakistan's development. Through this letter, I am pleased to share with you an update on the key macroeconomic and selected sector developments in Pakistan as well as our outlook for the new fiscal year (FY) 2009 (July 2008-June 2009) and beyond. My account below of the macroeconomic situation, what we have done, and what we plan to do to strengthen Pakistan's economy and accelerate economic and structural transformation should, I expect, give confidence as you finalize ADB's support to Pakistan through the Accelerating Economic Transformation Program (AETP).

I. Recent Developments

In recent years, Pakistan's economy grew on an average by over 7% backed by structural economic and social transformation. A sequence of global events has however hit Pakistan more severely in comparison with many other developing economies, and detracted the trends of macroeconomic fundamentals. The severe impact of the skyrocketing increases in the international prices of oil and food products, and the rising import bills for these and the imported inflation at large, have impacted Pakistan's budget and the balance of payments. The turmoil in the international financial markets combined with the political impasse and the economic situation in Pakistan have curtailed investor confidence for much of FY08.

The new Government, which assumed office in March 2008 has been swift to diagnose the short and medium term issues and constraints facing the economy and is now launching with full ownership and commitment a macroeconomic stabilization program along with medium term structural reforms. Our outlook for this FY (July 2008-June 2009) and beyond is one of confidence.

In order to deal with the macroeconomic situation that has emerged, we have done extensive assessments and consulted with domestic and international stakeholders widely. On the international front, we have engaged the multilateral development agencies including the ADB to formulate and execute our policy responses to deal with the large and devastating exogenous shocks. We have had technical consultations with the International Monetary Fund (IMF).We are

pleased that ADB is supporting us in implementing a segment of the broader structural reforms through the AETP.

Before we summarize our policy responses which we believe will help in building that confidence further, it is illustrative to highlight the severity of the exogenous shocks and their impact on Pakistan's economy:

- Inflationary pressures: The overall year-on-year inflation rose from 7% in July 2007 to over 24% in July 2008. The Pakistani Rupees (PRs) has depreciated by over 22% over the last year. Marred largely by the global financial markets turmoil coupled with domestic challenges, the Karachi stock index – which was among the best performing in the region – has dropped significantly.
- Deterioration of external accounts: The higher global oil and food prices have meant greater import needs. Despite the export recovery we enjoyed (over 16% during FY08 in comparison with the 4.5% in FY07) and the robust workers' remittances (of over $11 billion) that we enjoyed, our current account deficit has widened due to the larger import bill
- Decline of foreign exchange reserves: The general global financial markets turmoil and the slowing of capital inflows led to a decline in the State Bank of Pakistan (SBP)'s gross international reserves by about 40% during FY08 to $8.6 billion and further to $6 billion in late August 2008.
- Unprecedented subsidy needs: Clearly, we have had to cushion the impact of the large exogenous shocks on the people. While we have since formulated a series of measures (as explained below) including better targeting of the subsidies, during FY08 we had to deal with and provide for a 4-fold jump in subsidy spending largely on power, fuel and wheat to PRs.408 billion against the originally budgeted PRs.114 billion. As a result, our fiscal deficit almost doubled to about 7.4% during FY2008.
- Impact on real GDP growth: It is hardly surprising that shocks of the magnitude we have seen will have an impact on growth. Our real GDP growth slowed to 5.8% during FY2008 against the 7% we had the previous year.

II. Our Policy Responses

The Government of Pakistan, working closely with the SBP and other stakeholders, has adopted a two-pronged strategy. The first is Macroeconomic Stabilization, a clear 5-point plan to deal with the macroeconomic and social impact of the exogenous price shocks. The second is Medium-Term Structural Transformation Reforms.

A. Macroeconomic Stabilization

1. **Deal with the Inflation**: Our task of balancing between price stability and growth has been a challenging one in light of the severity of the global shocks. Yet, the discount rate of SBP was increased by 350 basis points over FY2008. The cash reserve and statutory liquidity requirements were increased by 100 basis points in May 2008. In parallel, the federal Government has been coordinating with the provincial counterparts to reduce administrative barriers on the mobility of goods.

2. **Pass through the Subsidies**: We are fully committed to cutting our fiscal deficit to 4.7% of GDP by June 2009 in line with the budget. For this, we need to cut subsidies and trim expenditures including development spending. We have adopted a two-pronged strategy on fuel and power subsidies. On fuel, domestic fuel prices are being adjusted on a fortnightly basis. The Government started adjusting administered prices of key fuel items on 1 March 2008. Our goal is to move towards automatic price adjustments by the end of December 2008. The domestic prices of gasoline and high octane fuel are 1.7 times that of the import prices, and there is virtually no subsidy component there. On kerosene and light diesel oil, we have been reducing the subsidies. In June 2008, their domestic prices were 70% and 73%, respectively, of the import prices, implying around 30% subsidies. In July 2008, the gap narrowed to 75% and 77%, and in August 2008 further to 88% and 93%, respectively, in light of the declining global price of oil. On power, we plan on increasing the power tariffs by 62% before the end of FY2009 (June 2009). The first dose of 31% is likely to be made effective in early September 2008. The pass-throughs planned in the coming months on power and fuel will inevitably lead to higher inflation, which we stand ready to tackle through the targeted safety nets as well as through effective monetary measures.

3. **Protect the Poor from Economic Shocks**: The Government has considerably increased the allocation for social safety nets. The budget for FY2009 has an allocation of PRs41 billion, which could provide some social safety net cover for up to 5 million households. Much of it will go for the newly established Benazir Income Support Program. The safety net cover will be expanded during the next three years. In parallel, the growth-inducing measures will help increase livelihood opportunities and incomes.

4. **Shore up Foreign Exchange Reserves**: We are taking steps in five directions to strengthen the reserves and meet the immediate financing needs for the current FY. First, the macroeconomic stabilization measures being adopted will restore confidence and stability. Second, discussions with friendly oil exporting countries are at a very advanced stage to defer the payment of oil imports of about $5 billion annually. Third, we plan to pursue an aggressive privatization program as well as issuance of GDRs. Fourth, we will seek support from international financial institutions, including the ADB and the World Bank. And, fifth, we have introduced several foreign exchange conservation measures including: a 50% limit on advance payments for imports; stipulation on exchange bureaus to repatriate the foreign exchange from their Nostro accounts and to sell at least 25% of any foreign exchange receipts in the interbank market; in order to contain luxury imports, regulatory duty of upto 50% has been imposed on over 360 items, as well as a margin requirement of 100% for opening letters of credits for non-essential imports; and stipulation that prior SBP consent has to be obtained for outward remittances of more than $50,000.

5. **Increase Fiscal Discipline and Reduce Borrowing from the Central Bank**: Our efforts to pass-through the subsidies and prune development spending will, among others, help achieve our 4.7% deficit target. In parallel, we also need to look for alternative modes of financing deficit, reducing the recourse to borrowing from SBP. While the latter provided over PRs.550 billion in FY08 (up from PRs.100 billion the previous year), we have a clear goal of keeping the net borrowing to zero on a quarterly basis, and we are seriously considering achieving that target

on a monthly basis. The Government is launching Government Commercial Papers (GCPs) and short-term instruments (3,6 and 12 months) of the National Savings Scheme (NSS) with a view to reducing its reliance on SBP borrowing to finance the deficit. There will be no obligation on SBP to buy the Treasury Bills as a residual buyer. The Government will draw on the SBP account for purposes of ways and means only.

B. Medium-Term Structural Transformation Reforms

All of the above are immediate macroeconomic stabilization measures that are vital now. In parallel, the Government clearly recognizes that we need to tackle certain key sector reform issues. We have a two-part agenda moving forward. The first, in continuation of the measures to reduce dependence on SBP and increase the financing role played by commercial banks and other domestic institutions, is to strengthen the financial sector. The second will be to launch a systematic process of economic transformation in Pakistan by focusing on: how to do things differently, particularly in agriculture and industry to boost productivity.

1. Strengthen the Financial Sector

Along with the above macroeconomic stabilization measures, SBP with support of the Government has now launched a blue print to guide a ten year financial sector strategy. The key objective of this strategy will be to broaden, deepen and diversify financial system so that it can meet the bulk of the financing requirement of the private sector, while enhancing the penetration of financial services to the underserved people and regions. The strategy will focus on enhancing the efficiency and competition of the banking system through a consolidation process to be encouraged by a further rise in the minimum capital requirements. At the same time a proactive program is under way to enhance access to development finance for the required sectors.

At the same time, SBP has launched work on a host of legislative reforms to strengthen the oversight of the financial system. Among these most critical pieces of legislative reforms are plans, or completed measures, to:

(i) Adopt a modern Central Bank Act in line with international best practices to boost independence and autonomy and accountability of the SBP.

(ii) Adopt a new Banking Companies Ordinance which aims to strengthen oversight of the financial system by bringing under the central bank domain the deposit-taking non bank financial institutions as well as establishing a framework for consolidated supervision system for financial conglomerates. This will not only address the complications arising from the fragmentation of regulatory and supervisory oversight of segments of financial markets but would also appropriately assess the risk associated with the groups. This will also facilitate compliance with the Basel Committee's Core Principles. The SBP will henceforth be the lead regulator for financial groups/conglomerate and necessary arrangements will be put in place to ensure effective cooperation between the regulators of banking companies and other non-bank financial institutions. Necessary legislative changes to allow for consolidated supervision and offer flexibility to financial institutions to form financial groups and conglomerates will be approved by the Cabinet shortly.

(iii) Operationalize the Real Time Gross Settlement (RTGS) system by SBP for banking transactions and putting in place a full-fledged automated payment system for retail transactions.

(iv) Adopt a new consumer protection law. Leading to this, SBP has already set up a separate consumer protection department.

(v) Launch work on deposit protection. With the banking system being largely in private hands, there is no longer implicit government guarantees for deposits. Recognizing this, the SBP and the Government have now prepared a concept paper and a draft law on Deposit Protection Scheme which will be submitted to the Cabinet soon.

(vi) Strengthen the Anti-Money Laundering (AML) framework. After the introduction of the AML law, SBP with support of the Government has now operationalized the Financial Monitoring Unit (FMU) which is an independent entity housed in Central Bank and funded by the Federal Government. In line with practices in other countries, the National Committee on AML will provide overall policy guidance to FMU. ADB technical assistance will continue to support the strengthening of the AML regime and amendments are being already considered in AML law to conform it to best practices.

2. Economic Transformation

Let me now turn to the medium-term reform agenda that we would like to embark on, which is also included under the AETP. Recognizing the need for enhancing country's competitiveness, Pakistan has launched work to transform itself towards high-value added manufacturing and a better performing agriculture sector, with services backing up to provide logistics and finance. The country has to evolve a niche in global trade through high value creation. The Government would like to adopt a systematic approach towards structural economic transformation in order to reduce the macroeconomic imbalances we face today. We would like this agenda to be supported under AETP. Assisted by ADB TA, the Government has launched a macroeconomic assessment of the impediments to structural transformation; and launched work on evolving a business strategy for the National Trade Corridor to facilitate structural transformation of our economy. To effectively steer these efforts, the Government has constituted a High Level Steering Committee under the chairmanship of the Deputy Chairman of the Planning Commission with stakeholders to prepare a time-bound Action Plan for Structural Transformation, and coordinate the implementation of the Action Plan.

III. Full Government Ownership of the Reform Process

Mr. Kuroda, in outlining our efforts in the context of the planned support from ADB and other institutions, I wish to note specifically that the reform process is fully owned and driven by us. The five-point plan on the macreconomic stabilization front is based on a clear recognition of the need to address the short-term distortions. The sector reform agenda is in recognition of how to consolidate growth once we have gone through the adjustments this year. Our aim through the AETP (and planned investment and other support from other development partners) is to utilize the resources to address the short-term stabilization needs. Measures such as pass-throughs and

better targeting of subsidies and strengthening of demand management and reserves will put us on a sound footing to take up the medium-term reforms.

IV. Conclusion

In conclusion, Pakistan, being one of the most affected countries from the global commodity inflation, has launched a sound macroeconomic stabilization program. Despite its short tenure in office, the Government has taken some painful decisions that have been pending, including pass-through of international commodity prices, cut public expenditures and adopt sound demand management policies to contain the macroeconomic imbalances. To safeguard the poor and vulnerable, we believe sound efforts are underway to implement targeted safety net programs. In line with the immediate stabilization and medium-term reform agenda that we have laid out, the ADB's planned AETP aims to help us in meeting the short-term needs while we plan and launch reforms to accelerate growth and economic transformation now and beyond. For the current FY ending in June 2009, we have sought fresh assistance through the AETP of $500 million coming in September, 2008 (through the first subprogram of AETP) and another infusion of $500 million against which we will take measures over October 2008-May 2009, with the ADB's approval anticipated in June 2009. Needless to emphasize that release of the first tranche of $500 million of AETP in September, 2008 is extremely important given MOF's own commitment to have zero net borrowing from the Central Bank at the end of each quarter. Any slippage on this commitment will be very embarrassing for the MOF and is bound to send a negative signal on the resolve of the Government to deliver on its own reform agenda.

In the medium-term (over 2009-2011), we need to implement reforms that ought to have lasting changes on our economic landscape. These will be supported through the subsequent subprograms of AETP and assistance from other development partners in related areas. Working together with you, we are confident that the short and medium-term challenges can be effectively addressed.

Thank you and best regards,

Yours sincerely,

Naveed Qamar

SYED NAVEED QAMAR

Mr. Haruhiko Kuroda,
President,
Asian Development Bank,
Manila
Philippines.

POLICY MATRIX FOR THE PAKISTAN ACCELERATING ECONOMIC TRANSFORMATION PROGRAM

Key Program Dimensions	Selected Indicators
Impact: Sustained high economic growth **Outcome**: Structural transformation **Outputs** • Distortions removed in the short-term: o Wheat and energy subsidies rationalized and better targeted, and the role of Government institutions reduced and their governance strengthened o Poor and vulnerable protected in a targeted manner • Financial intermediation strengthened • Value creation accelerated	• GDP growth accelerated from 5.8% in 2007-08 to 8% per year over 2010-2020 • Untargeted subsidies rationalized from 3.5% of GDP in 2007-08, and targeted better to protect the poor and vulnerable • Banking sector credit to private sector expanded from 27% of GDP to 42% by 2018 (in State Bank of Pakistan's strategy) • Share of manufacturing sector in GDP increased from 19% in 2007-08 to 21% by 2012 and 30% by 2020 • Share of high-value added output in exports increased to 15% by 2012 and to 40% by 2020

Outputs	Subprogram 1 Activities	Subprogram 2 (June 2009) Indicative Activities	Subprogram 3 (June 2010) Indicative Activities
Output 1: Immediate distortions removed to initiate structural transformation			
Output 1.1: Targeted safety nets designed and rolled out for the poor and vulnerable households			
Social impact of food and fuel inflationary pressures mitigated through targeted safety net programs	Safety net cover for up to 5 million poor households provided for through allocation of PRs41 billion in FY2009 budget[1] Clear criteria developed for selecting beneficiaries of cash transfers through the Benazir Income Support Program	Budget allocation provided in FY2009-10 budget for income support for up to 7 million households Safety net programs evaluated and revisions adopted	Budget allocation provided in FY2010-11 budget for income support for up to 9.5 million households Implementation of improved safety net programs
Output 1.2: Market-based wheat pricing and efficient reserve management in place			
Wheat subsidies reduced and eliminated; wheat procurement made competitive	Time-bound action plan adopted by Economic Coordination Committee (ECC) for market-based pricing and reserve management[2]	Support price of wheat for farmers increased to at least 80% of import parity level	Support and issue prices for wheat raised to the market level

[1] Through expansion and strengthening of the Bait-ul-Mal Food Support Program and establishment of the new Benazir Income Support Program.

[2] The action plan will address: (i) elimination of wheat subsidies through the support price of wheat for farmers; (ii) elimination of operational reserves while maintaining strategic reserves at 2 months of annual average national consumption requirements by June 2010; (iii) removal of administrative restrictions on domestic wheat trade; (iv) completion of restructuring of PASSCO and the provincial food departments and directorates; (v) implementation of a targeted safety net program for poor and vulnerable households; and (vi) divestment of government ownership in unused warehouses, storage facilities and other market infrastructure. The action plan shall be implemented over the period between subprograms 1 and 3.

Outputs	Subprogram 1 Activities	Subprogram 2 (June 2009) Indicative Activities	Subprogram 3 (June 2010) Indicative Activities
	Support price of wheat for farmers increased from PRs425[3] to PRs650	Issue price of wheat to flour mills increased to at least 90% of market price Wheat reserves set at 3 months of national annual average consumption requirements (by September 2008); and pursuant to this, administrative restrictions on domestic movement of wheat eliminated Divestment of unused Government-owned storage and warehouse facilities; upgrading of existing facilities; and leasing of new storage facilities through public-private partnerships initiated	Operational reserves for wheat eliminated and strategic reserves capped at 2 months of annual average national consumption requirements Restructuring of PASSCO and the provincial food departments and directorates completed Status report on the implementation of the action plan endorsed by the ECC Divestment of unused Government-owned facilities completed
Output 1.3: Electricity subsidies funded and power sector debt restructuring initiated			
Past liabilities, including electricity subsidies, settled and debt restructuring plan implemented	Parliamentary approval obtained to reduce electricity subsidies through: (i) elimination of generalized sales tax subsidies for all domestic consumers and up to 500 units for commercial consumers; (ii) introduction of automatic monthly fuel price adjustments through a surcharge; and (iii) introduction of an additional surcharge to be levied on all consumers to reduce the gap between determined and notified tariffs. Work on estimation of power sector debt overhang and circular debt initiated	Power sector debt overhang restructuring plan prepared and implementation commenced including ring-fencing of the debt owed by distribution companies	Circular debt in the power sector eliminated and the overall debt liabilities adequately settled Differential between the determined and notified tariff eliminated to reflect the actual cost of supply of power to end consumers (except lifeline households)

3 For 40 kilograms, which is the standard unit of measurement in Pakistan.

Outputs	Subprogram 1 Activities	Subprogram 2 (June 2009) Indicative Activities	Subprogram 3 (June 2010) Indicative Activities
	All past electricity subsidy payments (PRs133 billion for FY2008) fully settled, and PRs88 billion allocated in the FY2009 budget to partially cover the difference between determined and notified tariffs [for FY 2009]		
Output 2: Financial intermediation strengthened to support structural transformation			
Prudential regulation and supervision strengthened	SBP has drafted a new Banking Act aligning it with international best practices	New Banking Act enacted and being implemented	
	SBP has raised minimum capital requirements as part of Basel II implementation	Prudential and other regulatory norms brought in line with Basel Core Principles	Prudential and other regulatory norms being implemented and progress evaluated.
	SBP has launched work on a 10-year financial sector strategy to broaden and diversify financial markets while developing supportive financial safety nets, safeguards for consumer protection and effectively fighting against money laundering and financial crimes	Implementation of financial sector strategy underway	Implementation of financial sector strategy advanced
	Cabinet approval obtained for legislative amendments to enable SBP to better manage systemic risks by: (i) adopting a consolidated supervisory framework, allowing SBP to be the lead supervisor of financial groups and conglomerates in compliance with Basel Core Principle 24; and (ii) transferring the licensing, regulation and supervision authority of deposit-taking institutions to SBP[4]	Regime for consolidated supervision established and being implemented Amendments to AML Law enacted. Implementation rules and regulations adopted for AML Law.	Implementation of AML regime evaluated and changes proposed

[4] A financial conglomerate includes any group of legal entities whose exclusive or predominant activities is banking and at least one other activity in the financial sector.

Outputs	Subprogram 1 Activities	Subprogram 2 (June 2009) Indicative Activities	Subprogram 3 (June 2010) Indicative Activities
	Cabinet approval obtained for amendments to strengthen the anti-money laundering (AML) legal framework[5] incorporating international standards and best practices. FMU established and operationalized, with the SBP providing interim budget support and administrative oversight	FMU granted financial and operational autonomy, including adequate budget allocations The national-level committee to adopt and roll-out a national AML training program	
Autonomy and governance of the central bank strengthened	SBP has launched work on a new Central Bank Law that provides for greater autonomy and accountability of SBP in its monetary and financial policies, effective regulation and supervision of financial institutions under its oversight, and clarity in the role of SBP in financial safety net and lender of last resort functions	New SBP Act enacted and key provisions implemented	
National payment systems strengthened	Payments Systems and Electronic Funds Transfer Act (2007) enacted Real-Time Gross Settlement (RTGS) system launched Centralized online system for retail payment systems established	RTGS fully rolled out and retail payment systems being implemented	Payment systems implementation evaluated and improvements introduced
Consumer and depositor protection strengthened	Consumer Protection Department established in SBP and work launched on a Consumer Protection Law	Consumer Protection Law enacted	

[5] Among other things, the amendments will: (i) provide for a single national-level committee to oversee and provide policy guidance for AML efforts, instead of two committees that operate at present; (ii) ensure financial and operational autonomy of the Financial Monitoring Unit (FMU); (iii) provide that the FMU shall act as the secretariat for the national level committee; and (iv) set out transparent criteria for the appointment and dismissal of the head of FMU.

Outputs	Subprogram 1 Activities	Subprogram 2 (June 2009) Indicative Activities	Subprogram 3 (June 2010) Indicative Activities
	Concept paper and draft Law on Deposit Protection Scheme prepared and consultations launched with stakeholders	Deposit Protection Law drafted SBP monitoring compliance with new disclosure policies, including framework for handling consumer complaints	Deposit protection scheme launched
Output 3: National structural transformation strategies designed and implemented			
Develop and implement national structural transformation strategy	High-level steering committee [6] established (reporting to the Prime Minister/Cabinet) to lead work on Pakistan's structural transformation All preparatory steps finalized for the studies on structural transformation	A national structural transformation strategy and action plan adopted by the Cabinet Priority sectors identified, and sector specific reform measures initiated in selected priority sectors	Implementation of the action plan underway (and status report on implementation prepared by the working group for submission to the Prime Minister/Cabinet by subprogram 4) Industry/sector programs implemented Key economic ministries and agencies restructured to facilitate structural transformation and attract investments
Measures adopted to facilitate investments	Auto Industry Development Program adopted (to accelerate the share of this segment from 2.8% of the GDP from 2005-06 to 5.6% by 2011-2012) Risk-based customs inspection introduced and an e-filing and payments systems adopted for customs and sales tax	Customs modernization expanded to cover all locations Corporate expansion facilitated through tax and other incentives Disparate labor laws consolidated to reduce transaction costs	Medium-term tariff policy prepared and adopted E-readiness assessed for conducting government business; electronic communications recognized as official

[6] The steering committee's deliberations and strategy formulation will be supported by ADB TA on growth diagnostics and structural transformation, and the business investment potential of the National Trade Corridor.

IMF MACROECONOMIC ASSESSMENT LETTER

Pakistan—Assessment Letter to the Asian Development Bank

August 28, 2008

This note provides the IMF staff's assessment of Pakistan's macroeconomic developments and prospects as background for an Accelerating Economic Transformation Program loan to be considered by the Executive Board of the Asian Development Bank.

Recent Macroeconomic Developments

Pakistan's macroeconomic situation deteriorated significantly in 2007/08 (fiscal year ended June 30) and in the first two months of 2008/09 owing to political and security developments, large exogenous price shocks (oil and food), and policy inaction during the political transition, beginning around mid-2007. The present government has recently taken some limited steps to address the current macroeconomic imbalances, but is still in the process of developing a comprehensive policy plan. Specifically:

- Real GDP growth slowed to 5.8 percent (7 percent in 2006/07), reflecting weaker performance of the agricultural and manufacturing sectors.

- Headline CPI 12-month inflation rose to 24.3 percent in July 2008, with core inflation (excluding energy and food) also increasing to 14.7 percent. The rupee has depreciated by 22 percent against the U.S. dollar since end-June 2007, with most of the depreciation taking place in recent months as the State Bank of Pakistan (SBP) has allowed for greater exchange rate flexibility in the context of growing pressures in the foreign exchange market.

- The external current account deficit widened to about $14 billion or 8½ percent of GDP in 2007/08. Export growth recovered to 16½ percent (4½ percent in 2006/07) and workers' remittances and other current transfers performed strongly to reach $11.1 billion, but total imports grew by more than 30 percent owing to an increase of $4 billion (2½ percent of GDP) in the value of oil imports and strong aggregate demand growth.

- With the slowing of capital inflows, the surplus in the financial account of the balance of payments declined to $8.7 billion in 2007/08, from $10.1 billion in 2006/07. As a result, the SBP's gross international reserves dropped by $5.7 billion, to a level of $8.6 billion at end-June 2008. Gross reserves declined further by $2.6 billion subsequently, to $6.0 billion (1½ months of imports and about 90 percent of foreign currency deposits and short-term external liabilities on a remaining maturity basis) as of August 22.

- The fiscal deficit is estimated to have risen to 7.4 percent of GDP in 2007/08, from 3.7 percent in 2006/07, mainly because of a substantial increase in energy and food subsidies (in a context of rising international prices that were not passed through) and

higher than envisaged interest payments on National Savings Scheme (NSS) instruments. The deficit was largely covered through SBP financing.

- Broad money growth slowed to 15.3 percent in 2007/08, with credit growth to the private sector decelerating to 16.4 percent. Reserve money growth, however, increased to 21.6 percent. Budgetary support from the SBP amounted to PRs700 billion (about $10 billion) in 2007/08. The expansionary impact of central bank financing of the deficit was partially compensated by the drop in international reserves and in the SBP's outstanding credit to commercial banks.

- Increases in interest rates have been insufficient in light of the rise in inflation. The SBP has increased its discount rate in several steps by 350 basis points since July 2007, to 13 percent. In addition, cash reserve and statutory liquidity requirements were raised by 1 percentage point in May 2008. Cut-off interest rates in the bi-weekly auctions of treasury bills have largely followed the changes in the discount rate. Up to end-June 2008, commercial banks reduced their holdings of treasury bills. Partial data since end-June 2008 suggest that commercial banks have increased somewhat their holdings, but SBP financing of the government has continued.

- Political uncertainties, the deteriorating economic performance, and the turmoil in international financial markets have dampened investor sentiment. The EMBIG spread of Pakistani sovereign bonds has risen to above 900 basis points. Moreover, after climbing to new record highs by end-April 2008, the Karachi KSE-100 stock index has dropped by 35 percent.

- Progress on the structural front has been slow. No significant privatization has been completed since the Supreme Court declared void the sale of Pakistan Steel Mills in June 2006, and electricity tariffs remain well below cost recovery levels. In addition, the planned corporatization and computerization of the NSS has not yet been completed.

- Faced with increasing pressures in the foreign exchange market, in May 2008 the authorities adopted several exchange measures consisting of: (i) a 50 percent limit on advance payments for imports; (ii) the requirement for exchange bureaus to repatriate foreign exchange from their Nostro accounts and to sell 25 percent of any foreign exchange receipts in the interbank market; (iii) prior SBP consent for outward remittances of more than $50,000; and (iv) a margin requirement of 35 percent for the opening of letters of credit for non-essential imports.

Prospects for 2008/09 and Authorities' Plans to Address Pakistan's Vulnerabilities

IMF staff's preliminary projections for 2008/09 based on a continuation of the prevailing monetary policy stance, expected external financing, and revised oil prices envisage an external current account deficit of $14 billion (7.7 percent of GDP) in 2008/09. With capital inflows of about $7.0 billion, the staff estimates an external financing gap of about $7.0 billion. Given the difficulties involved in forecasting capital flows in an unsettled macroeconomic environment, this financing gap is subject to a high degree of uncertainty. Real GDP growth is expected to slow further to about 4½–5 percent in 2008/09, while average inflation is projected to increase to 16–17 percent owing in part to the envisaged pass-through of higher international prices for energy and food.

Recently, the authorities specified their policy plans for the current fiscal year and stressed their commitment to addressing Pakistan's macroeconomic imbalances and putting the economy back on a sustainable path.

The authorities emphasized the government's intention to reduce the fiscal deficit to 4.7 percent of GDP in 2008/09, in line with the budget recently approved by parliament, including by phasing out subsidies on fuel products by December 2008 and on electricity by June 2009, and rationalizing both current and development expenditures. Moreover, following the recent increases in the discount rate and the adoption of a policy of greater exchange rate flexibility, the authorities indicated that the SBP stood ready to take further actions in this direction, as needed. The authorities also committed to meeting the government's domestic financing needs through market-based instruments and ensuring that borrowing from the SBP is zero on a net basis at the end of each quarter.

The authorities also intend to strengthen the international reserves position by accelerating the pace of privatization and tapping equity markets through the issuance of GDRs and exchangeable bonds. At the same time, the authorities have requested friendly countries (Saudi Arabia, Kuwait, and the UAE) to defer the payments for imports of crude oil and products, and expect to receive a favorable response in the near future.

Staff's Assessment

Pakistan's macroeconomic situation is very fragile and further significant reserve losses would make the country vulnerable to a crisis. In this context, the outlook for 2008/09 depends critically on steadfast policy implementation and the availability of substantial additional external financing.

The authorities need to implement quickly and decisively the policies they have outlined, which represent an important step forward to restore macroeconomic stability. The authorities have already taken some of the measures aimed at strengthening the fiscal

position. In particular, domestic fuel prices are being adjusted on a fortnightly basis to phase out oil subsidies, and the pace of development spending has been slowed. However, further measures are required to achieve the target of reducing the fiscal deficit to 4.7 percent of GDP. On the expenditure side, the authorities need to move ahead with the planned increase in electricity tariffs to eliminate electricity subsidies, and with larger than budgeted reductions in other outlays to offset the impact of potentially higher interest rates on the government's debt service. This will require removing other subsidies, containing other noninterest current expenditures, and carefully prioritizing development spending. The authorities should also ensure the implementation of the targeted social protection mechanisms incorporated in the 2008/09 budget to cushion the impact of lower subsidies on vulnerable groups. Regarding revenue, a stronger than envisaged effort is needed to broaden the tax base by eliminating some tax exemptions.

On the monetary side, as noted above, recent increases in interest rates have been insufficient to stem reserve losses and eliminate central bank financing of the government. Thus, interest rates should be allowed to rise as needed to lower inflation and ensure that the domestic financing of the deficit is covered entirely by commercial banks and non-bank sources. In addition, the SBP should limit its intervention in the interbank foreign exchange market to smoothing excessive volatility, and allow the exchange rate to respond fully to market forces.

Given the low level of gross official reserves, there is an urgent need to fill the financing gap for 2008/09 and strengthen the reserves position. This will be challenging and depends both on the implementation of the macroeconomic policies outlined by the government as well as on securing significant external financing. In particular, the authorities have requested an oil facility from Saudi Arabia to defer the payment of oil imports of 110,000 barrels per day, which at current oil prices would amount to about $5.0 billion on an annual basis. This facility would allow Pakistan to cover a large part of the financing gap in 2008/09, but its timing and terms are still under discussion. Additional external financing needs to be mobilized from international financial institutions and bilateral sources, and by stepping up privatization. Provided that appropriate financing is secured shortly, timely and consistent implementation of the policies described above would go a long way toward addressing Pakistan's macroeconomic vulnerabilities in 2008/09.

Looking beyond 2008/09, a further fiscal effort, together with the continuation of a tight monetary policy and exchange rate flexibility, will be required to achieve a sustainable current account position and bring down inflation. In particular, strong tax and policy administration measures will be necessary to further reduce the fiscal deficit while allowing for higher spending on infrastructure and the social sectors. Specifically, Fund staff believes that tax revenue should be increased by at least 3-4 percentage points of GDP over the medium term (from 10 percent of GDP in 2007/08) by broadening the base of the general sales tax to services, taxing commercial agriculture under the income tax, eliminating other tax exemptions, and significantly strengthening tax enforcement.

Status of IMF Relations with Pakistan

The 2007 Article IV consultation was concluded on December 17, 2007. Since that time, there have been frequent informal contacts between the staff and authorities. A staff team from the Fund and the World Bank will visit Pakistan in early September to conduct an updated assessment of the financial sector under the Financial Sector Assessment Program (FSAP). The 2008 Article IV consultation mission is tentatively scheduled for the second half of October 2008.

LIST OF INELIGIBLE ITEMS

No withdrawals shall be made in respect of:

(i) expenditures for goods included in the following groups or subgroups of the United Nations Standard International Trade Classification, Revision 3 (SITC, Rev. 3), or any successor groups or subgroups under future revisions in the SITC, as designated by ADB to the Borrower:

Table 1: Ineligible Items

Chapter	Heading	Description of Items
112		Alcoholic beverages
121		Tobacco, unmanufactured; tobacco refuse
122		Tobacco, manufactured (whether or not containing tobacco substitute
525		Radioactive and associated materials
667		Pearls, precious and semiprecious stones, unworked or worked
718	718.7	Nuclear reactors, and parts thereof, fuel elements (cartridges), nonirradiated for nuclear reactors
728	728.43	Tobacco processing machinery
897	897.3	Jewelry of gold, silver, or platinum-group metals (except watches and watch cases) and goldsmiths' or silversmiths' wares (including set gems)
971		Gold, nonmonetary (excluding gold ore and concentrates)

Source: United Nations.

(ii) expenditures in the currency of the Borrower or of goods supplied from the territory of the Borrower;

(iii) expenditures for goods supplied under a contract that any national or international financing institution or agency will have financed or has agreed to finance, including any contract financed under any loan from ADB;

(iv) expenditures for goods intended for a military or paramilitary purpose or for luxury consumption;

(v) expenditures for narcotics;

(vi) expenditures for environmentally hazardous goods, the manufacture, use, or import of which is prohibited under the laws of the Borrower or international agreements to which the Borrower is a party; and

(vii) expenditures on account of any payment prohibited by the Borrower in compliance with a decision of the United Nations Security Council taken under Chapter VII of the Charter of the United Nations.

TECHNICAL ASSISTANCE

I. Impact and Outcome of the TA

1. The purpose of the TA is to mobilize quality expertise and share international experience to help the Government of Pakistan in a range of economic policy areas. The impact of the TA is the facilitation of economic transformation in Pakistan. The TA outputs will include a well-sequenced reform agenda and greater consensus amongst the policy makers and relevant stakeholders on the need for, and approaches to, short, medium and long-term transformational reforms. The implementation of the TA will start in September 2008, and may be continued until August 2010. The TA outcome will primarily be the actual implementation of a slice of the reform agenda over this period. The TA design and monitoring framework is presented in Table A13.1 below.

Table A13.1: Design and Monitoring Framework

Design Summary	Performance Targets/Indicators	Data Sources/Reporting Mechanisms	Assumptions and Risks
Impact: Facilitation of economic transformation in Pakistan	• Time-bound action plan for the structural transformation agenda adopted		**Assumption** • Private sector responds positively to policy reforms **Risks** • Resistance from vested interest groups
Outcome: Successful implementation of a slice of reform (i.e., transformation agenda and financial sector development) under the AETP	• Identification of priority sectors of high value-addition		**Assumption** • Ongoing support and ownership by implementing agencies **Risks** • Weak absorptive capacity of implementing agencies
Outputs **1. Implementing structural transformation** 1.1. Support to High Level Working Group; coordination with provincial governments; implementation of the action plan	Implementation of the action plan on-track	Ministry of Finance	**Assumptions** • Private sector dialogue is effective • Development partner support and close coordination **Risks** • Political instability • External vulnerabilities
1.2. Short-term investment climate measures (Labor and skills)	Adoption of measures by the High Level Working Group	Ministry of Labor	
1.3. Assessment of policy, tax, and institutional distortions and incentives	Appropriate business incentives formulated based on tax and tariff structure analysis	Ministry of Finance	
2. Financial sector development 2.1. Establishment and roll-out of consolidated supervision	Regime for consolidated supervision of financial groups (including financial conglomerates) established and being implemented	State Bank of Pakistan	

2.2. Non-bank financial sector development to aid structural transformation	Selected policy and institutional reforms adopted	State Bank of Pakistan/Securities and Exchange Commission of Pakistan	
Activities with Milestones 1.1.1. Prepare structural transformation strategy and time-bound action plan (December 2008) 1.1.2. Design support/development programs in key sectors identified based on structural transformation strategy (June 2009) 1.2.1. Prepare a report in the labor area summarizing the reform principles which the Government should achieve, including consolidating multiple laws and regulations, and gradually eliminating distortions while providing specific incentives (December 2008) 1.3.1. Prepare recommendation to facilitate corporate expansion through tax and other incentives (December 2008) 1.3.2. Prepare recommendation for the restructuring of key economic ministries and agencies to facilitate structural transformation and attract investments (September 2009) 1.3.3. Prepare medium-term tariff policy (December 2009) 2.1.1. Prepare recommendation on the establishment of a regime for consolidated supervision (October 2008) 2.1.2. Develop the policy, institutional and regulatory architecture for holding companies (December 2008) and developing an automatic electricity tariff adjustment mechanism (June 2009) 3.1.1. Prepare recommendation on reform measures to promote long-term sources of financing corporate growth (including debt instruments) (December 2009)			Inputs ADB TA: $800,000 Government: $240,000

II. Scope of the TA

2. The Government and the ADB program team have identified TA needs in two areas. The following paragraphs present the coverage of issues, which may be further elaborated and refined prior to or during the implementation of the TA.

3. **Structural Transformation – Paving way for Medium-term Reforms**: As outlined in the main text of the RRP, the technical work on structural transformation will be undertaken through an ongoing TA and a TA loan. The purpose of this component of the proposed TA is to coordinate the formulation of structural transformation strategies, help the Government build consensus amongst the relevant stakeholders, and to implement the strategy. Specifically, the TA will support the High Level Working Group and help maintain reform momentum by (i) providing policy advice during deliberations of the working group, (ii) assisting in the formulation of reform actions, (iii) facilitating consensus building on reform measures, (iv) assisting in the roll out of the national structural transformation action plan, (v) assisting in the design of sector-specific development programs, (vi) monitoring the implementation of these programs, and (vii) providing recommendations on relevant issues such as how to promote structural transformation, streamlining business processes and structures of government agencies, and moving away from regulation to promoting innovation in the industries.

4. **Structural Transformation – Implementing Immediate/Short-term Reforms (Investment Climate)**: This TA component will help the Government in formulating and implementing a range of short-term measures critical to attracting investments, in parallel with the longer-term structural transformation agenda. At this stage, the specific areas identified include: (i) streamlining of labor laws – under which labor experts will assist in scoping out the

legal amendments initiated by the Government to consolidate the disparate labor laws, and provide recommendations on future steps that can be supported under AETP; this is in continuation of the reform agenda initiated with ADB support under the Small and Medium Enterprise Development Program; (ii) identifying tax-related distortions that prevent the formation of business or further expansion of existing ones, and helping with the formulation of appropriate incentives; and (iii) improving the tariff policy, based on past (and updated) assessments of the tariff bands and dispersions, and recommending measures to increase Pakistan's competitiveness.

5. **Finance/Corporate Sector Development**: The support under the TA will focus on carrying forward the agenda identified and initiated as part of subprogram 1 of AETP on banking, non-banking and corporate sector (with focus on holding companies or groups) fronts. International/national expertise will be mobilized on a needs-basis in any of the areas included in subprograms 1-3 of the policy matrix. In addition, consultants will also support in the design of measures for promoting long-term financing in Pakistan, specifically through pension and insurance sector reforms, which may be included in future subprograms.

III. Implementation Arrangements and Cost Estimates

6. It is estimated that 5-6 international experts and 6 national experts will be required with expertise in the areas identified in Table A13.2. Their outline terms of reference are presented in Section IV below. However, depending on the emerging circumstances, the CWRD team implementing the TA will retain flexibility on the number and person-month allocations between the categories as well as their tasks. All experts will be recruited on an individual basis, given the disparate nature of the tasks involved, and the possible need to recruit and deploy consultants at different points in time subject to reform traction. Table A13.3 presents the cost estimates and financing plan for the TA.

Table A13.2: Technical Assistance Requirements

Advisory Needs for Design and Implementation of Reforms (Key Areas and Indicative Person-Months Requirements)		
Key Areas	**International**	**National**
1. Implementing structural transformation (3-4 international and 4 national expert)	**10**	**20**
1.1. Support to High Level Working Group; coordination with provincial governments; implementation of the action plan	6.0	10
1.2. Short-term investment climate measures (Labor and skills)	1.5	2
1.3. Assessment of policy, tax, and institutional distortions and incentives	2.5	8
2. Financial sector development (2 international and 2 national)	**5**	**10**
2.1. Establishment and roll-out of consolidated supervision	2	5
2.2. Non-bank financial sector development to aid structural transformation	3	5
Indicative Total Requirements	**15**	**30**

7. The Ministry of Finance (MOF) will be the executing agency (EA) for the TA. MOF will facilitate the work under Components 1 and 2, and help the consultants in the coordination of technical work with any of the concerned departments/agencies. Work under Component 3 will be directly under the supervision of the concerned financial sector regulators.

8. As the overall purpose of the TA is to facilitate structural transformation, there is need for: (i) increasing awareness amongst government officials and policy makers; (ii) improving coordination between the federal and provincial governments, as the policy and institutional jurisdiction is split between the two levels; and (iii) improving the interface between investors and corporates on the one hand and the government on the other. The TA will organize workshops or special events/sessions targeted at selected industries.

Table A13.3. Cost Estimates and Financing Plan for AETP TA

Item	**Total Cost**
A. Asian Development Bank Financing	
1. Consultants	
a. Remuneration and Per Diem	
i. International	435.00
ii. National	130.00
b. International and local travel	70.00
2. Workshops and Seminars	25.00
3. Contingencies	140.00
Subtotal A	**800.00**
B. Government Financing	
1. Office Space and Facilities	120.00
2. Remuneration and Transport of Counterpart Staff	80.00
3. Others	40.00
Subtotal B	**240.00**
Total	**$1,040.00**

IV. Outline Terms of Reference for the AETP Design and Implementation TA

9. The following terms of reference (TORs) have been formulated on the basis of the TA needs assessment during AETP appraisal. Changes – both in coverage and expertise – may be necessary during implementation.

10. **Structural Transformation**: This component will be partly technical and design of reform measures, but mostly implementation of the plan prepared as part of the ongoing studies being undertaken with the Government of Pakistan on structural transformation.

11. **Medium-term Transformation Agenda** (broadly item 1.1 in Table A13.2): The ongoing TAs are likely to be completed by about March-April 2009. The most challenging part of the process will be the actual implementation of the recommendations of the two studies. The experts under this component of the TA will work closely with the Planning Commission and Ministry of Finance and other relevant parties (including provincial governments) to begin implementation the transformation agenda. Specifically, the experts who will work on an intermittent basis, will:

(i) work closely with the two advisory teams in the last stages of their work to come to speed on (preparing) the Action Plan, principally to provide peer-review type feedback as well as to ensure that the actions are practical to implement in Pakistan's context;

(ii) identify, for each set of actions, the lead and supportive agencies/ministries/levels of governments, that need to be in charge of implementation, and build ownership;
(iii) develop a full fledged implementation chart, with clear indicators and milestones, to monitor and evaluate the action plan execution;
(iv) develop a system of identifying blocks to smooth execution and informing the Government's senior management team to take immediate corrective actions;
(v) explain the benchmarking exercise done as part of the studies to all relevant stakeholders and build and sustain reform momentum for change;
(vi) organize consultative workshops or sessions with other countries/jurisdictions that have gone through the transformation process, and to help continue the interface (to learn from real and successful examples);
(vii) organize/facilitate/recommend consultations between stakeholders within Pakistan to execute the action plan smoothly;
(viii) help the government in identifying one or two industries (or segments of industries) as pilots for full implementation of the action plan; design a system for using the feedback for subsequent expansion of the transformation agenda;
(ix) help the government in identifying common, generic constraints that prevent structural transformation; group them into themes (e.g. labor/skills; taxes/tariffs; infrastructure; legal/regulatory) and help the government prioritize actions to gradually dismantle the constraints; and
(x) act as an effective interface between the original study teams, the Government and ADB to ensure that information flows smoothly, any problems are identified and solutions sought in a collective manner, and measures put in place to accelerate execution of the action plan.

12. **Near-Term Transformation Agenda** (items 1.2 and 1.3 of Table A13.2): Under this sub-component, 2 international and 2 national experts will be recruited to help the Government address the immediate investment-climate related challenges facing Pakistan, which in turn would pave way for the medium-term transformational reforms. The experts will:

(i) examine recent assessments done by the Government, and those by ADB and other development partners on the key challenges affecting the investment climate adversely, including labor market rigidities (e.g. exit barriers) and skills shortages, and tax and tariff distortions;
(ii) identify key priorities and specific reform measures, and sequence them for the Government's attention and consideration; establish a timeline for implementation (also with a view to providing specific measures/milestones that the Government can achieve for subprogram 2 of AETP, that is between September 2008-June 2009, and beyond);
(iii) in the labor area, prepare a short report summarizing the reform principles the Government should aim to achieve, such as consolidating multiple laws and regulations, reducing regulatory arbitrage, and gradually eliminating distortions while providing specific incentives;
(iv) in the tax and tariff areas, assess recommendations put together already by institutions such as the Engineering Development Board of Pakistan, the various chambers of commerce and industry, and trade/industry associations/think tanks, and prioritize and sequence practical and least distortionary actions for the Government's considerations; and establish a timeline for implementation (in a manner as in (ii) above); and

(v) evaluate the current institutional architecture for investment approvals and recommend measures to streamline the policy-making, regulatory and business processes among commerce, trade, industries (and other relevant economic) ministries, and the Board of Investment and other statutory bodies; essentially, examine if Pakistan needs a plethora of agencies dealing with various issues, and how they can function better (including through reorganization/realignment options) to promote innovation and efficiency (eventually leading to transformation)

13. **Financial/Corporate Sector Development** (item 2 of Table A13.2): Under this component, ADB has ongoing engagement on the regulatory and supervisory fronts. The exact TA requirements are not clear at this stage, while the broad directions are evident. These include: need for adopting a legal/regulatory architecture for group companies (which may play an important role in structural transformation, while in some cases may stifle it as well through opaque dealings within groups); and need for identifying long-term financing sources for corporate growth, including by expanding pension and insurance coverage. The experts in this area will:

(i) help the government and the concerned regulatory agencies (State Bank of Pakistan; and Securities and Exchange Commission of Pakistan) to effectively roll-out and implement the architecture for consolidated supervision;
(ii) help develop the policy, institutional and regulatory architecture for holding companies;
(iii) identify reform measures to promote long-term sources of financing corporate growth in Pakistan, with focus on both demand and supply sides (including debt instruments – specifically corporate bond market development; how the existing national saving system can be revamped; development of contractual savings institutions); and
(iv) suggest institutional measures for promoting domestic currency infrastructure financing in Pakistan.

SUMMARY POVERTY REDUCTION AND SOCIAL STRATEGY

Country/ProgramTitle: Pakistan/Accelerating Economic Transformation Program

Lending/Financing Modality:	Policy-Based	Department/ Division:	**CWRD/CWGF**

I. POVERTY ANALYSIS AND STRATEGY

A. Linkages to the National Poverty Reduction Strategy and Country Partnership Strategy

The Government's second generation poverty reduction strategy (PRSP II) is built around seven pillars: (i) drivers of economic growth and macroeconomic stability, (ii) crafting a competitive advantage, (iii) harnessing potential of the people, (iv) financial sector deepening and economic development, (v) provision of world class infrastructure, (vi) effective governance and management, and (vii) targeting the poor and the vulnerable. ADB's Country Strategy and Program for Pakistan similarly supports the Government's emphasis toward higher sustained growth.

The recent trends in global and regional poverty as well as Pakistan's own experience from the last PRSP suggest that rapid economic growth over a prolonged period is essential for poverty reduction. At the macro level, economic growth implies greater availability of public resources to improve the quantity and quality of education, health and other services. At the micro level, economic growth creates employment opportunities, increases the income of people and therefore, reduces poverty. The proposed Program will help Pakistan achieve and sustain higher economic growth in the medium term through a process of structural transformation.

B. Poverty Analysis **Targeting Classification: General Intervention**

1. Key Issues

Between 2000/01 and 2004/05, Government estimates suggest a significant decline in the incidence of poverty in the country.[1] The proportion of population living below the poverty line fell sharply from 34.5% in 2000/01 to 23.9% in 2004/05,[2] with approximately 13 million people moving out of poverty. This happened at the back of Pakistan's strong economic growth which accelerated from 3.1% during 2001/02 to 4.7% the next year, and onto an average of 8.1% during 2003/04 and 2004/05. The steep decline in poverty of over 10 percentage points in four years actually more than offset the sharp rise in poverty during 1997-2001 when overall poverty increased by 8.7 percentage points as GDP was growing only by a modest 3.3% per annum on average. Notwithstanding this development, around 36.45 million people in Pakistan still live below the poverty line. Moreover, the incidence of poverty in 2004/05, using a longer time horizon, was not much different than the level of poverty of 25.5% recorded in 1992/93. Poverty appears to have come full circle in Pakistan. In the immediate to short-run, the challenge is to maintain the hard won improvement in poverty levels and even improve upon it through sustained growth in the range of 6-8 percent per annum.

To sustain high rate of growth, Pakistan needs to, among others, address immediate distortions in the economy, particularly in the agriculture and energy sectors. The pricing and procurement system for wheat needs to be restructured, and subsidies better targeted to benefit the poor and vulnerable. The poorly targeted subsidies cost the Government PRs40 billion ($600 million) in FY2008, not including the additional resource requirements – estimated upwards of $1.6 billion at a minimum - to cushion the poor against the escalating prices. Pakistan also needs to fix its subsidy system in the electricity sector. In the absence of an automatic adjustment mechanism, the Government has not been able to settle the payments owed to distribution companies, which has resulted in a vicious circular debt problem and debt overhang in the sector. This problem needs to be addressed urgently to resolve the present energy crisis facing Pakistan. The immediate resource requirements are upwards of $2.5 billion.

Household expenditure surveys indicate the average share of food in total expenditures is inversely related to income levels. A sharp rise in food price can have a devastating effect on the poor. In Pakistan, food prices have gone up by more than 20% in the first quarter of 2008. ADB's analysis[3] shows that a 10% increase in food prices can throw an additional 7 million into poverty in Pakistan, a 20% increase 14.7 million and a 30% increase an additional 22 million. While energy prices have also gone up by about 30% in the first quarter, the rise in poverty incidence is estimated to be much smaller of about 1.5 percentage points. ADB's analysis also shows that, if every poor person were to be compensated to offset the loss in real expenditure, the Government may incur between PRs18.5 billion (0.3% of GDP)

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[1] The poverty line is based on a threshold of 2350 calories per adult equivalent per day, using the calorific approach for estimation.
[2] The latest Government estimates suggest that there has been a further decline in the incidence of poverty to 22.3% in 2005/06.
[3] ADB. May 2008. *Food Prices and Inflation in Developing Asia: Is Poverty Reduction Coming to an End?*. Special Report. Manila; and AA. Chaudhry and T.T. Chaudhry. 2008. *The Effects of Rising Food and Fuel Costs on Poverty in Pakistan*. Lahore School of Economics.

to PRs83 billion (1.3% of GDP).

2. Design Features

The Program's pro-poor design includes measures to (i) expand the social safety net and make it more efficient to protect the poor and vulnerable from the adverse impact of recent global developments, and (ii) adopt structural reforms to address inefficiencies in the agricultural sector, particularly with respect to wheat markets and food security policies. (The poor and vulnerable are found to be affected most by a hike in wheat price.) Specific interventions are discussed in detail below.

C. **Poverty Impact Analysis for Policy-Based Lending**

1. Discuss the impact channels of the policy reform(s) to the country and major groups affected.

The Program will provide significant benefits in general, and directed benefits for the poor in particular.

- First, it will help meet the immediate and massive fiscal needs of the Government. At a minimum, the agriculture and energy subsidies need to be met at a cost of upwards of $3 billion.
- Second, the Government needs to move away from the inefficient and untargeted subsidies to a targeted safety net program for the poor. Beginning with about 2 million households, the Program will help target up to about 5 million households, or roughly about one-fourth of the poor who are likely to be directly affected by the spiraling food inflation.
- Third, the Program will open the way for structural transformation.
- Fourth, the Program will help cut the transaction costs for businesses (reductions in red tape in tax payments) and improve investment climate.
- Fifth, the Program will raise public confidence in the banking system arising from development of a financial sector safety net, including a depositor protection scheme, and stronger financial intermediaries that are better able to mobilize and allocate resources and risks, and promote financial sector stability.

2. Discuss the impact of the policy reform(s) on vulnerable groups and ways to address it/them (refer to social analysis).

The appropriate direction of food security policy in the short-term should safeguard food availability and accessibility of the poor and vulnerable. For farmer producers, a guaranteed minimum price (but indexed on both costs of production and the export parity level) may be needed to enable farmers to reap some of the economic gains of wheat price hikes. As part of Subprogram (SP) 1, the Government has increased the supply price of wheat for farmers by more than 50% or 80% of the export parity price in early 2008. This is a good step towards market-based pricing, but there has to be an automatic adjustment process put in place, which will be pursued under subsequent subprograms. As part of subprogram 1, the Government has lowered its wheat reserves to 3 months of national consumption requirements. This is an important step, as the Government has never been able to procure more than 20% in the past. The higher target, despite being unrealistic, has exerted artificial pressures on the markets.

Specific policies are needed to deal with the root causes and consequences of high energy prices. Although the current political economy and global landscape pose complex policy challenges, the Government has taken certain key actions under subprogram 1. These include: ensuring up-to-date payments of the tariff differential subsidies to power distribution companies (DISCOs), allocating sufficient resources for energy subsidies in the budget to meet the forecast needs over FY2009, and determining the extent of circular debt and debt overhang in the electricity sector and ring-fencing the debt owed by DISCOs. The settlement of the past subsidies owed by the Government will cost $1.1 billion. Addressing the circular debt and debt overhang is likely to need another about $3-$3.5 billion over 2008-2010.

Another achievement of subprogram 1 is to enhance awareness of the need to move from the poorly targeted and inefficient subsidies in the food and energy sectors to a more targeted safety net system. The Government has set aside resources in the FY2009 budget to provide cash transfers and food support for about 5 million poor and vulnerable households in a targeted manner. Means-tested cash transfer programs have been developed. Ultimately, the Government aims to expand the safety net cover over the next 2-3 years.

3. Discuss how the policy reform(s) contribute(s) to poverty reduction, pro-poor growth, and the MDGs.

Poverty levels in Pakistan fluctuated a great deal during the last one and a half decade, with the fluctuation generally associated with the economic growth performance of the country. The Program aims to help Pakistan achieve and sustain higher economic growth of about 8% on average per year from 2012-2020, through a process of structural transformation of the country's economy. The Program will provide the fiscal and implementation support needed to undertake and leverage reforms. With the observed macro level poverty-growth correlation, this sustained high economic growth is expected to contribute to poverty reduction.

The challenge of poverty alleviation still remains huge. Pakistan, being a signatory to the Millennium Development

Goals (MDGs), is committed to achieving the MDG target for poverty by halving the level of poverty incidence between 1990 and 2015. The estimated level of poverty in 1990 in Pakistan was 26%. This needs to go down to 13% by 2015 if the target is to be met. With the present poverty level of 24%, there is clearly still a long way to go. The poverty problem, therefore, is not about to be immediately eliminated and will require sustained efforts. Continued and consistent pursuit of pro-poor growth policies, along with accompanying investments and a focus on the effectiveness of investment spending, and forging long-term and constructive partnerships with the private sector, civil society and development institutions, will be key to ensuring the long term success of the Government's poverty reduction strategy and programs.

The proposed Program is premised on three key principles. First, Pakistan needs to address certain economic distortions in the short-term, specifically by reorienting inefficient subsidies and targeting them to benefit the poor and vulnerable. Second, Pakistan needs to diversify its economy and increase the share of industry from the current level of 25% of GDP and particularly increase the share of high value added manufacturing. In parallel, it needs to increase agriculture productivity and make its service sector produce greater value. Third, Pakistan needs to deepen financial intermediation and increase financial sector stability and soundness.

There can be no presumption that structural transformation of an economy of the size and nature such as Pakistan's can happen in a short-span of time, or through rigidly prescribed conditionalities. To achieve the principles laid out above, the Program sets out a 4-5 year design and implementation period, and a cluster structure that provides flexibility to meet evolving circumstances. It sets out short and medium-term actions, with changes to come beyond the 5-year period. The Program will only tackle the more tangible issues, with a large number of procedural and process related changes taking place in parallel to the proposed reform measures.

II. SOCIAL ANALYSIS AND STRATEGY

A. Findings of Social Analysis

Among the most pressing crises facing the Government is the rising food prices, especially the main staple, wheat. A confluence of global factors resulted to this phenomenon: high food demand and changing food consumption patterns, increasing energy prices which encourage shift in production land use from food to alternative biofuel, increased land cultivation for feeds, and structural neglect for agriculture investments.

Pakistan experienced a 20% increase in wheat prices between November 2007 and February 2008. In November 2007, the Federal Bureau of Statistics reported that food and beverage prices had risen by 14.7% from October 2006 to October 2007. The poorest segments of the population are particularly hard hit by the increases in food prices. Long queues have formed at government stores and wheat ration cards have been reinstituted. Violent protests have also erupted in the country. While high food prices hurt poor consumers, they are expected to help poor farmers: however, this depends critically on whether farmers can get access to needed fertilizer, irrigation, and markets.

Half of Pakistan's population is considered to be "food insecure," according to the World Food Programme. Food security as defined in the World Food Summit (Rome 1996) is a situation "when all people, at all times have physical and economic access to sufficient, safe, and nutritious food and to meet their dietary needs and food preference of an active and healthy life." Food security is measured in terms of (i) physical access to food (or availability), economic access to food, and biological utilization of food (food absorption). Many studies note that in Pakistan, physical availability of food (including wheat flour) may not be the main issue, but rather consumers are constrained by poverty or their low income that in turn, impedes their ability to use the food adequately for a balanced proper nutrition.

Pakistan has set up a range of schemes to help the poor, with many based on targeting. The Government has also devoted significant efforts to expand microfinance outreach. The existing schemes, however, suffer from four key problems: weak design (including poor eligibility criteria), poor implementation, risk of elite capture, and weak monitoring and evaluation. Further, the scale of the needs and challenges facing Pakistan now are quite significant, calling for a robust safety net scheme that is based on strong data and criteria.

The Program will assist the Government in ensuring food availability and access of wheat flour especially for the poor and vulnerable groups. Key agenda for action include: (i) establishing a more cost-effective and market-oriented reserve stock management system, and (ii) developing and implementing a means-tested cash transfer and food safety net program.

In the medium-term, food security cannot be sustained through provision of consumer and producer subsidies. Measures that enhance economic activities and job creation would be a more sustainable basis for the poor to cope with food price spikes. Further, higher productivity of the food producing sector and its integration to a more efficient and effective integration of the food supply chain are required instead of distortionary price supports. Specifically, farmers need to be equipped with access to (i) high yielding seed varieties, modern technology and agronomic practices and secured water supply and land use rights; as well as (ii) access to accurate information on market conditions, market infrastructure, and institutional arrangements that effectively link them to the domestic and global market. With these, the farmers can make the right choices and to realize profits from evolving global trading system.

B. Consultation and Participation

1. Provide a summary of the consultation and participation process during the project preparation.

Extensive consultations were conducted with the Government [including Ministry of Finance (MOF); Ministry of Industries; Ministry of Commerce; Ministry of Food, Agriculture and Livestock; Ministry of Labor, Manpower and Overseas Pakistanis; State Bank of Pakistan; Planning Commission; Board of Investment; Privatization Commission; Engineering Development Board, Pakistan Bait-ul-Mal and the Prime Minister's Secretariat responsible for the Benazir Income Support Program] private sector (including ABN/AMRO, KPMG, McKinsey) and other development partners (including IMF and World Bank).

2. What level of consultation and participation (C&P) is envisaged during the project implementation and monitoring?
☐ Information sharing ☐ Consultation ☒ Collaborative decision making ☐ Empowerment

3. Was a C&P plan prepared? ☒ Yes ☐ No
If a C&P plan was prepared, describe key features and resources provided to implement the plan (including budget, consultant input, etc.). If no, explain why.

A list of key agencies and individuals to be consulted are drawn up prior to loan processing missions. Strong coordination and decision making abilities are vital for the Program. The Secretary of Finance will steer the Program.

C. Gender and Development

1. Key Issues.

The Program has no specific gender implications.

2. Key Actions. Measures included in the design to promote gender equality and women's empowerment—access to and use of relevant services, resources, assets, or opportunities and participation in decision-making process:
☐ Gender plan ☐ Other actions/measures ☒ No action/measure

III. SOCIAL SAFEGUARD ISSUES AND OTHER SOCIAL RISKS

Issue	Significant/Limited/ No Impact	Strategy to Address Issue	Plan or Other Measures Included in Design
Involuntary Resettlement	No impact		☐ Full Plan ☐ Short Plan ☐ Resettlement Framework ☒ No Action
Indigenous Peoples	No impact		☐ Plan ☐ Other Action ☐ Indigenous Peoples Framework ☒ No Action
Labor ☐ Employment opportunities ☐ Labor retrenchment ☐ Core labor standards	No impact.		☐ Plan ☐ Other Action ☒ No Action
Affordability	No impact		☐ Action ☒ No Action
Other Risks and/or Vulnerabilities ☐HIV/AIDS ☐Human trafficking ☒Others(conflict, political instability, etc), please specify: Social instability	The Program addresses other risks such as social instability by reforming the safety net to be (i) more sustainable in the long-run, and (ii) in the short-run directly addressing the urban poor and lower middle class against food price spikes.		☐ Plan ☐ Other Action ☒ No Action

IV. MONITORING AND EVALUATION

Are social indicators included in the design and monitoring framework to facilitate monitoring of social development activities and/or social impacts during project implementation? ☐ Yes ☒ No