ADB

Report and Recommendation of the President to the Board of Directors

Project Number: 53247-001
November 2019

Proposed Special Policy-Based Loan
Islamic Republic of Pakistan: Economic Stabilization Program

Asian Development Bank

CURRENCY EQUIVALENTS

(as of 11 November 2019)

Currency unit	–	Pakistan rupee/s (PRe/PRs)
PRe1.00	=	$0.0064
$1.00	=	PRs156.0034

ABBREVIATIONS

ADB	–	Asian Development Bank
BISP	–	Benazir Income Support Programme
DMC	–	developing member country
EFF	–	Extended Fund Facility
GDP	–	gross domestic product
IMF	–	International Monetary Fund
MOF	–	Ministry of Finance
PFM	–	public financial management
PRC	–	People’s Republic of China
SBP	–	State Bank of Pakistan
SDR	–	special drawing right
SOE	–	state-owned enterprise
SPBL	–	special policy-based loan
SRO	–	Statutory Regulatory Order
TA	–	technical assistance
UAE	–	United Arab Emirates

NOTES

(i) The fiscal year (FY) of the Government of Pakistan ends on 30 June. “FY” before a calendar year denotes the years in which the fiscal year ends, e.g., FY2019 ends on 30 June 2019.

(ii) In this report, “$” refers to United States dollars.

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PROGRAM AT A GLANCE

1. Basic Data — **Project Number:** 53247-001

Project Name	Economic Stabilization Program	**Department/Division**	CWRD/CWPF
Country	Pakistan	**Executing Agency**	Ministry of Finance
Borrower	Islamic Republic of Pakistan		
Country Economic Indicators	https://www.adb.org/Documents/LinkedDocs/?id=53247-001-CEI		
Portfolio at a Glance	https://www.adb.org/Documents/LinkedDocs/?id=53247-001-PortAtaGlance		

2. Sector

Sector	Subsector(s)	ADB Financing ($ million)
✓ **Public sector management**	Economic affairs management	250.00
	Public expenditure and fiscal management	250.00
	Reforms of state owned enterprises	250.00
	Social protection initiatives	250.00
	Total	**1,000.00**

3. Operational Priorities

✓ Addressing remaining poverty and reducing inequalities
✓ Accelerating progress in gender equality
✓ Strengthening governance and institutional capacity

Climate Change Information

Climate Change impact on the Project: Low

Sustainable Development Goals

SDG 1.a
SDG 5.b, 5.c
SDG 9.1
SDG 16.6
SDG 17.1, 17.4

Gender Equity and Mainstreaming

Some gender elements (SGE) ✓

Poverty Targeting

General Intervention on Poverty ✓

4. Risk Categorization: Complex

5. Safeguard Categorization — **Environment:** C **Involuntary Resettlement:** C **Indigenous Peoples:** C

6. Financing

Modality and Sources	Amount ($ million)
ADB	**1,000.00**
Sovereign Special Policy-Based Lending (Regular Loan): Ordinary capital resources	1,000.00
Cofinancing	**0.00**
None	0.00
Counterpart	**0.00**
None	0.00
Total	**1,000.00**

Currency of ADB Financing: US Dollar

I. THE PROPOSAL

1. I submit for your approval the following report and recommendation on a proposed special policy-based loan (SPBL) to the Islamic Republic of Pakistan for the Economic Stabilization Program.

2. The SPBL is part of a comprehensive multidonor economic reform program led by the International Monetary Fund (IMF), and will help the Government of Pakistan to mitigate the significant negative economic and social impacts of an extraordinary macroeconomic crisis.[1] The proposed economic reform program of the IMF will (i) introduce important fiscal consolidation measures, led by revenue mobilization measures, to ensure sustainable public debt; (ii) implement a tight monetary policy and a flexible market-determined exchange rate to reduce the current account deficit and moderate inflation; (iii) facilitate structural reforms in the energy sector, institutions, and governance to ensure high and inclusive growth; and (iv) augment social sector spending to minimize the effect of the reforms on the poor.

II. PROGRAM AND RATIONALE

A. Background and Development Constraints

3. **Weak macroeconomic fundamentals undermined by unanticipated shocks.** Pakistan's economy, with a history of boom-and-bust economic cycles, has reached a tipping point where economic and financial stability are at risk. Growing economic imbalances have led to a major deterioration in external and macroeconomic stability, which has begun eroding economic well-being and social welfare through high inflation and falling real incomes, particularly for poor and vulnerable communities. Pakistan's economic crisis has been caused by a rapidly expanding fiscal deficit and public debt (para. 5), a large balance-of-payments gap and critically low foreign exchange reserves (para. 7), and growing losses from several major state-owned enterprises (SOEs) (para. 11). While macroeconomic fundamentals have been weak for a sustained period, several unanticipated shocks have led to a crisis situation. Since mid-2018, Pakistan's external account has been hit by a sharp drop in foreign direct investment and portfolio investment inflows (net) caused by an uncertain political and global economic environment.[2] Net portfolio investment contracted by $1.2 billion in FY2019, a sharp turn from a net positive inflow of $2.2 billion in FY2018.[3] Consequently, net foreign exchange reserves have declined by almost $3 billion, and as of June 2019 equaled just 1.4 months of import cover.

4. These developments caused growth to slump to 3.3% in FY2019, well below the government's target of 6.2%, and pushed public debt to 75% of gross domestic product (GDP).[4]

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[1] IMF. 2019. Pakistan: Request for an Extended Arrangement under the Extended Fund Facility: Press Release: Staff Report; and Statement by the Executive Director for Pakistan. IMF Country Report. No. 19/212. Washington, DC. See also IMF's first post-program monitoring report for the previous Extended Fund Facility (EFF), approved on 4 September 2013: IMF. 2018. Pakistan: First Post-Program Monitoring Discussions—Press Release; Staff Report; Statement by Staff; and Statement by the Executive Director for Pakistan. IMF Country Report. No. 18/78. Washington, DC.

[2] Many factors pose bottlenecks to foreign direct investment flows into Pakistan. These include political instability, the law-and-order situation, economic performance and policies, and lack of infrastructure. A. H. Khan and Y.-H. Kim. 1999. Foreign Direct Investment in Pakistan: Policy Issues and Operational Implications. *ERCD Report Series.* No. 66. Manila: Asian Development Bank.

[3] This implies a gross impact of $3.4 billion of inward capital flows.

[4] Sector Assessment (Summary): Public Sector Management (accessible from the list of linked documents in Appendix 2).

An unforeseen rise in international oil prices during 2018 aggravated the situation by pushing up imports and expanding the trade deficit.[5] In response to its deteriorating economic situation, the government adopted countercyclical fiscal spending in FY2017 and FY2018, which temporarily lifted economic growth to 5.5% in FY2018 but was not able to address the underlying vulnerabilities. Meanwhile, with limited liquidity in the domestic financial system, the cost of servicing outstanding borrowing has continued to grow. The government's gross financing needs reached 34.0% of GDP in FY2018, up from 29.4% in FY2017, crowding out fiscal space for countercyclical investment and social protection programs.

5. **Unsustainable fiscal deficit and rising public debt.** Expansionary fiscal policy undertaken in FY2018 to boost medium-term growth and support populist measures led to a surge in the fiscal deficit to 6.6% of GDP, 2.5 percentage points higher than budgeted (Table 1). In FY2019, the deficit has expanded further to reach 8.9% of GDP, driven by high nondiscretionary expenditure as a result of poor fiscal planning for expenditure allocations, including public investments, untargeted subsidies to lessen the social impact of high inflation, and rising security expenditures. Low revenue collection is also contributing to higher-than-expected deficits, with tax revenues reaching 11.6% of GDP in FY2019, far below the government's long-term target of 20% of GDP.[6] Excessively large and frequent tax exemptions and concessions and weak tax administration are contributing to a low tax base and low tax collection rate. As a result, the government has been unable to meet its fiscal expenditure needs within a sustainable fiscal framework. The high fiscal deficits recorded in recent years have led to a sharp uptick in domestic and international borrowing and public debt, which has reached 75% of GDP—well above the government's target of 60% of GDP.

6. Rising public debt, coupled with a depreciation of the Pakistan rupee, are also causing a sharp rise in debt servicing payments—further eroding the fiscal space needed to address the crisis. In FY2019, the total debt servicing costs of the government reached 5.2% of GDP, up from 4.3% of GDP in FY2018.

Table 1: Fiscal and External Sector Indicators, FY2016–FY2019

Indicator	FY2016	FY2017	FY2018	FY2019
Total revenue and grants (% of GDP)	15.5	15.5	15.2	12.7
Total expenditure (% of GDP)	19.2	21.1	21.8	21.6
Budget balance, including grants (% of GDP)	(3.7)	(5.6)	(6.6)	(8.9)
Primary balance, including grants (% of GDP)	(0.2)	(1.5)	(2.1)	(3.5)
General government debt with IMF obligations (% of GDP)	67.6	67.0	71.7	74.9
Current account balance (% of GDP)	(1.7)	(4.1)	(6.3)	(4.8)
Current account balance ($ billion)	(4.9)	(12.6)	(19.9)	(13.1)
Capital and financial account balance ($ billion)	7.1	10.6	14.7	11.1
Consumer prices (percentage change, end of period)	3.2	3.9	5.2	8.4

( ) = negative, GDP = gross domestic product.
Source: Government of Pakistan, Ministry of Finance; IMF Staff Report.

7. **Weak external sector performance eroding foreign exchange reserves.** Pakistan's current account deficit has widened significantly, driven by a growing trade deficit and stagnant international remittance growth. The current account deficit expanded to a record high of $20 billion in FY2018 or 6.3% of GDP, from $5 billion in FY2016 (Table 1), and reduced slightly to 4.8% of GDP in FY2019. The trade deficit has increased rapidly because of stagnant export growth combined with rapidly increasing imports of both capital and consumer goods. Private

[5] The crude import bill rose by 56% during FY2018 as against 7% in FY2017.
[6] Government of Pakistan. 2019. *Pakistan Budget Speech, FY2019–20*. Islamabad.

consumption accounted for 81% of GDP in FY2018, largely supported by imports. Therefore, increased domestic demand from higher growth contributed to increased imports, with consumer goods making up 57% of imports in FY2018. Imports also increased from expanding public spending on capital goods and infrastructure projects.

8. Pakistan's export to GDP ratio of 8.2% in FY2018 is the lowest among its competitor countries and the regional average of 17.7%. Its export performance lags that of South Asian and Southeast Asian comparator countries, some of which are relatively new entrants in key export markets, such as Bangladesh, Cambodia, Sri Lanka, and Viet Nam. Foreign direct investment in Pakistan, including the export segment, has remained relatively low at less than 1% of GDP despite increased government infrastructure spending and past attempts to spur competitiveness.[7] Exports remain concentrated in less-sophisticated, lower value-added products and lack the diversification that is evident in agriculture, textiles, and leather products. Exporters face weak institutional capacity for trade facilitation and related services. In addition, the levying of ad hoc trade taxes, i.e., customs and regulatory duties, which aimed to raise revenue during FY2015 and FY2016, has increased costs to exporters for imported machinery and intermediate goods used in production. This has created a significant negative effect on the competitiveness of domestic industries involved in global value chains, and hence the total value of exports.[8]

9. To protect the state budget from higher costs of imported capital goods and foreign debt servicing, the real effective exchange rate of the Pakistan rupee was allowed to appreciate by more than 20% from 2013 to 2017, which further eroded export competitiveness. By maintaining a mostly fixed nominal exchange rate against the United States dollar, the Pakistan rupee was estimated to be 10%–18% overvalued in July 2017, which increased demand for imports, worsening the current account deficit, and reduced the price competitiveness of exporters.[9] During 2018, the Pakistan rupee was allowed to devalue by 25% against the United States dollar, which partially helped improve the price competitiveness of exporters.

10. The widening current account deficit during FY2017 and FY2018 has put significant pressure on the balance of payments, which has been worsened by insufficient net surplus in the capital and financial accounts to offset the deficit (Table 1).[10] As a result, Pakistan's gross international reserves have followed a downward trend, from $19.4 billion at the end of FY2016 to $11.3 billion at the end of FY2018 and $9.1 billion in December 2018—equivalent to 1.4 months of import cover.[11] Defending the overvalued exchange rate and increasing debt service on borrowed reserves has contributed to falling foreign reserves. The devaluation of the Pakistan rupee in 2018 had limited effect on slowing the decline of reserves. Hence, given the sizable net deficit across the current, capital, and financial accounts and subsequent falling reserves, large-scale increases in foreign borrowing (reflected in the financial account) are needed to maintain the critically low foreign reserves of the State Bank of Pakistan (SBP). This will help to avoid further depletion of reserves in the short term, while structural reforms aim to reduce the current account deficit. Sufficient levels of reserves are necessary to provide a buffer against external shocks and to avoid a balance-of-payments crisis.

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[7] World Bank. 2019. *World Development Indicators*. Washington, DC.

[8] World Bank. 2019. Boosting Pakistan's Export Competitiveness: Private Sector Perspectives. Washington, DC.

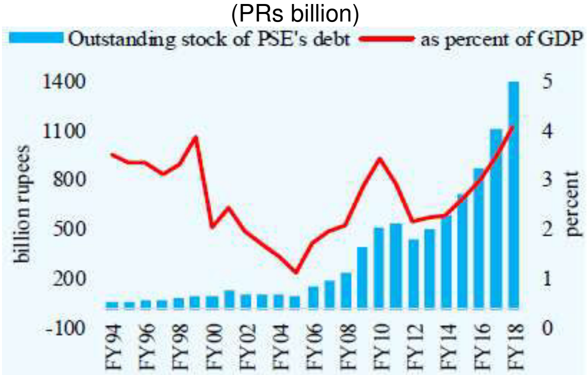
[9] IMF. 2017. Pakistan: Article IV Consultation—Press Release; Staff Report; Informational Annex; and Statement by the Executive Director for Pakistan. *IMF Country Report.* No. 17/212. Washington, DC.

[10] Based on IMF definitions for balance-of-payments statistics, the capital account shows credit and debit entries for non-produced nonfinancial assets and capital transfers between residents and nonresidents, and the financial account shows net acquisition and disposal of financial assets and liabilities.

[11] State Bank of Pakistan (SBP). Summary Balance of Payments (accessed 4 July 2019).

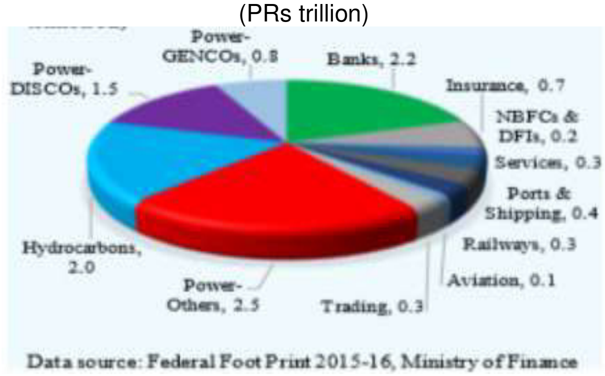
11. **Deteriorating performance of state-owned enterprises.** Accumulated losses of large SOEs have increased more rapidly since FY2017, adding further pressure to the government for providing subsidies to ensure service delivery. Energy sector SOEs, which comprise about 60% of total SOE assets (Figure 2), have been a major driver of these losses. Following several years of steady decline in the flow of circular debt in the energy sector, a sharp jump in arrears and debt was recorded in FY2017 and FY2018.[12] This was caused mainly by delays in adjustments to planned tariffs, prevention of planned load shedding, and the nonpayment of subsidies by the government as its own fiscal pressures mounted. In total, the energy and gas sector recorded accumulated debt equivalent to about 2.5% of GDP by the end of FY2018. When combined with accumulated losses from other SOEs, the total outstanding stock of SOE debt reached just above 4% of GDP (Figure 1).[13] In addition to nonpayment by creditors, the energy sector's financial performance is constrained by several structural factors, including lack of corresponding downstream investments to augment power transmission and distribution infrastructure which have caused congestion, inefficiencies, and high system losses that by the end of 2018 were 2% higher than 2016 levels.[14] More than a quarter of electricity generated is lost because of overstressed and dilapidated infrastructure, theft, and inadequate energy accounting. Moreover, delays in undertaking important reforms in the energy sector, including the timely revision of tariffs, and nonpayment of implicit subsidies have contributed to arrears.[15] Technical and distribution losses also add to the circular debt of the energy sector. Eliminating energy sector losses will require a combination of new pricing strategies and sustained improvements in governance and infrastructure.

Figure 1: Stock of State-Owned Enterprises' Debt
(PRs billion)



GDP = gross domestic product, PSE = Pakistan Stock Exchange, SOE = state-owned enterprise.
Sources: Government of Pakistan, Ministry of Finance and Pakistan Bureau of Statistics.

Figure 2: Sectoral Classification of State-Owned Enterprises' Assets
(PRs trillion)



DFI = development finance institution, DISCO = distribution company, GENCO = generation company, NBFC = nonbank financial institution, SOE = state-owned enterprise.
Source: Government of Pakistan, Ministry of Finance. *Federal footprint FY2016*.

[12] Circular debt is payables from distribution companies to power generators and fuel suppliers. These are caused by electricity system losses including commercial losses, non-payment of financial obligations by end-users and regulatory deficiencies. Circular debt flow is the increase in payables towards suppliers in a certain period. Circular debt stock is the accumulated liabilities towards suppliers and lenders.

[13] World Bank. 2018. Power Sector Distortions Cost Pakistan Billions. Press release. 12 December.

[14] The problem of congestion was aggravated after the creation of the additional generation capacity.

[15] The wavering of political support and guidance in carrying out the timely revision of power tariffs contributed to the accumulation of circular debt. This is also attributed to the non-privatization of selected power sector distribution companies. Independent Evaluation Department. 2019. *Sector Assistance Program Evaluation: ADB's Support to Pakistan Energy Sector (2005–2017)*. Manila: Asian Development Bank (ADB).

12. **Social impact of the crisis**. The social impact of the crisis is not limited to the economic crisis. The subsequent structural reform measures are expected to have short-term adverse social impacts. For example, average inflation increased significantly to 7.3% in FY2019 and is expected to rise further during FY2020 (the first year of the IMF's Extended Fund Facility [EFF]). High inflation was primarily driven by cost push inflation, stemming from a 21% exchange rate depreciation (from July 2018 to June 2019); a significant increase in domestic household gas, electricity, and oil prices; and a further increase in regulatory duties on imports. Together with a 5.75 percentage point hike in the policy interest rate to 12.25% in 2018, these factors have imposed a major constraint on the business environment and massively eroded the purchasing power of low- and medium-income workers who are less able to protect their earnings against price increases. Despite a decline in Pakistan's consumption poverty rate from over 50.4% in FY2006 to 24.3% in FY2016, multidimensional poverty is still high—about 38.8% of people are poor, with stark regional and urban–rural disparities (54.6% in rural areas and 9.4% in urban areas).[16] Therefore, the social cost of adjustment is expected to be high for the poor and vulnerable over the next 2–3 years, while weak growth prospects indicate economy-wide impacts including higher unemployment.

13. However, the decline in headcount poverty has not been smooth.[17] On average, the decline was slowest during FY2013–FY2016. There are several reasons for this. First, higher inflation led to an accelerated erosion of the purchasing power of households, particularly fixed-income households. Second, lower economic activity has affected employment prospects, leading to higher unemployment rates. Moreover, for individuals already employed, slow growth in overall income has led to a slower or no increase in their income over the stabilization period. Third, fiscal consolidation has often been accompanied by cuts in developmental expenditure, which adversely affected social welfare programs in real terms. Therefore, ensuring that the government continues to finance social protection initiatives, with improved transparency and better targeting, and without jeopardizing the broad fiscal consolidation framework, will remain a major focus of the current program.

B. Policy Reform and ADB's Value Addition

14. On 3 July 2019, the executive board of the IMF approved a 39-month extended arrangement under the IMF's EFF for Pakistan for an amount of SDR4,268 million (about $6 billion or 210% of the IMF quota).[18] The primary goal of the program is to restore economic sustainability and lay the foundations for balanced growth. To achieve this objective, the proposed reforms under the program aim to (i) improve exchange rate management in the context of limited foreign exchange reserves; (ii) strengthen public financial management (PFM) to mobilize more revenue and restore the allocative efficiency of scarce public resources, and address the energy sector pricing issues; and (iii) reduce the social impacts of the crisis through improved targeting and transparency of existing social protection programs (Appendix 1). The government and the IMF

[16] Consumption poverty in Pakistan defines poor when consumption is below the threshold level of nutritional requirements. The multidimensional poverty index complements consumption-based poverty by reflecting deprivations people face in other dimensions such as education, health, and standard of living.

[17] Headcount poverty in Pakistan is defined as the number of people below the consumption-based poverty line.

[18] Unlike regular IMF standby arrangements, the EFF provides longer-term assistance in support of comprehensive programs that include policies of the scope and character required to correct structural imbalances over an extended period (typically up to 3 years). The EFF was designed to assist countries (i) experiencing serious payments imbalances because of structural impediments or (ii) characterized by slow growth and an inherently weak balance-of-payments position. Pakistan's last IMF EFF program was undertaken from September 2013 to September 2016. ADB provided regular program and project lending during this period but did not provide any dedicated crisis-related support.

reached staff level agreement on the first review under EFF on 8 November 2019. It was reported that all performance criteria for end-September were met and progress towards meeting all structural benchmarks continues.[19]

15. To support the implementation of the agreed IMF EFF milestones, the government has agreed with ADB on a subset of policy actions that will be completed by 31 October 2019 (Table 2). This subset includes 11 policy actions that will contribute to attaining the IMF's three program reform areas: (i) exchange rate management strengthened, (ii) public resource management improved, and (iii) social protection enhanced. Appendix 4 provides a complete list of prior actions and structural benchmarks that will be completed under the IMF EFF program from May 2019 to September 2022. A description of the reform areas and policy actions supported by the Asian Development Bank (ADB) SPBL is provided below and summarized in Table 2.[20]

Table 2: Reform Areas and Policy Actions

Reform area 1: Exchange rate management strengthened
1. The State Bank of Pakistan moved to a flexible market-determined exchange rate to improve external imbalances (EFF prior action).
Reform area 2: Public resource management improved
2. Parliament approved the Public Financial Management Law to improve the allocative efficiency of public resources (additional action).
3. The government reached a formal agreement (memorandum of understanding) between the federal and provincial governments on fiscal targets to sustain comprehensive fiscal consolidation efforts (EFF prior action).
4. Parliament approved the FY2020 budget consistent with the International Monetary Fund program targets (EFF prior action).
5. The government approved reform measures to strengthen the financial performance of state-owned enterprises including (i) the implementation of a quarterly automatic tariff adjustment in the electricity sector by at least 10% to generate PRs150 billion in additional revenue and (ii) notification by the government of the gas tariff adjustment proposed by the regulator (effective on 1 July 2019) (EFF prior action).
6. The Ministry of Energy prepared a draft comprehensive circular debt reduction plan to eliminate energy sector losses and submitted it to the Ministry of Finance (EFF structural benchmark).
7. The government amended the law to eliminate the legal authorization for the executive to grant sales tax exemptions and concessions through statutory regulatory orders (EFF structural benchmark).
8. The Federal Board of Revenue issued licenses for the implementation of the track-and-trace system for excise on cigarettes to improve revenue mobilization (EFF structural benchmark).
9. The Ministry of Energy issued a revised electricity tariff schedule for FY2020 as determined by the Regulator (EFF structural benchmark).
Reform area 3: Social protection enhanced
10. The government finalized the Benazir Income Support Program's banking contracts to ensure that cash transfers are more efficient and transparent (EFF structural benchmark).
11. The government approved a financial inclusion strategy for women to ensure the financial and digital inclusion of the target group of women (EFF structural benchmark).

EFF = Extended Fund Facility.
Source: Asian Development Bank.

[19] IMF. 2019. Pakistan: IMF Reaches Staff-Level Agreement with Pakistan on the First Review under the Extended Fund Facility. Press Release No. 19/402.

[20] Policy actions 5 and 6 in Table 2 are also referred to in the policy matrix for subprogram 1 of the proposed programmatic approach for Islamic Republic of Pakistan: Energy Sector Reforms and Financial Sustainability Program, which is scheduled for Board approval in December 2019. This programmatic approach will allow ADB to provide follow-up support for deepening of the energy sector reform initiatives supported under the SPBL.

16. **Exchange rate management strengthened**. To correct imbalances and support the buildup of reserves, the SBP has adopted a flexible, market-determined exchange rate.[21] Coupled with a tightening of monetary policy,[22] this reform will help to reduce accumulated external imbalances, provide a buffer against shocks, and support the rebuilding of international reserves. To reduce pressure on exchange reserves, the SBP has agreed to limit its short swap and forward foreign exchange position.

17. **Public resource management improved**. Fiscal reforms focus on reducing fiscal and quasi-fiscal deficits, supported by stronger revenue growth, to create fiscal space to support social and development spending. The agreed strategy aims to broaden the tax base and enhance tax compliance to achieve a 4–5 percentage point increase in the tax to GDP ratio by the end of the program period. The approval of the FY2020 budget in June 2019 supports these objectives, with primary fiscal adjustment of 3% of GDP underpinned by high-quality permanent revenue measures of 1.6% of GDP. On the expenditure side, the budget also incorporates implicit subsidies in the energy sector that were not budgeted in the past and contributed to the buildup of circular debt. Likewise, the Ministry of Energy has prepared a comprehensive circular debt reduction plan to eliminate energy sector losses and submitted it to the Ministry of Finance.

18. The adoption of the Public Financial Management Act in 2019 will increase fiscal discipline by requiring parliamentary approval of supplementary budget authorizations. Recent legal amendments will limit the use of Statutory Regulatory Orders (SROs) to emergencies, preventing their use (as in the past) for creating frequent tax concessions by waiving sales tax obligations. Provinces have agreed to contribute to the fiscal consolidation efforts by delivering surpluses of about 1% of GDP in FY2020, gradually increasing to 2.7% by the end of the program. To support these efforts, provinces aim to increase the collection of property and sales taxes and to assume more spending responsibility.

19. **Social protection enhanced**. The government introduced the *Ehsaas* program in March 2019 to address poverty and inequality comprehensively. The *Ehsaas* program was conceptualized to reduce poverty and inequality, support the economic empowerment of women, and promote income-earning opportunities in areas where poverty is highest. This program will be delivered in part through an expanded Benazir Income Support Programme (BISP), working with international partners including ADB, which is responsible for the implementation of social assistance programs through their conditional and unconditional cash transfer programs, currently reaching around 5 million households headed by women.[23] To strengthen the transparency and efficiency of this program, the government has finalized the BISP's banking contracts to make the disbursement of stipends more efficient. In parallel, the government has launched the "one woman one account" initiative, which will ensure the financial and digital inclusion of about 5 million households headed by women under the program.

20. Complementing initiatives under the ADB-supported component of the BISP program, the government has agreed to undertake several other short- to medium-term initiatives to protect the

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[21] As part of this policy reform, the SBP has noted that intervention may be necessary in certain situations to prevent possible overshooting or disorderly market conditions. At the same time, market intervention should not suppress underlying trends and should be conducted in a manner consistent with rebuilding reserves.

[22] Since the beginning of 2018, the SBP has tightened monetary policy by more than 500 basis points.

[23] ADB. 2013. Report and Recommendation of the President to the Board of Directors: Proposed Loan to the Islamic Republic of Pakistan for the Social Protection Development Project. Manila (Pakistan: Social Protection Development Project); and ADB. 2019. Report and Recommendation of the President to the Board of Directors: Proposed Loan for Additional Financing to the Islamic Republic of Pakistan for the Social Protection Development Project. Manila.

most vulnerable. These include providing a one-off disbursement of PRs1,000 to existing BISP beneficiaries; boosting girls' educational enrollment by augmenting the BISP-provided *Waseela-e-Taleem* conditional cash transfer program with a girl bonus of PRs250 to be provided on a quarterly basis; and updating the National Socio-Economic Registry by the end of June 2020 to better reflect Pakistan's poverty structure and allow for the enrollment of new beneficiaries.

21. **The case for SPBL and ADB value addition**. The special policy-based lending will support the IMF EFF, in accordance with the eligibility criteria specified in ADB's Review of Program Lending Policies, which defines a crisis as a situation in which a developing member country (DMC) is facing unanticipated difficulties in meeting its payment obligations, external and internal, and where a large IMF-led international rescue package is being mounted to help restore stability.[24] This financial support is also important in ensuring that the government can accumulate sufficient foreign exchange reserves to meet its external account requirements and to prevent disruptive cuts in development expenditure, especially those targeted at job creation and social protection.[25] ADB has provided both direct and indirect support to the preparation of the IMF's EFF program, leveraging its deep policy engagement and long experience in designing and implementing structural reforms through a series of programmatic approaches, covering PFM, energy and SOE reform, and trade and competitiveness. This has included technical assistance (TA) and policy dialogue to support the implementation of reforms to improve trade competitiveness (including tariff rationalization and strengthening of institutions to facilitate trade) and to strengthen tax administration.[26] ADB has also provided targeted TA to support the implementation of energy sector reforms, including improvements in governance and technical efficiency and financial sector development. In addition to leveraging its long-standing sector technical engagement, ADB has supported the preparation of the IMF EFF program by (i) closely participating with other development partners, especially the IMF and the World Bank, to finalize a unified reform package with the government; and (ii) supporting the ongoing implementation of the IMF's economic reform program by facilitating the identification of key reforms and international good practices in several areas of economic management where ADB has ongoing policy dialogue. ADB's continued support for the BISP (footnote 23) is also critical to ensure effective social protection.

22. **Sequencing of reforms**. The support provided by ADB through the SPBL is sequenced as part of a broader package of financial assistance necessary to restore external stability under the IMF EFF program. Factors contributing to Pakistan's economic crisis could be aggregated under two broad groups: policy distortions and structural factors. Policy distortions include, among others, an overvalued exchange rate, ad hoc tariffs and regulatory duties on imported raw materials, incomplete pass-through of high international oil prices, and ineffective tax holidays that have affected macroeconomic performance in Pakistan. Structural factors include the

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[24] ADB. 1999. *Review of Program Lending Policies*. Manila. This document stipulates that SPBLs are expected to provide crisis support on a large scale and beyond anticipated levels indicated in country assistance plans (country partnership strategies). The eligibility is also conditional on a DMC being eligible for regular ordinary capital resources lending, and ADB support should be provided as part of wider financial burden-sharing across international financial institutions in providing large-scale support to DMCs during such crisis. The review emphasizes that ADB should adopt a flexible definition of crisis for the SPBL modality, noting that a complete listing of characteristics of crises can be elusive as the historical record shows that each crisis may have some characteristics in common with previous crises but may also have some new dimensions.

[25] To offset the worsening impacts of the crisis, the FY2020 budget, which incorporates financing from both the IMF and ADB, has increased expenditure on social protection from PRs127 billion in FY2019 to PRs193 billion in FY2020 (a 52% increase from FY2019).

[26] ADB. 2018. *Technical Assistance to the Islamic Republic of Pakistan for Preparing the Trade and Competitiveness Program*. Manila (Pakistan: Preparing the Trade and Competitiveness Program); and ADB. 2018. *Technical Assistance to the Islamic Republic of Pakistan for Economic Management Support.* Manila.

implementation of a clear policy on circular debt, weak trade facilitation institutions, the absence of credible medium-term expenditure planning, lack of a clear approach to the privatization of loss-making SOEs, and weak tax administration. Typically, the policy distortions are addressed first in the short term to stabilize the economy, followed by structural reforms that have a medium- to long-term horizon.

23. As summarized in Table 3, approval of the IMF EFF program was conditional on the satisfactory completion of four prior actions and agreement to complete 13 subsequent structural benchmarks and was followed by the disbursement of SDR716 million in July 2019. In line with this program, the approval of ADB's SPBL is conditional on the satisfactory completion of the four original prior actions plus an additional six policy actions in common with structural benchmarks of the IMF EFF program and one additional action. Based on ADB's assessment of documents received, all policy actions have been completed, including the actions that are a subset of the IMF structural benchmarks. Disbursement of the SPBL is expected to take place in December 2019, subject to the ADB Board of Directors' approval. The remainder of the IMF EFF program is planned to be disbursed according to the schedule outlined in Table 3. In parallel, ADB will continue to provide ongoing budgetary support through policy-based loan programs for structural reforms aligned with the IMF EFF's program. These include the Pakistan Trade and Competitiveness Program,[27] the Pakistan Energy Sector Reform Program, and the Financial Market Development Program. All these programmatic approaches will support the implementation of key structural reforms over the medium term that will reinforce the objectives of the IMF EFF program. The timeline for the approval and disbursement of these operations during FY2020 is outlined in Table 3.

Table 3: Proposed Sequencing of Budget Support Financing for Pakistan, 2019–2020 (ADB and International Monetary Fund)

Date	Planned Program Approval	Planned Disbursement
July 2019	Approval of IMF EFF program with agreed reform package based on four prior actions and 13 subsequent structural benchmarks to be implemented from July 2019 to September 2022	$1 billion disbursed in July 2019 following approval of the arrangement
August 2019	Approval of ADB's Trade and Competitiveness Program	$500 million disbursed after completing all the first subprogram policy actions
November 2019	Review of tranche 2 of IMF EFF program	$450 million is expected to be disbursed in December 2019 based on the completed first review.
December 2019	ADB Board of Directors consideration of ADB SPBL based on 4 IMF prior actions, 6 structural benchmarks, and 1 additional action	$1 billion disbursement is expected in December 2019, based on completing the 11 policy actions and subject to Board approval.
December 2019	Board consideration of ADB Energy Sector Reform and Financial Sustainability Program, Subprogram 1	$300 million disbursement is expected in December 2019 against the completion of all first subprogram policy actions and subject to Board approval.

[27] ADB's Trade and Competitiveness Program, approved on 7 August 2019, will support the implementation of the national single window system, e-commerce facility, and Export Import Bank. These initiatives are expected to improve the quality of Pakistan's exports. They will also help correct many distortions in tariffs and duties, especially for raw materials (ADB. 2019. *Report and Recommendation of the President to the Board of Directors: Proposed Programmatic Approach and Policy-Based Loan for Subprogram 1 to the Islamic Republic of Pakistan for the Trade and Competitiveness Program*. Manila).

Date	Planned Program Approval	Planned Disbursement
March 2020	Review of tranche 3 of IMF EFF program	$450 million will be disbursed in March 2020 based on the completion of the second review.
May 2020	Board consideration of the Financial Sector Development Programmatic Approach	$300 million will be disbursed in June 2020 following the completion of all first subprogram policy actions and subject to Board approval.
June 2020	Review of tranche 4 of IMF EFF program	$450 million will be disbursed in June 2020 based on the completion of the third review.

ADB = Asian Development Bank, EFF = extended fund facility, IMF = International Monetary Fund, SPBL = special policy-based loan.
Sources: International Monetary Fund staff report (Table 9) and Asian Development Bank.

24. **Development partner coordination.** The SPBL forms part of a larger assistance framework under the IMF's economic reform program. The government has played an active role in ensuring strong development partner coordination throughout the preparation of the IMF EFF program. ADB has also coordinated directly with the IMF and other major development partners during the preparation of the SPBL. As a result of this strong coordination, the IMF EFF program aims to catalyze total financing of about $38.6 billion over 3 years from Pakistan's international partners.[28] The first 12 months will be financed with support expected from multilateral development banks and bilateral creditors as follows: the People's Republic of China (PRC) $6.3 billion, Saudi Arabia $6.2 billion, United Arab Emirates (UAE) $1.0 billion, the World Bank $1.3 billion,[29] ADB $2.1 billion (policy-based loans), and the Islamic Development Bank $1.1 billion. To support long-term debt sustainability, the government of Pakistan have also received firm commitments from key bilateral partners (the PRC, Saudi Arabia, and UAE) to maintain their exposure throughout the program period and to adjust the financing modalities to ensure that the new financing is consistent with the program debt sustainability objectives, thereby ensuring a manageable external debt servicing profile beyond the end of the IMF-supported program.

25. At a sector and technical level, the SPBL, the energy sector reform program, and the recently approved ADB program on trade competitiveness have been prepared in discussions with the IMF team to ensure strong alignment with the reform objectives. ADB has also had numerous interactions with the IMF team on specific areas of the EFF, including the debt sustainability analysis carried out by the IMF; and sequencing and disbursement of the SPBL has been coordinated with the IMF. ADB continues to coordinate efforts for improving trade and competitiveness with other development partners based on common reforms that are important to accelerate and sustain medium-term growth.

[28] IMF. 2019. Pakistan: Request for an Extended Arrangement under the Extended Fund Facility: Press Release: Staff Report; and Statement by the Executive Director for Pakistan. *IMF Country Report*. No. 19/212. Washington, DC.
[29] The World Bank is processing budget support programs using its development policy operation and program for results modalities, which aim to (i) strengthen fiscal management, through the establishment of a Fiscal Policy Office; (ii) harmonize sales tax regulations; (iii) strengthen property valuation and tax collection systems; (iv) improve debt management; (v) improve the business environment and trade competitiveness; and (vi) facilitate human development through education and health system strengthening. Over the next 3 fiscal years (including FY2020), the World Bank proposes to provide $2 billion in budget support (DPL) and $1.4 billion in loans with disbursement-linked indicators.

C. Impacts of the Reform

26. The program is aligned with the following overarching development objective: macroeconomic management strengthened and more sustained and inclusive growth.[30] The program will have the following effects of the reform: sustainable fiscal position with reduced external imbalances achieved.[31] The program is structured around three reform areas: (i) exchange rate management strengthened, (ii) public resource management improved, and (iii) social protection enhanced. It comprises 11 policy actions, which the government completed from May to October 2019.

27. Macroeconomic targets announced in the FY2020 federal budget on 11 June 2019, incorporating the economic reform program, are in Table 4. These targets include that, by FY2020, the government's primary balance, as a percentage of GDP, will be equal to or greater than –0.4%. Gross public debt, as a percentage of GDP, is expected to reach 70.8% of GDP by FY2023 and 67.1% by FY2024, from a peak of 80.5% of GDP in FY2020.

Table 4: Fiscal and External Sector Projections, FY2020–FY2023

Indicator	FY2020	FY2021	FY2022	FY2023
Total revenue and grants (% of GDP)	16.3	17.9	19.1	19.6
Total government expenditure (% of GDP)	23.4	23.1	22.8	22.2
Budget balance, including grants (% of GDP)	(7.1)	(5.2)	(3.7)	(2.6)
Primary balance, including grants (% of GDP)	(0.4)	1.0	2.1	2.7
General government and government-guaranteed debt (% of GDP)	80.5	78.0	74.4	70.8
Current account balance (% of GDP)	(2.6)	(2.0)	(1.8)	(1.7)
Consumer prices (percentage change, period average)	13.0	8.3	6.0	5.0

( ) = negative, GDP = gross domestic product.
Sources: Government of Pakistan authorities and International Monetary Fund staff projections.

28. Structural reforms under the program are expected to depress GDP growth temporarily to a low of 2.4% and push inflation as high as 13% in FY2020. The social cost of this adjustment is expected to be high for the poor and vulnerable, with weak growth prospects leading to economy-wide impacts including higher unemployment and lower purchasing power. To mitigate the social impact of the economic crisis and the short-term adjustment costs related to the reform measures, the program facilitates measures for protecting the most vulnerable citizens, including an expansion of social safety nets and increasing federal government social expenditure by 52% from FY2019 to FY2020 with timely delivery of cash transfers to 5 million households headed by women. Over the medium term, GDP growth is expected to recover, rising to 5% by FY2023 with inflation easing significantly to 5% by FY2023.

D. Development Financing Needs and Budget Support

29. The government has requested a regular loan of $1,000,000,000 from ADB's ordinary capital resources to help finance the program.[32] The loan will have an 8-year term, including a grace period of 3 years; an annual interest rate determined in accordance with ADB's London interbank offered rate (LIBOR)-based lending facility plus 200 basis points; a commitment charge of 0.75% per year; and such other terms and conditions set forth in the draft loan agreement. The

[30] Government of Pakistan, Ministry of Planning, Development and Reform. 2014. *Pakistan 2025: One Nation – One Vision*. Islamabad.
[31] The design and monitoring framework is in Appendix 1.
[32] The Government of Pakistan sent a letter to ADB on 13 May 2019 requesting an SPBL of $1 billion.

loan amount will be disbursed in a single tranche. These funds will meet the government's emergency financing needs to prevent significant adverse social and economic impacts of its balance-of-payments and fiscal crises and to build foreign exchange reserves. The proposed pricing has taken into consideration (i) Pakistan's financing needs, (ii) ADB's risk-bearing capacity, and (iii) the terms offered by other multilateral creditors such as the IMF.

30. **Pakistan's development financing needs**. The government estimates that it requires about $29.98 billion during FY2020 to alleviate external financing pressures and build the targeted foreign exchange reserves. Of the total requirement during FY2020, the IMF will provide $2.4 billion through the EFF program. ADB's SPBL, together with approved and planned policy-based lending assistance (Table 3), will provide an additional $2.1 billion or 11.9% (Table 5) of total financing requirements.[33] To ensure that medium-term public debt repayments remain sustainable, and that newly mobilized funds can be used to address the immediate causes of the crisis, the PRC, Saudi Arabia, and UAE have also agreed to roll over outstanding public debt obligations and a deferred oil payments facility equal to about $13.5 billion during FY2020.

Table 5: Gross Financing Requirements and ADB Financing
($ million unless otherwise mentioned)

Financing items	**2019–2020** (FY2020)	**2020–2021** (FY2021)
A. Gross external financing requirement	25,616	28,100
B. Reserves accumulation targets under the macroeconomic framework prepared by the IMF	4,364	3,280
C. Total requirement (A+B)	29,980	31,380
D. Available financing (excluding official creditors and the IMF) from foreign direct investment, portfolio investment, borrowing by banks	9,984	11,995
E. IMF financing	2,383	1,253
F. Additional requirements from official creditors (C-D-E)	17,613	18,132
G. Proposed ADB financing (policy-based loans only, including SPBL)	2,100	700
H. ADB financing as a percentage of additional requirements	11.9	3.9
I. Memo: Foreign Exchange Reserves Targets (fiscal year opening reserves plus B) under the Program Scenario ($ billion)	11.2	14.5

ADB = Asian Development Bank, IMF = International Monetary Fund, SPBL = special policy-based loan.
Sources: IMF. 2019. Pakistan: Request for an Extended Arrangement under the Extended Fund Facility: Press Release: Staff Report; and Statement by the Executive Director for Pakistan. IMF Country Report. No. 19/212. Washington, DC; and Asian Development Bank estimates.

31. **Assessment of ADB risk-bearing capacity**. The SPBL is within ADB's risk-bearing capacity, not constraining future ADB-wide lending operations at the current Pakistan sovereign ratio rating of *SO11 (B-)*. If Pakistan were downgraded to *SO12 (CCC+)* or *SO13 (CCC/CC/C)*, then ADB might need to restrain future regular ordinary capital resources allocations to Pakistan to prevent a breach in the capital utilization ratio threshold of 90%.

32. **Financing terms**. The pricing and terms of the SPBL are broadly comparable with those being offered under the IMF EFF program. The IMF EFF pricing and terms are based on the IMF's market-related interest rate, known as the basic rate of charge, which is linked to the special drawing rights (SDR) interest rate. The current basic rate of charge is the SDR interest rate plus

[33] Complementing these budget support programs, ADB's investment project commitments are expected to be about $550 million–$600 million during FY2020.

100 basis points. The SDR interest rate is 0.76% as of 7 November 2019. Large loans carry a surcharge of 200 basis points, paid on the amount of credit outstanding above 187.5% of the quota. If credit remains above 187.5% of the quota after 51 months, this surcharge rises to 300 basis points, and is designed to discourage large and prolonged use of IMF resources. The IMF EFF has a maturity of 12 years, including a grace period of up to 4.5 years.

E. Implementation Arrangements

33. The Ministry of Finance (MOF) will be the executing agency of the program. The implementing agencies are the Federal Board of Revenue, MOE, MOF, and SBP. The SPBL will be disbursed in accordance with ADB's *Loan Disbursement Handbook* (2017, as amended from time to time). The program was implemented over 6 months (1 May–31 October 2019). The loan closing date will be 30 June 2020.

III. DUE DILIGENCE

A. Governance

34. The enactment of the Public Financial Management Act on 1 July 2019 as part of the FY2020 Finance Act, if implemented well, will introduce PFM reforms to improve fiscal discipline and reduce governance risks. Overall, provisions in the act will embed stronger practices, transparency, and confidence in the use of budget resources by+ requiring parliamentary approval of budget authorizations during the fiscal year. Other recent legal amendments will limit the use of SROs, previously used to grant discretionary tax exemptions and concessions. PFM reforms planned by the government will also introduce a fiscal risk unit in the MOF to identify and monitor fiscal risks, including from SOEs, public–private partnerships, and development projects; and create a treasury office in the MOF responsible for commitment controls and cash management. However, the risk of fiscal slippages and resistance to some of the fiscal measures could undermine the government's fiscal consolidation strategy, putting debt sustainability at risk. Vested interests may oppose progress in governance, weakening structural reforms and medium-term growth prospects. To mitigate these risks, ADB, through various policy-based loans, is providing TA on lasting governance reforms and institutional building, including PFM and SOE reforms in the energy sector. The focus of the SPBL (and broader donor initiatives) on strengthening social protection programs and expenditures is also expected to gain political support to implement the ambitious policy measures. The government is enhancing the use of anti-money-laundering tools to support anticorruption efforts and ensure that banks and other reporting institutions improve their ability to identify politically exposed persons and apply enhanced due diligence measures. The government plans further outreach to banks and other reporting institutions in complying with obligations to file suspicious transaction reports; and plans to allocate sufficient resources to the Financial Monitoring Unit to improve the dissemination of financial intelligence used to support corruption investigations. Pakistan is on the Financial Action Task Force (FATF) grey list and will continue to implement the anti-money laundering and counter terrorism reforms agreed in the action plan with FATF. Last but not least, these initiatives are supported by changes in the leadership positions of some key institutions.

B. Poverty, Social, and Gender

35. A two-pronged approach is needed to address the social cost of crisis and structural adjustment. First, the financing support is critical to operationalize targeted social protection programs to moderate the impact on the poor and vulnerable (para. 13). Second, helping the government to identify and implement important policy actions to enhance social protection is

equally important. These two initiatives, in turn, will help the government to complete the proposed reforms uninterrupted. In parallel to the IMF EFF program, the government has embarked on major initiatives to make growth equitable and inclusive. It launched the *Ehsaas* program to scale up social protection that includes the financial and digital inclusion of about 5 million households headed by women, housing, health insurance, and welfare program for the poor and people with disabilities. The SPBL will share the financial burden for implementing these schemes. Moreover, targeted gender-related actions have been incorporated to strengthen the implementation of the *Ehsaas* program. First, improved access to finance women entrepreneurs will have a significant impact on women. Research shows that women entrepreneurs lack access to basic banking services. The loan will address this issue and facilitate improved financial inclusion of women. Second, support for a new banking contract for cash transfers under the BISP[34] is expected to make cash transfers to women swift, transparent, and safe.[35] ADB continues to provide support to the BISP through other programs as well (footnote 23). Moreover, improved growth, attributed to structural reforms, will have a significant impact on employment opportunities and income poverty, especially in a situation of rising inflation.

C. Safeguards

36. The loan is categorized C for environment, involuntary resettlement, and indigenous peoples. The policy actions are not expected to cause land acquisition or adverse impacts to the environment or indigenous peoples. Investment activities prohibited under ADB's Safeguard Policy Statement (2009) will be excluded.

D. Risks and Mitigating Measures

37. Major risks and mitigating measures are summarized in Table 6 and described in detail in the risk assessment and risk management plan.[36]

Table 6: Summary of Risks and Mitigating Measures

Risks	Mitigation Measures
Fiscal slippages and low fiscal headroom due to resistance by stakeholders force the government to cut social sector expenditure.	ADB, along with other donors, and the development partners (including IMF), continue to engage with the government to finance social sector developmental expenditure. ADB should continue to provide support for long-term governance reforms through TAs under various policy-based loans.
The government lacks the technical expertise for program implementation, causing incomplete reforms.	Continuous technical and policy engagement by ADB and other development partners, including IMF, with the government

ADB = Asian Development Bank, IMF = International Monetary Fund, TA = technical assistance.
Source: Asian Development Bank.

[34] The BISP is an integral part of the *Ehsaas* program.
[35] The BISP is the most extensive social safety program and largest unconditional cash transfer program in South Asia. It was launched in 2008 by the Government of Pakistan. The program targets women (as the head of the families) through direct unconditional cash transfers. The BISP influenced a change in the perception of women in the household and the community. I. Cheema et al. 2016. Benazir Income Support Programme: Final Impact Evaluation Report. Oxford: Oxford Policy Management.
[36] Risk Assessment and Risk Management Plan (accessible from the list of linked documents in Appendix 2).

IV. ASSURANCES

38. The government has assured ADB that implementation of the SPBL shall conform to all applicable ADB policies including those concerning anticorruption measures, safeguards, gender, procurement, consulting services, and disbursement as described in detail in the loan documents.

V. RECOMMENDATION

39. I am satisfied that the proposed special policy-based loan would comply with the Articles of Agreement of the Asian Development Bank (ADB) and recommend that the Board approve the loan of $1,000,000,000 to the Islamic Republic of Pakistan for the Economic Stabilization Program, from ADB's ordinary capital resources, in regular terms, with interest to be determined in accordance with ADB's London interbank offered rate (LIBOR)-based lending facility plus 200 basis points; for a term of 8 years, including a grace period of 3 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.

Takehiko Nakao
President

15 November 2019

DESIGN AND MONITORING FRAMEWORK

Country's Overarching Development Objective
Macroeconomic management strengthened and more sustained and inclusive growth supported (Pakistan's Vision 2025)[a]

Results Chain	**Performance Indicators with Targets and Baselines**	**Data Sources and Reporting Mechanisms**	**Risks**
Effect of the Reform Sustainable fiscal position with reduced external imbalances achieved	By FY2020: a. Current account deficit, as a percentage of GDP, reduced by at least 2 percentage points (FY2019 baseline: 4.8%) b. Primary balance, as a percentage of GDP, is equal to or above –0.4% (FY2019 baseline: –3.5%) c. Energy SOEs generate at least an additional PRs150 billion in revenue (FY2019 baseline: PRs1,358 billion) d. At least 90% of BISP beneficiaries received cash transfers through the biometric verification system (2018 baseline: 61%)	a. SBP data b.–c. MOF data d. BISP document	Global or regional economic slowdown leads to lower export demand and slower recovery in growth.
Reform Areas 1. Exchange rate management strengthened	**Key Policy Actions** By 2019: 1.1 SBP moved to a flexible market-determined exchange rate, with interventions in the foreign exchange market limited to smoothing excessive volatility (2018 baseline: Fixed exchange rate)	1.1 SBP press release and IMF assessment	Low fiscal headroom forces the government to cut social sector expenditure. Unexpected hike in international oil prices limits the

Results Chain	Performance Indicators with Targets and Baselines	Data Sources and Reporting Mechanisms	Risks
2. Public resource management improved	2.1 Formal agreement (MOUs) reached between all federal and provincial governments on the fiscal targets consistent with the IMF's macroeconomic framework (2018 baseline: Agreement was not in place) 2.2 Parliament approved FY2020 budget consistent with IMF program targets (2018 baseline: Not in place) 2.3 Automatic quarterly adjustment in electricity tariff achieved by at least 10% effective from 1 July 2019 (2018 baseline: Not in place) 2.4 Comprehensive circular debt reduction plan for SOEs drafted (2018 baseline: Not drafted) 2.5 Parliament approved the Public Financial Management Law for improved allocative efficiency of public resources (2018 baseline: Not approved) 2.6 Law to eliminate legal authorization for executives to grant sales tax exemptions and concessions through SROs amended (2018 baseline: Executives had power to award tax exemptions/concessions through SROs)	2.1 Copies of the MOUs 2.2 Budget documents for FY2020 2.3, 2.5, and 2.6: Government notifications 2.4 Circular debt reduction plan	government's ability to implement critical reforms.

Results Chain	Performance Indicators with Targets and Baselines	Data Sources and Reporting Mechanisms	Risks
3. Social protection enhanced	3.1 BISP's banking contracts finalized (2018 baseline: Not in place) 3.2 Financial inclusion strategy for women launched (2018 baseline: Not in place)	3.1–3.2 Government notifications	

Budget Support
Asian Development Bank: $1 billion (regular ordinary capital resources)

BISP = Benazir Income Support Programme, GDP = gross domestic product, IMF = International Monetary Fund, MOF = Ministry of Finance, MOU = memorandum of understanding, SBP = State Bank of Pakistan, SOE = state-owned enterprise, SRO = Statutory Regulatory Order.

[a] Government of Pakistan, Ministry of Planning, Development and Reform. 2014. *Pakistan 2025: One Nation – One Vision*. Islamabad.

Source: Asian Development Bank.

LIST OF LINKED DOCUMENTS
http://www.adb.org/Documents/RRPs/?id=53247-001-3

1. Loan Agreement
2. Sector Assessment (Summary): Public Sector Management
3. Development Coordination
4. Country Economic Indicators
5. International Monetary Fund Assessment Letter[1]
6. Summary Poverty Reduction and Social Strategy
7. Risk Assessment and Risk Management Plan
8. List of Ineligible Items

Supplementary Documents

9. Debt Sustainability Analysis
10. Pakistan Special Policy-Based Loan: Impact on Asian Development Bank's Risk Bearing Capacity
11. Pakistan Net Resource Transfers

[1] The IMF agreed that the attached Press Release (*No 19/402: IMF Reaches Staff-Level Agreement with Pakistan on the First Review under the Extended Fund Facility*) may serve as the IMF Assessment Letter. [https://www.imf.org/en/News/Articles/2019/11/08/pr19402-IMF-Reaches-Staff-Level-Agreement-with-Pakistan-on-First-Review-under-Extended-Fund-Facility].

DEVELOPMENT POLICY LETTER

Dr. Abdul Hafeez Shaikh
Adviser to Prime Minister on
Finance and Revenue

No. 415-Adv-PM(Fin)/2019

ISLAMABAD

October 11, 2019

Development Policy Letter

Dear President Nakao,

The Government of Pakistan has launched a comprehensive economic stabilization and recovery reform program to address macroeconomic challenges. We have entered into an Extended Fund Facility arrangement with the International Monetary Fund (IMF) for an amount of USD 6 billion to facilitate the government's reform program.

The program aims to: (i) improve exchange rate management in view of limited foreign exchange reserves; (ii) strengthen public financial management to mobilize more revenues, restore allocative efficiency of scarce public resources and address the power sector pricing issues; and (iii) reduce the social impact of adjustments with improved targeting and transparency of existing social protection programs.

The government has already implemented important reforms to stabilize the economy, which include:

I. Adoption of FY 2020 budget based on significant revenue gains to accelerate fiscal consolidation;

II. Adoption of a flexible market-determined exchange rate as a buffer against external shocks, with SBP's intervention in the foreign exchange market limited to preventing disorderly market conditions;

III. Further tightened monetary policy to shore up confidence and control inflation;

IV. Increased gas and power tariffs to stop growth of quasi-fiscal deficits; and,

V. Expanded social support, including establishment of Ehsaas as our main poverty reduction and safety nets program.

We have developed additional structural reform measures with the help of IMF to reduce budget deficits and ensure debt sustainability while generating resources needed to augment government spending on health, education, and social support. Moreover, we are also developing key institutions to sustain our reform initiatives.

However, we face significant external financing requirements in coming years. Therefore, financing commitments from our multilateral and bilateral partners are critical to cover the financing gap and ensure that the proposed reforms are implemented effectively and in a timely manner. Moreover, it is crucial for us to build robust foreign exchange reserves.

The outcomes of the program will be reflected in, and monitored through, sustainable fiscal and debt positions of Pakistan. Improved fiscal performance, in turn, is expected to help the Government of Pakistan in carrying out necessary developmental activities, especially in meeting the elevated social protection expenditures.

We understand the challenges entailed in our program, and are committed to its effective implementation. We express our sincere appreciation for ADB's support for our economic stabilization and recovery program and the financial assistance being provided under the Special Policy Based Loan.

We would like to thank the ADB for working closely with Government of Pakistan in supporting our program and would like to reiterate our full support for its initiatives.

With kind regards,

Yours sincerely,

AHShaikh

(Dr. Abdul Hafeez Shaikh)

Mr. Takehiko Nakao,
President,
Asian Development Bank,
Manila,
Philippines

IMF PRIOR ACTIONS AND STRUCTURAL BENCHMARKS

Prior Actions	Structural Benchmarks
1. Move to a flexible, market-determined exchange rate by (i) announcing that the SBP moves to a flexible market-determined exchange rate with a focus on price stability and interventions are limited to safeguarding financial stability and preventing disorderly market conditions (DMC) and (ii) tightening the monetary stance by 150 bps. 2. Reach formal public agreement between the federal and provincial governments on the fiscal targets consistent with the program. 3. Adopt by parliament the FY 2020 budget consistent with program targets. 4. Adopt a package of measures in the energy sector: (i) Implement a quarterly automatic tariff adjustment in the electricity sector by about 10 percent to generate Rs 150 billion in additional revenues and (ii) notify by government the FY 2020 gas tariff adjustment as proposed by the regulator to become effective on July 1st, 2019.	1. Commit to not grant further tax amnesties – Continuous monitoring 2. Issue licenses for the track-and-trace system for excises on cigarettes- end-September 2019 3. Adopt measures to strengthen the effectiveness of the AML/CFT framework to support the country's efforts to exit- end October 2019 4. Submit to parliament, in consultation with IMF staff, amendments to the State Bank of Pakistan Act – end December 2019 5. Notify the FY 2020 electricity tariff schedule as determined by the regulator- end September 2019 6. Prepare a comprehensive circular debt reduction plan in collaboration with international partners- end September 2019 7. Submit to parliament amendments to the NEPRA Act to (i) ensure full automaticity of the quarterly tariff- end December 2019 8. Conduct and publish new audits by reputable international auditors of Pakistan International Airlines and Pakistan Steel Mills- end December 2019 9. Conduct a triage of all SOEs, dividing them into companies to (i) maintain under state management; (ii) privatize; or (iii) liquidate – end September 2020 10. Submit to Parliament a new State-Owned Enterprise law to improve governance and transparency – end September 2020 11. Finalize BISP's banking contracts and launch financial inclusion strategy for women – end October 2019 12. Update the benefit structure of Waseela-e-Taleem (WeT) to narrow the educational gender gap- end December 2019 13. Finalize the update of the BISP beneficiaries' database (National Socio-Economic Registry)- end June 2020

AML/CFT = anti-money laundering/combating the financing of terrorism
Source: IMF Staff Report