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PAKISTAN

February 2012

2011 ARTICLE IV CONSULTATION AND PROPOSAL FOR POST-PROGRAM MONITORING

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2011 Article IV consultation and Proposal for Post-Program Monitoring with Pakistan, the following documents have been released and are included in this package:

- **Staff Report** for the 2011 Article IV consultation and Proposal for Post-Program Monitoring, prepared by a staff team of the IMF, following discussions that ended on November 19, 2011, with the officials of Pakistan on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on January 23, 2012. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- **Informational Annex** prepared by the IMF.
- **Public Information Notice** (PIN) summarizing the views of the Executive Board as expressed during its February 3, 2012 discussion of the staff report that concluded the Article IV consultation.
- **Statement by the Executive Director** for Pakistan.

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PAKISTAN

STAFF REPORT FOR THE 2011 ARTICLE IV CONSULTATION AND PROPOSAL FOR POST-PROGRAM MONITORING

January 2012

KEY ISSUES

Context: Pakistan has confronted difficult challenges in the past few years: external and domestic economic shocks, political uncertainty, and security problems. Faced with these challenges, Pakistan has implemented several reforms, including under the recently expired Stand-By Arrangement, which helped the economy avoid a full-blown crisis. More recently, however, continued security issues, unresolved structural problems (especially in the energy sector), two major floods, and large fiscal deficits accommodated by the central bank have combined to make inflation persistently high, and limit growth and employment creation. These have left Pakistan's economy highly vulnerable, with few buffers to absorb shocks. Given this context, the 2011 Article IV discussions focused on macroeconomic policies to address vulnerabilities and reforms to promote robust inclusive growth.

The Outlook: On current policies, Pakistan's near- and medium-term prospects are not good. Growth would remain too low to absorb the large number of new entrants into the labor force, inflation would remain high, and the external position would weaken significantly. Moreover, there are considerable downside risks to this somber baseline, in the context of an increasingly fragile global environment and concerns about policy weakening ahead of senate elections in 2012 and parliamentary elections in 2013. The current mix of large fiscal deficits and accommodative monetary policy is increasingly unsustainable.

Main policy recommendations: Urgent policy action is needed on three fronts, to contain vulnerabilities, and to place Pakistan on a higher, inclusive growth trajectory: (i) strengthen public finances through revenue mobilization, cuts in wasteful and low-priority expenditure, and a strengthened fiscal decentralization framework; (ii) reform the energy sector to reduce power shortages and the large untargeted electricity subsidies, and more generally reduce the government's footprint in the economy; and (iii) implement financial policies to reduce inflation, protect the external position, and safeguard the stability of the financial sector.

Approved By
David Owen and James Roaf

Discussions were held in Dubai and Islamabad during November 9-19, 2011. The staff team comprised Messrs. Mazarei (head), Duenwald, Amaglobeli, and Ross (all MCD), Mr. Jonas (FAD), Mr. Saiyid (MCM), and Mr. Painchaud (SPR). Messrs. Mojarrad and Sethi (OED) participated in the discussions. The team met with Finance Minister Shaikh, State Bank of Pakistan Governor Anwar, Finance Secretary Khan, and other senior officials, as well as private sector and civil society representatives. Representatives from the World Bank and the Asian Development Bank also participated in the discussions.

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INTRODUCTION

1. **At the time of the last Article IV consultation in March 2009, Pakistan was slowly emerging from the 2008 crisis**. Supported by the Stand-By Arrangement (SBA) approved in November 2008, economic activity had begun to rebound, inflation was declining, and, most importantly, a full-blown crisis was averted.

2. **Since then, despite some progress under the last SBA, economic institutions and policies remain weak**. The authorities have implemented some reforms, including improvements in tax administration, removal of some tax exemptions, the introduction of an interest rate corridor, establishment of a more market-based exchange rate regime, and a strengthening of the State Bank of Pakistan's (SBP) enforcement powers for dealing with problem banks. In addition, they have raised domestic prices of the main petroleum products by about 70 percent and electricity tariffs by about 90 percent since early 2008, while achieving a reduction in inflation, especially in 2009. Moreover, the Benazir Income Support Program (BISP) has provided basic income support to the poor during the various shocks that have hit Pakistan. Yet, other key reforms were not followed through, and the program went off-track in June 2010 (following the fourth review in May 2010), and stayed off-track until it expired at end-September 2011.

3. **The outlook for Pakistan is challenging**. At present, macroeconomic policies are overly expansionary and fundamental reforms to resolve the economy's structural problems are not being tackled well. As a result, the economy is increasingly vulnerable, with weak growth, persistent inflation, rising balance-of-payments pressures, and few buffers to absorb shocks. And with senate elections in March 2012 and parliamentary elections in 2013, the political climate is not conducive to reform.

4. **Against this background, the discussions focused on the policies needed to reduce vulnerabilities, build buffers, and promote inclusive growth—one that allows all segments of the population to contribute to and benefit from economic growth**. There was broad concurrence between the authorities and the mission on policy priorities, namely, tighter fiscal policy, a less accommodative monetary policy stance, and structural reforms (especially in the fiscal and energy sectors) to strengthen the economy's medium-term growth potential. The mission stressed that the government should build on its *New Growth Strategy* to develop a comprehensive economic strategy for the next several years, a strategy with broad buy-in from stakeholders in Pakistan (Box 1). The reforms under this strategy would need to correct a number of the key microeconomic and institutional problems that are at the root of macroeconomic imbalances and low growth. They relate in part to the nature of the government's intervention in the economy—for instance, in the area of agricultural procurement and electricity subsidies—and patronage, weak management, poor service delivery and other governance issues that have created a fertile ground for rent-seeking and corruption.

Box 1. Pakistan's New Growth Strategy

The government of Pakistan recognizes that the economy has performed well below its potential and requires an annual average rate of 7 percent to absorb youth labor growth. It has therefore formulated a new growth strategy (NGS).[1] The NGS promotes sustained growth by addressing what it considers the two main constraints to growth: (i) inadequate market development, caused by lack of competition, policy distortions, entry barriers, and poor regulation; and (ii) inefficient public sector management, especially in the provision of core public goods such as security of life, property, transactions, and contracts, and in the accumulation of human and physical capital. The NGS encourages a joint government and private effort to increase productivity by tackling: noncompetitive markets, poor governance, limited urban development, inadequate education, low openness, and limited innovation due to limited research. It also acknowledges the role that provincial governments will play following the 18th amendment of the Constitution.

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[1] Planning Commission of Pakistan, *Pakistan: Framework for Economic Growth*, May 2011.

BACKGROUND

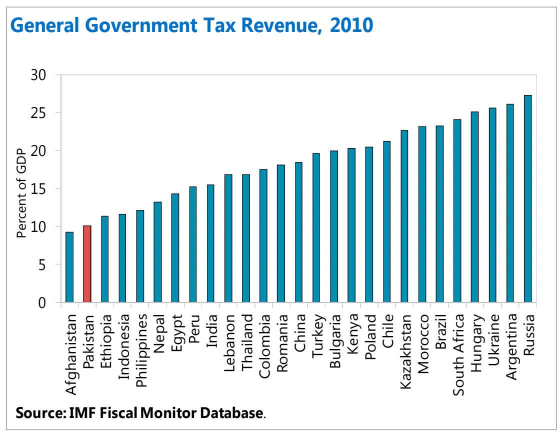
A. Key Features of Pakistan's Economy and Policy Framework

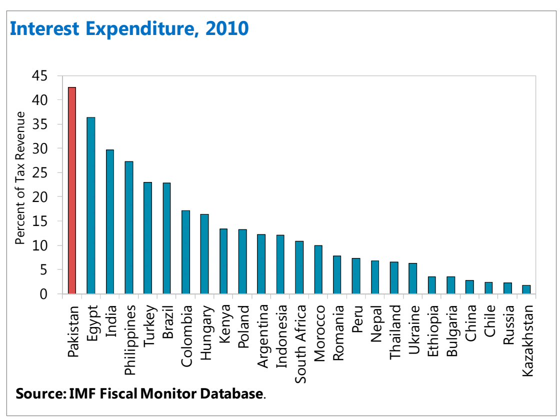
Pakistan's recent economic performance and prospects have suffered from difficult political and security conditions, natural disasters, and shortcomings in its institutions and policy framework.

5. **A country with abundant potential**. Pakistan is of considerable geostrategic importance, straddling Central Asia, and South Asia, and close to the Middle East, and rich in natural and human resources. Expansion of regional trade is a particular opportunity for Pakistan, as is the potential demographic dividend from a young population.[1] Pakistan's high potential, however, is not being fully realized because of several structural factors.

6. **A difficult political structure and major internal security problems**. Important steps have been taken in recent years to build democracy, but, as in other countries, the transition has not been smooth. Since 2008, a civilian coalition government has been in power. The judiciary and the press have become more independent, but at the same time the military continues to have considerable political influence. Political instability, along with rent-seeking and patronage, has undermined attempts at sustained economic reform and fiscal discipline. Internal security has also remained a major challenge.

7. **An economy vulnerable to exogenous shocks**. Pakistan has repeatedly suffered from natural disasters, including the two major floods in 2010 and 2011.[2] The people of Pakistan have shown great resilience in the face of these shocks, but the human and physical impact of these disasters should not be underestimated. In addition, given a lack of a diversified export base (cotton and textiles account for more than half of exports) and the need to import oil and some food products,





[1] About half of Pakistan's population is under the age of 20.

[2] The IMF provided emergency financial assistance to Pakistan (amounting to US$451 million) to help cope with the aftermath of the 2010 floods.

Pakistan is vulnerable to fluctuations in international commodity prices.

8. A weak fiscal structure. Government tax revenue is about 10 percent of GDP, one of the lowest in the world. There is a general unwillingness to pay taxes, due to poor public service delivery and because of perceived unfairness in the tax system. For example, a major sector, agriculture, is mostly outside the tax net, and the number of taxpayers filing income tax returns is very small relative to the size of the population (about 1 percent). At the same time, there are large demands for government spending. Most notably, subsidies (mostly electricity subsidies) and interest payments consume almost half of government revenue while security spending uses up another quarter. As a result, there are large budget deficits that are difficult to finance, especially when foreign assistance is limited. Therefore, budgetary management relies too much on the containment of investment spending and borrowing from the banking system.

9. Large loss-making public enterprises sap fiscal resources. A number of public-sector enterprises (PSEs), especially in the power, transportation, and agriculture sectors, operate without hard budget constraints and incur large losses. Subsidies to cover these losses, which amounted to nearly 2 percent of GDP in 2010/11,[3] divert resources away from more productive spending.

10. Increased fiscal decentralization without clear rules (Appendix 1). The seventh National Finance Commission (NFC) Award process, which governs revenue sharing between the federal and provincial budgets, allocated a much larger share of government revenue to provinces starting from July 2010. Thus, more than half of federally collected tax revenue is now transferred to the provinces. Further, the implementation of the 18th Constitutional Amendment in July 2011 devolved additional expenditure responsibilities to the provinces, but in some areas, the assignment of responsibilities between the provinces and the center is not yet clearly defined. Revenue raised by provinces themselves is very low and finances only a small share of provincial spending, thus creating incentives for fiscal indiscipline. Moreover, the rules of the game need strengthening, and a binding mechanism should be introduced to assure attainment of the general government deficit target by coordinating provincial and federal fiscal targets.

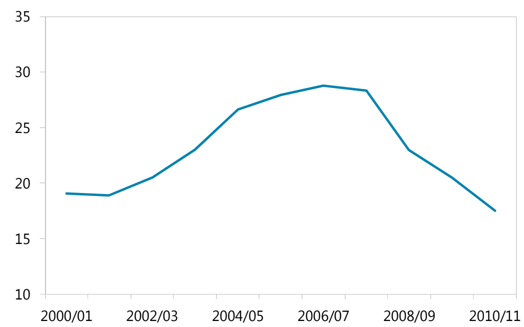
11. A highly constrained and unpredictable energy supply. This longstanding problem has been exacerbated in recent years by a lack of investment, price distortions, and poor management of the sector. While many reform plans have been prepared, implementation has not been sustained. As a result, there are widespread outages (averaging eight hours a day in the summer of 2011), which is a large constraint on growth (estimated at 2 percent of GDP) and employment. Budgetary electricity subsidies reached about 1½ percent of GDP in 2010/11 (including 0.6 percent of GDP recognition of past subsidies), higher than the expenditure on health. A tariff rate below the level needed for cost recovery, and poor collections, has brought about a buildup of interenterprise arrears (circular debt, estimated at 3 percent of GDP). These arrears have been partly financed by credit from banks that further crowds out

[3] Pakistan's financial year runs from July 1 to June 30.

the private sector. Furthermore, periodically, the government has to take on its books the circular debt, an additional subsidy that undermines public finances.

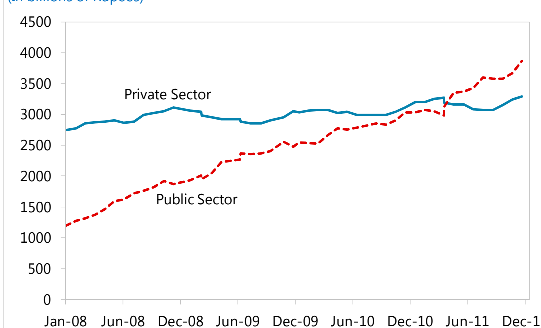
12. Private sector credit growth has been weak (Tables 4 and 5). The government's large financing needs, considerable commodity operations (see below), together with risk aversion by banks, has led to the increasing diversion of credit away from the private sector, reducing funds available for investment. Indeed, bank lending to the private sector has declined in relation to GDP in recent years, and has been surpassed by lending to the public sector. This could also reflect: (i) the deterioration in the macroeconomic situation, which has contributed to lower demand from the private sector; and (ii) a rise in private-sector nonperforming loans (NPLs), which has reduced banks' willingness to lend. Limited competition between large banks and with other sources of finance (on account of limited capital market development) makes it easy for banks to offer relatively low rates on deposits, a factor contributing to wide banking sector spreads (Appendix 2).

Private Credit, 2001–11
(In percent of GDP)



Sources: Pakistani authorities; and IMF staff calculations.

Banking Sector Credit, 2008–11
(In billions of Rupees)



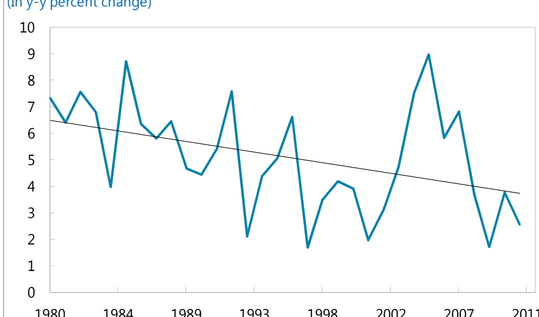
Sources: Pakistani authorities; and IMF staff calculations.

B. Economic Outcomes

Following the economic crisis of 2008, Pakistan has succeeded in taking steps toward economic stabilization. But, reflecting its institutional structure and policy framework, as well as exogenous shocks and a difficult global environment, Pakistan's economic performance has been well below its potential.

13. Sub-par growth. Pakistan's real GDP growth has been on a declining trend and relatively volatile. While there have been GDP growth spurts (most recently during 2004–07 when annual growth averaged over 7 percent), overall growth performance has been disappointing, especially when compared to other regional economies like India (Figure 1). And in the past four years, real GDP growth has averaged only 3 percent (Table 1),

Real GDP, 1980–2011
(In y-y percent change)



Sources: Pakistani authorities; and IMF staff calculations.

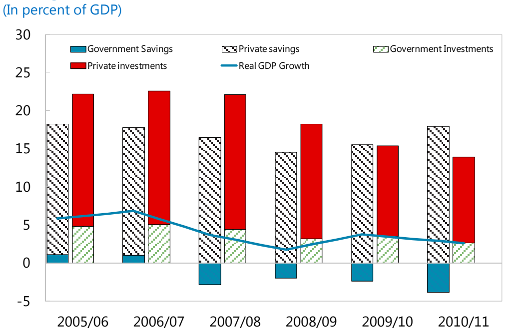
although natural disasters have contributed to this outcome.

14. High unemployment. A low official unemployment rate of 6 percent masks deep problems (Appendix 3). Underemployment and considerable unpaid employment (the latter estimated at 28 percent of the employed in the 2010/11 Labor Force Survey) remain major problems, as a large young population is not being absorbed due to low growth and despite many Pakistanis finding employment abroad. Indeed, it is estimated that average GDP growth needs to be around 7 percent per year to absorb about 2 million new labor market entrants annually.

15. Low savings and investment. Private investment has declined in recent years, undermined by political and economic uncertainty, problems in the banking system

Savings and Investments, 2006–11

(In percent of GDP)



Sources: Pakistani authorities; and IMF staff calculations.

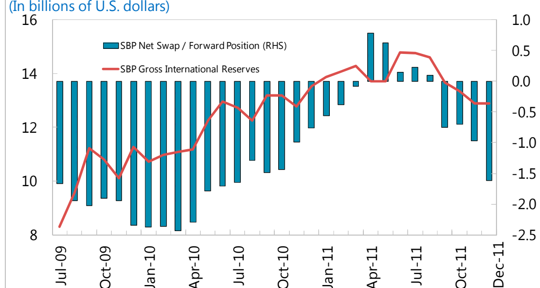
that reduce the supply of credit, crowding out by the public sector, and infrastructural bottlenecks. At the same time, public investment has fallen as declining government resources and rising current spending demands have forced cuts in development spending. And private savings remain low compared to other countries in the region (Figure 1).

16. High inflation. In the decade prior to 2008, Pakistan's inflation performance was good. In 2008, however, inflation rose sharply with the spillover of higher international commodity prices and accommodating domestic policies, and, although it has declined subsequently, it has remained persistently in double digits.[4] Staff analysis suggests that central bank financing of the fiscal deficit has been an important driver of inflation (Box 2). In addition to its obvious impact on poverty, high inflation also hurts growth.[5]

17. A weakening external position (Table 2). While a surge in exports and strong remittances helped Pakistan rebuild its international reserves in 2010/11, more recently a deterioration in the current account position and weakening financial inflows have put pressure on the rupee, prompting foreign

SBP Gross International Reserves and Net Swap/Forward Position, 2009–11

(In billions of U.S. dollars)



Sources: Pakistani authorities; and IMF staff calculations.

exchange market intervention in the spot and forward markets. During July–December 2011, despite increased exchange rate flexibility

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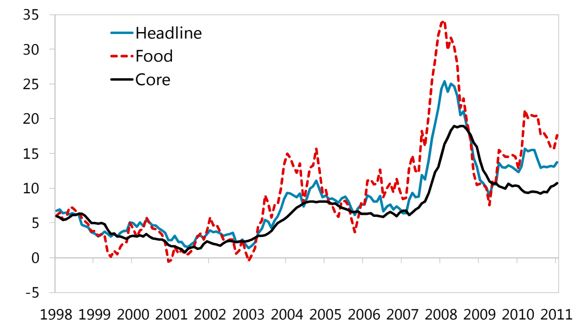
[4] In December 2011, CPI inflation slipped below 10 percent for the first time in two years (9.7 percent year-on-year).

[5] Empirical work suggests that inflation above a certain threshold becomes harmful to growth. For Pakistan, this inflation threshold has been estimated at 9 percent (see Mubarik, Y.A. (2005), "Inflation and Growth: An Estimate of the Threshold Level of Inflation in Pakistan," *State Bank of Pakistan Research Bulletin*, Vol. 1, No. 1.). Moreover, recent cross country work for developing countries suggests a threshold of 10 percent (see Espinoza, R. et al, (2011), "When Should We Worry About Inflation?" *World Bank Economic Review*).

Box 2. Why is Inflation in Pakistan So High and Persistent?

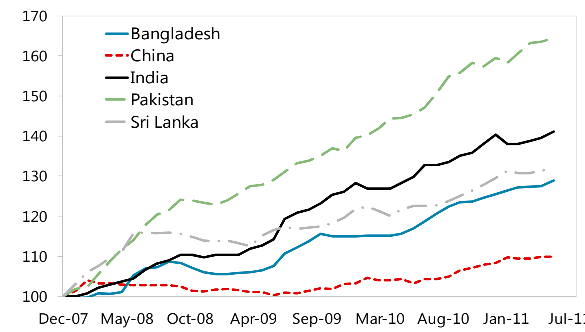
Central bank lending to finance fiscal deficits has been a key driving force behind the high inflation levels observed in the last few years. Before 2008, 12-month CPI inflation had averaged about 5.5 percent for more than a decade.[1] In 2008, global commodity price shocks and a sharp depreciation of the rupee led to a spike in inflation (peaking at 25 percent year-on-year in August 2008), which, although declining, remained much higher than in the pre-2008 period, and higher than in neighboring countries. Through domestic price subsidies, the global food and fuel price shocks were reflected in larger fiscal deficits. With external financial inflows dwindling, these deficits were increasingly financed through the SBP, which put upward pressure on prices through excessive growth in SBP net domestic assets and exchange rate depreciation.[2]

Inflation in Pakistan
(In y/y percent change)



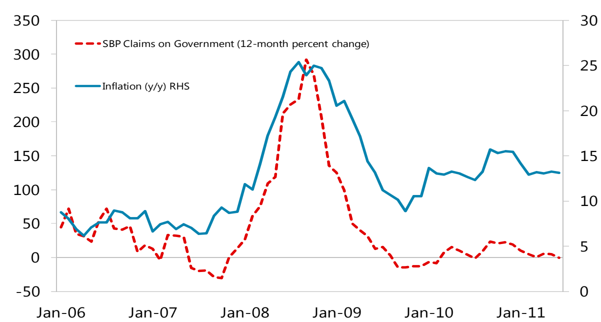
Source: Pakistani authorities.

CPI
(Index 2007=100)



Source: IMF World Economic Outlook Database.

SBP Lending to Government and Inflation



Source: Pakistani authorities.

CPI inflation persistence 1/
(June 2001–July 2011)

	Persistence	Change in persistence (2008-11/2001-07)
Bangladesh	0.15	0.01
India	0.03	0.19
Sri Lanka	0.28	0.43
Pakistan	0.38	0.33

Source: National Authorities; and IMF staff calculations.

1/ Calculated as first order auto-regressive coefficient for seasonally adjusted series.

Along with the inflation level, the persistence of inflation has increased since 2008. And, while moderate in absolute terms, persistence, which is essentially the correlation between current and lagged inflation, is higher than in the regional peers. The increase in persistence means that it now takes longer for inflation in Pakistan to return to its equilibrium level after a common shock hits the economy, which in turn implies that inflation, and inflation expectations, are likely to respond more sluggishly to policy changes. In fact, survey data indicates that inflation expectations have continuously remained at around 15 percent.[3] Persistence could be due to engrained inflationary expectations, institutional features, or CPI calculation problems.

The authorities can help reduce the level and persistence of inflation by credibly adopting a less accommodative monetary policy stance. The recent (since May 2011) decline in government borrowing from the SBP is a welcome development. However, the switch to government borrowing from commercial banks has been supported by large liquidity injections by the SBP, a policy that has similar inflationary effects as direct central bank financing. To reduce inflation and increase the SBP's policy credibility, such injections should be scaled back and direct government borrowing from the SBP should be avoided.

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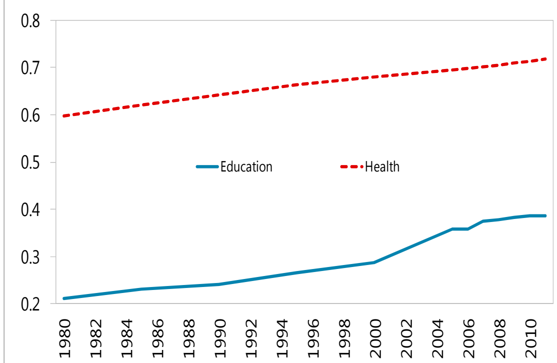
[1] Pakistan has recently started publishing a new CPI series, but a long time series is not available. Hence, for the purposes of this box, the former CPI series is used.

[2] A model-based analysis also confirms a statistically significant effect of SBP lending to government on inflation. A simple, single-equation model was estimated to explain the short-term relationship between headline CPI inflation and the following explanatory variables (asterisks denote statistical significance of the estimated coefficients at the 5 percent level): inflation inertia (lagged inflation)*, SBP claims on government*, global food price, global fuel price*, index of industrial activity (LSM) and interest rates*.

[3] See the Pakistan Institute of Development Economics (PIDE) inflation expectations survey Vol. 3, No. 2/2011.

and a 4½ percent depreciation of the rupee against the US dollar, reserves have declined by nearly US$2 billion, in part reflecting SBP intervention in the spot market (Figure 2). Moreover, the net swap/forward position has moved to US$1,625 million short as of end-December, 2011, from a long position of US$150 million at end-June 2011. Pakistan remains without tangible access to global financial markets. A standard analysis of Pakistan's real exchange rate indicates that the rupee could be somewhat overvalued (Box 3). However, with declining reserves, strains in global financial markets, and commodity price variability, there is considerable uncertainty about the extent of overvaluation.

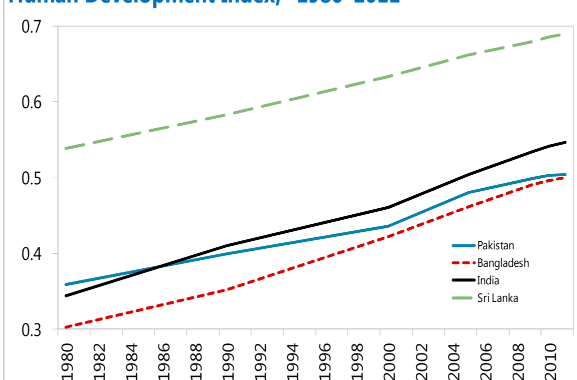
Social Indicators,* 1980–2011
(Indices)



Source: UNDP Human Development Report.
* Education is an index measure between 0 and 1, and it is calculated based on mean years of schooling (of adults) and expected years of schooling (of children).
Health is an index between 0 and 1, and it is calculated based on life expectancy at birth.

18. High poverty. The poverty rate was 17.2 percent in 2007/8, although broader measures suggest poverty incidence was almost 50 percent (UN *Human Development Report*, 2011). Over the past few years, low growth and high inflation, especially food inflation, and two major floods have probably led to an increase in poverty. Although Pakistan has made progress on strengthening human development indicators, it ranks 145th out of 187 countries on the UN's Human Development Index (*Human Development Report*, 2011), progress in key areas, such as education and health, has slowed in recent years and Pakistan appears to be falling behind its neighbors.

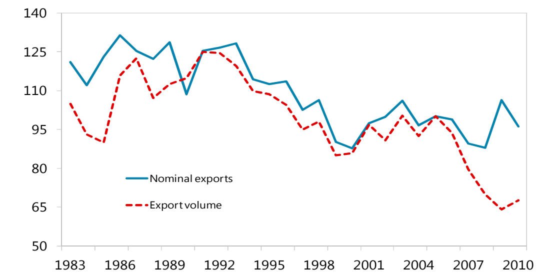
Human Development Index,* 1980–2011



Source: UNDP Human Development Report.
* Human Development Index (HDI): A composite index between 0 and 1 measuring average achievement in three basic dimensions of human development—a long and healthy life, knowledge and a decent standard of living.

Box 3. Assessment of the Real Effective Exchange Rate and External Competitiveness

Pakistan's export sector performance has been relatively weak, especially recently. Its share of world export volume has been trending down since the mid-1980s, with a significant decline in 2007 amid the crisis. In nominal terms, Pakistan's share of world exports has been relatively stable since 2007, helped by a recovery in cotton prices.



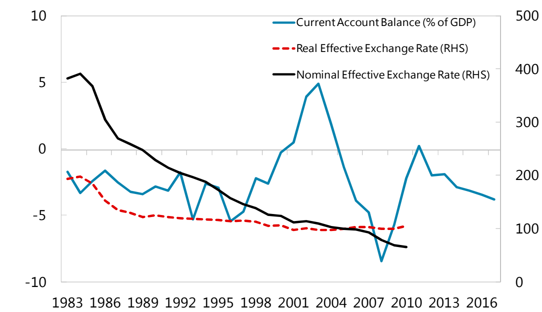
Sources: Pakistani authorities; and IMF staff calculations.

Pakistan's real effective exchange rate (REER) has been relatively stable since the end of the 1990s despite significant variations in the current account balance. Three complementary approaches are used to assess the degree of Pakistan's REER misalignment:

i. *Macroeconomic balance*: the current account deficit "norm" is estimated at 1¼ percent of GDP, while the "underlying" current account deficit is estimated at 3½ percent of GDP.[1] Assuming a number of different trade balance elasticities, the difference between the "norm" and the "underlying" current account indicates an overvaluation of the REER of about 10 percent.[2]

ii. *Equilibrium exchange rate:* a comparison of the current value of the REER and an estimate of its medium-term equilibrium value indicates that it is broadly in line with fundamentals.[3]

iii. *External sustainability*: assuming a negative net international investment position of approximately 30 percent of GDP, Pakistan's current account "norm" would be roughly 3¼ percent of GDP, indicating that the REER is broadly in line with fundamentals.



Sources: Pakistani authorities; and IMF staff calculations.

The key to Pakistan's external competitiveness is improving security conditions, the reliability of energy supply, and its business environment and governance. Out of 142 countries included in the World Economic Forum's *Global Competitiveness Report 2011–12*, Pakistan ranked 118, with weaknesses identified in: (i) macroeconomic environment; (ii) labor market efficiency; (iii) higher education and training; and (iv) infrastructure.[4] The World Bank *Doing Business* Report 2011, in which Pakistan ranked 83rd out of 183 countries, indicates that the cost of doing business in Pakistan could be reduced in the following areas: (i) enforcing contracts; (ii) paying taxes; and (iii) registering property. Based on the latest Country Policy and Institutional Assessment (CPIA) of the World Bank, Pakistan ranked 57th out of 77 low income countries with the following areas of improvement: (i) macroeconomic management; (ii) fiscal policy; and (iii) transparency, accountability and corruption in the public sector.

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[1] The current account norm is based on a panel regression of the current account on a set of fundamentals, including: (i) relative old age dependency; (ii) relative population growth; (iii) relative income; (iv) relative income growth; (v) oil trade balance; (vi) relative fiscal balance; (vii) initial net foreign assets; (viii) aid flows; and (ix) remittances flows.

[2] See Tokarick, S., 2010, "A Method for Calculating Export Supply and Import Demand Elasticities," IMF Working Paper 10/180.

[3] The equilibrium value of the REER is based on a panel regression of the REER on a set of fundamentals, including (i) terms of trade; (ii) relative productivity; (iii) relative government consumption; (iv) net foreign assets; (v) aid inflows; and (vi) remittances flows.

[4] See The Global Competitiveness Report 2011-12, World Economic Forum, 2011.

OUTLOOK AND RISKS

Pakistan's economic prospects are clouded by a risky world economy and by its current policy mix.

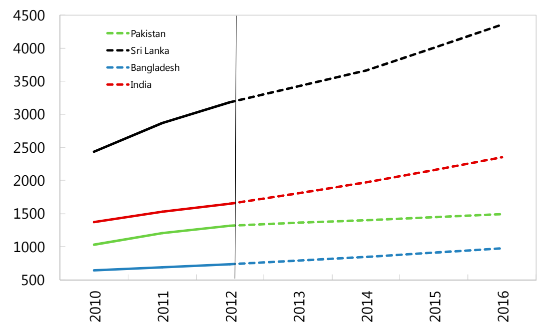
19. The outlook for 2011/12 is difficult. The economy is recovering from the floods, and real GDP growth is projected at 3.4 percent, a pickup from 2010/11. Average inflation is projected to be in double digits. On the external side, the balance of payments is coming under pressure. The current account balance is projected to return to a deficit, mainly reflecting lower exports due to a weaker external environment and lower cotton/textile prices, and only a modest increase in remittances (Appendix 5). Continued difficulties in attracting external financing and the beginning of IMF repurchases will also put pressure on the external position (Tables 7–8). Accordingly, reserves are expected to decline from US$14.8 billion at end-2010/11 to US$12.1 billion at end-2011/12 (slightly less than three months of imports). On the fiscal side, the authorities' 2011/12 deficit target of 4.7 percent of GDP is based on optimistic assumptions about some revenue components, strict spending control, and a provincial surplus. But, there is a real risk that the reforms needed to achieve that deficit target will not be implemented in an election year and the deficit (overall balance excluding grants) is likely to approach 7 percent of GDP (Tables 3a, 3b, and 3c).

20. Similarly, under a baseline scenario, medium-term prospects are not bright (Table 6). With sustained elevated fiscal deficits, credit to the private sector would continue to be crowded out, resulting in a continued decline in private investment from around 11 percent of GDP to below 10 percent by 2015/16. Private savings would decline to around 12 percent of GDP, insufficient to support robust investment and growth. Indeed, growth would likely settle at about 3½ percent, half of what is needed to absorb the rising labor force, causing unemployment to rise. Similarly, per capita income would grow only modestly. Without significant fiscal adjustment and with continued accommodative monetary policy, inflation would remain elevated, as would public debt. Reflecting a widening current account deficit and repayments to the Fund, the international reserves cushion would become very low (marginally above 1½ months of imports), despite assuming large unidentified inflows.[6] In other words, in the absence of major adjustment, Pakistan would face sizeable financing gaps even with low projected official reserves. Staff's debt sustainability analysis suggests that both external and public debt could decline even in a baseline scenario (Tables

[6] A risk-weighted metric (see "Assessing Reserve Adequacy," International Monetary Fund, February 2011) suggests that end-2011 reserves are at the lower end of an estimated range for an adequate reserves level for Pakistan. However, reserves are projected to fall well below the adequate level in the coming years.

9 and 10 and Figures 4 and 5).[7] However, public debt remains high throughout the medium term, government refinancing needs remain large, and both public and external debts are particularly sensitive to exchange rate depreciation. Indeed, if Pakistan-specific risks, relating for instance to the fiscal deficit or workers' remittances, were to materialize, public and external debt sustainability could be threatened.

Real GDP per Capita, 2010–16
(In U.S. dollars)



Sources: Pakistani authorities; and IMF staff calculations.

21. The risks to the outlook are tilted to the downside. Policy space to counter any further adverse shocks has become limited and the amount of financial support from the international community may not be very large. Given large fiscal and external financing requirements, risks relate mostly to potential liquidity rather than solvency concerns. In addition, security problems and political uncertainty cloud prospects:

- ***Fiscal gross financing requirements are projected to be very large*** (30 percent of GDP in 2011/12), resulting in high rollover risk for domestic debt; in fact, with rising fiscal risks and a high level of claims on government on banks' balance sheets, a tail risk of much lower bank demand for domestic debt cannot be ruled out.

- ***There are risks to inflation***, especially from possible supply shocks, pass–through from exchange rate depreciation, fiscal policy, and continued accommodative monetary policy.

- ***On the external side, inward real sector spillovers are a risk***. Financial contagion risks from the turbulence currently centered on Europe are limited, but Pakistan is exposed to negative trade and remittances spillovers.[8] Given Pakistan's heavy reliance on textile exports, a further significant fall in cotton prices could lead to external pressures.

- ***There are growing financial stability risks*** (Appendix 4). The overall banking system is reasonably well capitalized (nearly 15 percent of risk-weighted assets); relatively liquid due to large holdings of government securities; and

[7] This is due in large part to an assumption of continued negative real interest rates on public debt financing, with captive demand for domestic debt and concessional terms for part of the external debt.

[8] Roughly a quarter of Pakistan's exports go to Europe—a 20 percent decline in exports to Europe, for example, sustained over a year, would amount to a loss of about 10 percent of reserves. Remittances are another potential channel, but direct exposure to Europe is not very large. (Only 15 percent of remittances come from Europe, three quarters of which from the United Kingdom.) However, to the extent developments in Europe affect oil prices and the Middle East—which accounts for nearly 60 percent of Pakistan's remittances—there could be sizeable knock-on effects to remittances.

profitable on account of wide banking sector spreads. However, banks' balance sheets are becoming increasingly exposed to deteriorating private assets as evidenced by rising NPLs (gross NPLs were 16.7 percent of total loans at end-September 2011) and to sovereign risk. High NPLs are an issue especially for public sector and specialized banks that lend to the agriculture and manufacturing sectors. One large public bank and two specialized banks are being restructured but delays in returning problem banks to minimum capital requirements pose a risk for the system.[9] Finally, governance at some public financial institutions has been weak.

22. An alternative reform scenario illustrates the benefits of adjustment. In such a scenario, the authorities are assumed to implement prudent fiscal and monetary policies and structural reforms. In particular, the 2011/12 fiscal deficit would be cut to 5.7 percent of GDP using a combination of revenue and expenditure measures (see below). Over the medium term, tax policy, energy, business climate, and other structural reforms—along the lines previously discussed with the authorities in the context of the SBA—should enable further fiscal consolidation and higher productivity. The scenario assumes much less bank financing of the fiscal deficit and less crowding out of private credit. Together, these policies and reforms would produce higher growth, lower unemployment and inflation, and a more robust reserve cover (see text table and Figure 6).

[9] Banks operating with capital levels below the regulatory minimum account for less than 5 percent of banking system assets.

Pakistan: Baseline and Reform Scenarios, 2010/11–2015/16

	Estimate	Projections				
	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16
Baseline Scenario						
Real GDP at factor cost (percentage change)	2.4	3.4	3.5	3.5	3.5	3.5
Consumer prices (period average)	13.7	12.0	12.5	13.0	13.5	14.0
Budget balance excluding grants (in percent of GDP)	-6.6	-6.9	-6.3	-6.1	-5.9	-5.8
Total public debt (in percent of GDP, including all obligations to the IMF) 1/	60.1	61.7	60.2	58.3	56.2	54.6
Current account (in percent of GDP)	0.2	-2.0	-2.0	-3.0	-3.3	-3.7
Gross reserves (in months of next year's imports)	3.8	2.9	2.3	1.6	1.6	1.7
Unemployment (percent) 2/	6.0	7.7	9.2	10.7	12.0	13.1
Reform Scenario						
Real GDP at factor cost (percentage change)	2.4	3.8	4.5	5.0	5.5	5.5
Consumer prices (period average)	13.7	12.0	11.0	10.0	9.0	8.0
Budget balance excluding grants (in percent of GDP)	-6.6	-5.7	-4.4	-3.6	-3.3	-3.0
Total public debt (in percent of GDP, including all obligations to the IMF) 1/	60.1	60.0	56.6	52.8	49.1	46.2
Current account (in percent of GDP)	0.2	-2.1	-1.7	-2.5	-2.6	-2.8
Gross reserves (in months of next year's imports)	3.8	3.0	3.0	3.0	3.0	3.0
Unemployment (percent) 2/	6.0	7.5	8.6	9.3	9.8	10.1

Sources: Pakistani authorities; and IMF staff estimates and projections.

1/ The debt figures in baseline scenario do not include future circular debt that may need to be taken over by the government.

2/ Assumes employment elasticity of GDP growth estimate of 0.51.

POLICY DISCUSSIONS

Policy discussions focused on upfront policy actions needed to strengthen macroeconomic and financial stability and on structural reforms to lift medium-term growth.

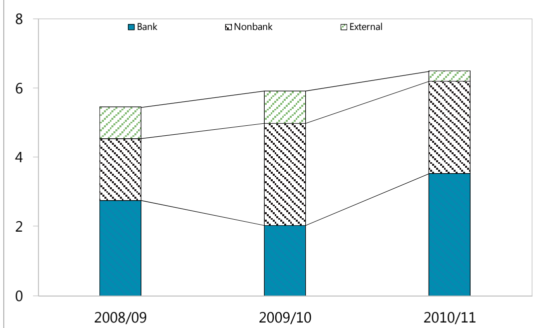
23. Broadly speaking, there was little disagreement between the authorities and staff on the diagnosis of the economic situation and on policy priorities. Both sides agreed that political constraints to reform had been binding for some time. Staff cautioned that the authorities' policy mix was leading the economy down an unsustainable and risky path: high fiscal deficits were crowding out the private sector and hurting growth, monetary policy was accommodating the deficits and keeping inflation high, while the external position was deteriorating significantly, in part reflecting global developments. Staff, therefore, recommended a set of short-term measures for dealing with the growing vulnerabilities. The authorities acknowledged the risks in the months ahead, but also noted some mitigating factors, such as continued strong remittances inflows and increased tax collection in 2011/12. They nevertheless agreed on the need to prepare a plan to mitigate risks. Beyond the short term, there was agreement on the importance of putting together a homegrown reform strategy for the next several years, based on a broad consensus, with the objective of raising inclusive growth.

A. Fiscal Policy

24. Pakistan's fiscal deficit has risen. The general government deficit (excluding grants) reached 6.6 percent of GDP in 2010/11, the highest level since the 2008 crisis.[10] Tax revenue collections again failed to pick up (in fact they declined slightly as a percent of GDP), as tax reform foundered due to insufficient political support. At the same time, although total spending declined by 1¼ percent of GDP, high spending on subsidies, security, and interest, as well as a 15 percent salary increase, crowded out more productive spending. Deficit financing shifted from external and nonbank sources to bank financing (including the SBP). So far in 2011/12 (July to September), the fiscal deficit was 1.2 percent of GDP, lower than the 1.5 percent of GDP deficit recorded in the same period in 2010/11. Both low expenditure growth and a brisk increase in tax revenue contributed to the lower deficit. However, strong tax revenue partly reflects one-time factors; revenue collection could weaken in the period ahead, particularly if the government succumbs to pressures to reverse the removal of tax exemptions and zero ratings.

[10] This figure includes the recognition in the budget of past electricity arrears (0.6 percent of GDP). Excluding arrears, the deficit reached 6 percent of GDP, marginally less than in the previous financial year.

Fiscal Deficit Financing, 2009–11
(In percent of GDP)



Sources: Pakistani authorities; and IMF staff calculations.

25. Reducing the fiscal deficit is central to safeguarding macroeconomic stability and setting the foundations for higher growth. The authorities have tried to keep spending under control, scaled back borrowing from the SBP, and implemented some tax and administrative reforms (see paragraph 29). Nevertheless, staff cautioned that the authorities' deficit target of 4.7 percent of GDP in 2011/12 appeared out of reach. While commendable, the efforts to raise additional revenue by means of stronger compliance enforcement have thus far not yielded adequate results. With electricity subsidies likely to be higher than assumed by the authorities and the assumed aggregate provincial surplus likely to be lower, staff argued that the deficit was heading for 7 percent of GDP, which would be difficult to finance. Hence, there is a need for immediate measures to contain the deficit, perhaps at 5.7 percent of GDP (5½ percent including grants). This would be achievable and probably sufficient to contain major fiscal risks.

26. Staff proposed a set of measures to build buffers and boost confidence, and cap the 2011/12 deficit at 5.7 percent of GDP. The government could use a combination of spending and revenue measures that include: tightening non-wage current government spending, including the reduction of non-power subsidies (e.g., wheat, fertilizers); re-introducing the special excise duty and income tax surcharge; and raising the sales tax rate. At the same time, efforts should be made to minimize the electricity subsidies and keep provincial budgets in surplus.

27. In the medium term, further fiscal adjustment is needed and should be based on structural measures. With gradual deficit reduction and continued low borrowing costs (relative to inflation) over the medium term, Pakistan's public debt would be sustainable, but the debt level is high, making it vulnerable to interest rate or exchange rate shocks. In addition, given financing constraints, lower deficits would reduce crowding-out and make more bank credit available for private-sector investment. In order to achieve this objective, a decisive break with the past is needed. A substantial increase in tax revenue is a necessary condition for sustainable deficit reduction, and another attempt should be made at implementing the reformed General Sales Tax (GST). The effort to improve tax administration and tax compliance will have to continue unabated, but in terms of revenue-generating capacity, they cannot yield as a much as a broad-based integrated GST, which could generate up to 3 percent of GDP in additional tax revenue. The authorities could also consider adopting a broader income tax regime and property taxes. On the spending side, the problems in the power sector and loss-making PSEs will need to be resolved, to remove these large drains on budgetary funds and to make room for more productive uses of public funds, especially for health, education, and poverty alleviation through better-targeted transfers, and to improve public service delivery. Similarly, commodity operations—the government's program of commodity procurements (e.g., of wheat, sugar, urea), which aims to stabilize the price of commodities in the domestic market and is financed by government-guaranteed bank loans—should be phased out as they are costly and divert bank credit away from the private sector.[11] Also, debt management, aimed at gradually extending debt maturities, will be particularly important in the period ahead to reduce rollover and interest rate risks. Finally, government cash management needs to be strengthened, in the context of sizeable government deposits in the banking system.

28. Fiscal decentralization needs to be managed carefully. If well managed, fiscal decentralization could improve the delivery of public goods and services. However, the large devolution of revenue to the provinces with more limited devolution of spending responsibilities have left the federal budget in a weaker structural position, make achievement of general government fiscal targets more difficult, and presents a risk to fiscal stability. The provinces will need to raise more of their own tax revenues, including revenues from property and agriculture, while at the same time improving the capacity to manage their new spending responsibilities. Greater clarity in the assignment of responsibilities at different levels of government is needed to strengthen accountability.

Authorities' Views

29. The authorities are well aware of the harmful effects of large budget deficits. Hence, they expressed their determination to achieve the 4.7 percent of GDP deficit target for this year. The authorities believed that the targeted deficit reduction could be achieved with a combination of spending restraint, carryover effects of last fiscal year's measures to broaden the tax base by removing exemptions and zero ratings, collection of past due taxes, and measures to improve tax administration and tax compliance. Regarding the latter, the authorities have used risk-based tax audits and implemented a campaign to identify and bring into the tax net wealthy individuals who do not pay taxes. On the spending side, they plan to ensure that nondiscretionary spending is kept within the budget limit, and to strictly contain electricity subsidies.

30. The authorities plan to cut the deficit to 3 percent of GDP over the medium term and simplify the tax system. Despite the resistance encountered on the previous attempts, they intend to replace the current general sales tax with a modern integrated reformed sales tax. They plan to continue the removal of remaining exemptions and zero ratings, and simplify the tax system to rely on three main pillars: sales tax, income tax, and customs duties.

31. The authorities recognize the risks to the public finances arising from decentralization. Nonetheless, they were confident that provinces would remain in surplus in 2011/12. They argued that the provinces needed to make a stronger effort to increase their own tax revenue—a view shared by staff. The authorities expressed interest in IMF technical assistance in this area.

[11] The stock of commodity credits currently stands at 1½ percent of GDP.

B. Financial Policies

32. **Monetary policy has accommodated fiscal deficits**. The SBP has adopted an expansionary monetary policy stance in the past few months. In its first two Board meetings during 2011/12 (July and September 2011), the SBP cut its policy rate by a cumulative 200 basis points to 12 percent, with interbank market rates also falling. At the same time, SBP lending to the budget has declined since May 2011, helped by an increase in liquidity injections by the SBP via open market operations to allow banks to purchase government paper (Figure 3). Reserve money growth has moderated, reflecting a decline in central bank net foreign assets, which have fallen in part due to the SBP's unsterilized intervention to support the rupee.

33. **Given the inflation and external risks, a more cautious monetary policy is needed**. Staff argued that the SBP's decision to reduce its policy rate was overly aggressive given the still-uncertain inflation outlook and the weakening of the external position, and that through its liquidity injections it was accommodating high fiscal deficits. Despite some moderation in headline CPI inflation in recent months, significant inflationary risks remain and core inflation remains high.

34. **Allowing more flexibility in the exchange rate is necessary to protect the external position**. The authorities have recently allowed more exchange rate flexibility, and as a result Pakistan's de facto exchange rate arrangement has recently been reclassified by the Fund as "floating." However, staff noted that recent reserve losses had been sizeable and that the exchange rate had not been allowed to move much, considering strong market pressures. Staff, therefore, argued that the SBP should allow more flexibility during phases of depreciation pressures, while building reserves during phases of appreciation pressures.

35. **Strengthening central bank autonomy and increasing monetary policy effectiveness should aid in achieving sustained disinflation**. The current legal structure, especially the absence of a strong framework for direct government financing, significantly impairs central bank independence. The legal reforms to increase SBP independence are critical, but the draft amendments currently being discussed in parliament do not meet this objective in that they do not ensure the operational independence of the SBP. In addition, increasing financial deepening by fostering competition in the banking sector and improving the functioning of financial markets are important for strengthening monetary policy effectiveness.

36. **Safeguarding financial stability in the face of rising risks is critical**. While systemwide capital adequacy levels are reasonably strong, capital ratios mask bank vulnerabilities arising from rising NPLs and large holdings of government securities.[12] Staff, therefore, urged steps to help address NPLs and also strengthen bank supervision while limiting regulatory forbearance. Staff stressed that problem banks should be restructured promptly, prudential regulations applied uniformly across institutions, and financial

[12] See "Pakistan's Banking System Outlook," Moody's Investor Service, December 15, 2011. Moody's maintains a negative rating on banks that it covers in Pakistan.

governance addressed in those institutions where it is a problem. Staff also recommended passing legislation for explicit deposit insurance, which has been prepared, possibly financed by levies on banks. Finally, the authorities should initiate the establishment of commercial courts to speed up the recovery of loans in default.

37. Development of capital markets should also be a priority. This would allow corporations to access credit from nonbank financial institutions and help support broad growth objectives. To this end, the authorities should encourage the development of the managed funds industry, and push for greater transparency in company data, particularly for unlisted subsidiaries of listed companies, which will help boost public confidence in capital markets.

Authorities' Views

38. The SBP felt that the recent cuts in interest rates were needed to stimulate growth. Furthermore, the SBP questioned whether higher interest rates would help in an environment of fiscal dominance. They argued that the September spike in exchange rate pressures was temporary and SBP intervention was necessary to calm the market. The SBP also agreed that inflationary risks remain and stressed that reducing the fiscal deficit was key. The SBP stressed that it was prepared to raise the policy rate if needed. Recognizing increased macroeconomic risks, including those arising from fiscal weaknesses and falling foreign exchange inflows, SBP opted at its November monetary policy meeting to keep its policy rate unchanged.

39. The authorities stressed they would continue to monitor NPLs closely and strengthen credit assessment procedures in order to protect banks' capital positions. They noted that they were taking steps to minimize the risks associated with delays in restructuring problem banks, including the recent capital injection of Rs 8 billion to a public bank (with Rs 256 billion in assets), bringing the total capital support from public funds to Rs 17 billion since 2008. The authorities also agree that in order to maintain capacity for private-sector credit while government borrowing is on the rise, banks will need to continue mobilizing deposits at a rapid pace. They also agreed that capital market development, particularly for corporate debt markets, is a priority. Overall, they were receptive to staff's proposals for safeguarding the financial sector, and expressed interest in related technical assistance.

40. The authorities outlined their plans for capital market development. They intend to promote depth and liquidity of equity and debt markets, for example, via better transparency in margin financing and debt pricing information. They expect to improve surveillance of company activities by strengthening real-time data monitoring capabilities. In addition, growth of the managed funds industry will be encouraged, in part, by product innovation, for example, exchange traded funds. There are also plans for the introduction of new debt and commodity hedging instruments, as exemplified by the new wheat futures contract.

C. Structural Reforms

41. Sustained and inclusive growth requires a number of structural reforms. Staff pointed out that a national consensus on structural reform was needed to raise productivity and competitiveness and lift constraints on growth. As was also confirmed by a seminar at the end of the mission (Box 4), there is little disagreement about the types of reform that are needed, but implementation has been lacking, reflecting a lack of broad political ownership. Improving the reliability and efficiency of Pakistan's energy supply remains the key priority on the structural reform agenda. Energy reform would also have important complementarities by unburdening the public finances. The authorities said they were committed to vigorously pursuing energy sector reform. To this end, the government has substantially raised domestic petroleum and electricity prices. This is necessary given higher international prices, but a management overhaul to reduce the high technical and collection losses and strengthen bill collection is arguably even more important. Staff stressed that a strategy, which could include privatization, was also needed to restructure the large loss-making PSEs. In this connection, a program of divesting public stakes in banks is also necessary to further reduce the state's footprint in the economy. Further, to boost productivity and spur entrepreneurship and innovation, staff underlined the need to improve the investment climate, by promoting better regulation and governance and facilitating the entry and exit of firms. Civil service reform is also necessary to improve the delivery of public services, which is under strain from low tax collection and stepped-up fiscal decentralization. Given the difficult situation in the labor market, staff noted that Pakistan needs sustained and inclusive growth and improved human capital to meet its large employment challenge. Improving the functioning of the financial sector to channel savings to borrowers is also critical, as is raising companies' access to capital markets. These reforms should be complemented by a further strengthening of the social safety net to support vulnerable parts of the population.

42. The authorities continue to pursue trade liberalization, which should help diversify exports. The mission welcomed Pakistan's recent moves to strengthen regional trade ties, in particular the recent efforts to continue trade normalization with India, which promises to revive commercial ties that have largely been dormant since 1947. In particular, Pakistan will introduce a "negative list" of imports from India by February 2012, which will replace the current "positive list." Furthermore, the "negative list" will be phased out gradually over time. Moreover, both Pakistan and India have agreed to move toward enhancing preferential trading arrangements under the South Asian Free Trade Agreement (SAFTA). Pakistan and India have also agreed to remove impediments to bilateral investments and opening bank branches. Finally, to promote trade, the SBP has recently signed bilateral currency swap agreements with the People's Bank of China and the Central Bank of Turkey.

Box 4. Seminar on Reviving Growth in Pakistan

Pakistan's Ministry of Finance and the Fund co-hosted a seminar on the revival of economic growth in Pakistan.[1] The seminar provided an opportunity to hear the views of Pakistani stakeholders. The discussion confirmed a broad consensus on key short-term and medium-term constraints and made recommendations that were mostly in line with the staff's views. Short-term constraints cited included water resources, energy shortages, security issues, and fiscal and external vulnerabilities. Medium-term constraints included the absence of a strong policy framework, policy inconsistency, weak institutions, and inadequate ownership of reform by the political leadership. Specific recommended measures included a more competitive exchange rate, better governance to support higher savings and investment, stronger public finances, energy sector reforms, and a deeper financial sector with more competition and greater inclusion.

[1] The seminar took place in Islamabad on November 19th, 2011. Participants included former government officials, members of Pakistani academia, civil society, parliament, and the private sector (corporate and financial), and representatives of development partners.

OTHER ISSUES

43. **The anti-money laundering and combating the financing of terrorism (AML/CFT) regime in Pakistan needs to be improved**. Pakistan's AML/CFT assessment in 2009 highlighted a number of important deficiencies many of which have yet to be addressed. The authorities should effectively regulate money service providers through an appropriate sanctions regime, and increase the range of ML/FT preventive measures applicable to them. Other major deficiencies include the lack of adequate criminalization and effective implementation of sanctions against terrorist financing, and the absence of effective controls for cross-border cash transactions. The authorities have recently stepped up their efforts to enforce AML/CFT regulations, including by instructing foreign exchange companies to comply with the requirements of the AML/CFT regime.

44. **In accordance with Fund policy, the Managing Director recommends the initiation of Post-Program Monitoring (PPM)**. Outstanding Fund credit to Pakistan exceeds the 200 percent of quota threshold for PPM, and there are no exceptional circumstances that would indicate that PPM is not warranted. The first PPM Board discussion is envisaged in mid-2012. In addition, Pakistan is an exceptional access borrower from the Fund and, therefore, an Ex-Post Evaluation (EPE) has begun, and a report will be produced for the Board.

45. **Data quality**. Macroeconomic statistics are broadly adequate for surveillance, but there are important gaps in the real sector and the quality of fiscal and social (especially poverty) data needs strengthening. The authorities are committed to strengthening data quality in order to better inform policy decisions and monitor outcomes. Indeed, the authorities have recently stepped up efforts toward joining the Special Data Dissemination Standard (SDDS).

STAFF APPRAISAL

46. **Without a fundamental policy correction, it will be difficult for Pakistan to maintain macroeconomic stability, raise living standards, and durably reduce poverty**. In such a scenario of unchanged policies, marked by high fiscal deficits, accommodative monetary conditions, and structural reform stasis, growth would remain subpar, inflation excessive, reserves too low, and social indicators disappointing.

47. **The risks to the outlook are tilted to the downside and contingency planning is needed**. The recent deterioration in Pakistan's external position highlights the macroeconomic risks, with looming pressures on the balance of payments from lower export prices, weaker growth in remittances, and repayments to the Fund. Policy space to deal with any further adverse shocks is limited. In addition to security problems and the risk of policy slippage in an election year, the government's high roll over needs, lower-than-expected external financial inflows, negative spillovers from the turmoil in Europe, and the high level of NPLs in the banking sector all represent significant risks to economic and financial stability. In view of the risks, the authorities should prepare and implement a plan to mitigate vulnerabilities.

48. **Pakistan's fundamental problems are well known**. Governance and institutional problems undermine the country's fiscal position. The complexity of fiscal management has recently been compounded by fiscal decentralization. Unpredictable and widespread power outages are stifling growth. Power sector subsidies, which are poorly targeted, have squeezed out social spending. Large public sector enterprises with soft budget constraints continue to sap fiscal resources, as do the government's commodity operations. Meanwhile, interenterprise arrears in the energy sector ("circular debt") undermine budget discipline and are clogging up the financial system. Financial intermediation to the private sector has declined to low levels, with the banking system supplying more credit to the public than to the private sector.

49. **The solutions to these problems, however, require politically difficult decisions**. The authorities recognize that Pakistan's macroeconomic problems have microeconomic and institutional causes that need to be addressed to achieve higher, inclusive growth. A fundamental break with the past is needed, and this will require a national consensus on a strategy to revive economic growth, along the lines of the NGS.

50. **Consolidation of the public finances is the starting point in any effort to set the economy on the right course**. Staff welcomes the authorities' efforts to remove tax exemptions and zero ratings, including in the sensitive agriculture sector. However, a more sizeable increase in tax revenue is needed. Measures could include a reformed GST, a broader income tax regime, introducing a property tax, re-introducing the special excise duty and

income tax surcharge, or raising the sales tax rate. On the spending side, it is critical to tighten non-wage current spending, especially by reducing untargeted subsidies, while protecting social spending. Loss-making public sector enterprises needed to be restructured, and commodity operations should be scaled back and phased out. Given substantial rollover risks of domestic government debt, carefully managing the government's growing debt load through extending maturities is also a priority. In addition, some of the rules of the game for fiscal decentralization, for instance those relating to provincial borrowing, need to be clarified, and the incentives of the provinces to raise their own revenue should be better aligned with requirements of sound public finances.

51. Monetary and exchange rate policy needs to better contain inflation and external risks. At its November 2011 policy meeting, the SBP rightly decided to keep its policy rate unchanged. Any further contemplation of monetary policy loosening should await clearer disinflation signals, and the SBP should be ready to tighten policy if inflation or external pressure increases. Greater exchange rate flexibility is also called for to facilitate external adjustment and to safeguard foreign reserves, which are projected to decline. Based on standard analysis, staff considers the rupee to be somewhat overvalued relative to fundamentals. However, declining reserves, strains in global financial markets, and commodity price variability suggest there is considerable uncertainty about the extent of overvaluation.

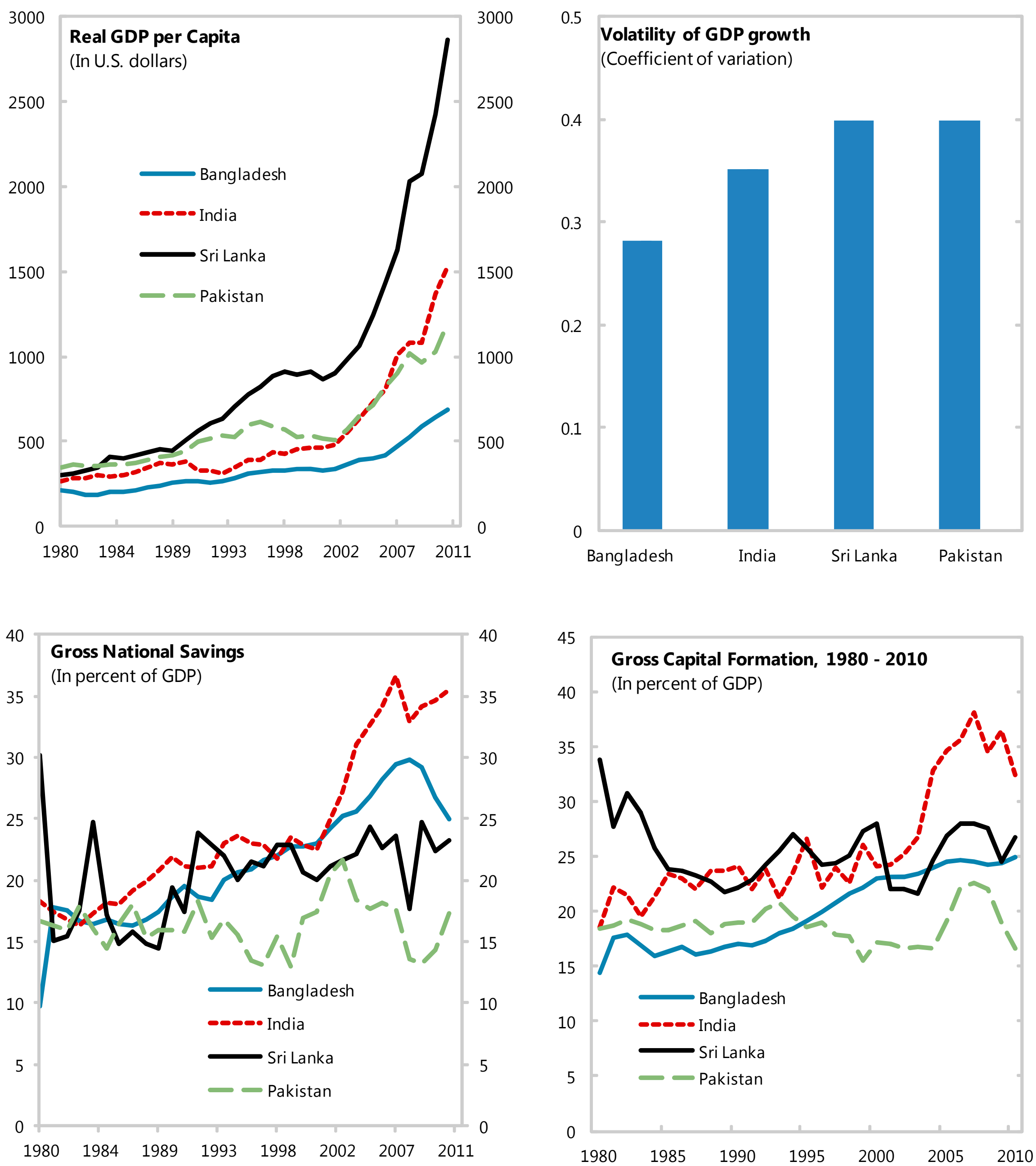
52. Reducing inflation will require comprehensive fiscal reforms and greater central bank independence. Fiscal consolidation would free monetary policy to pursue inflation objectives. A more independent central bank would be better able to resist pressures to finance the government deficit, either directly or indirectly. And lower inflation would help the poor.

53. Although capital adequacy ratios remain strong, increasing NPLs present risks to financial stability as do high concentrations of bank assets in government securities. Action is needed to address the NPLs and bank supervision should be strengthened. Remaining problem banks need to be resolved without delay. Closely monitoring vulnerabilities should remain a key priority, as should addressing financial governance problems in some institutions. In addition, establishing an explicit deposit insurance mechanism would boost confidence in the banking sector. Finally, the sector would benefit from a simplification of the collateral recovery process. A stronger financial sector, coupled with less government borrowing, would provide the resources for needed investment by the private sector.

54. In sum, Pakistan has the potential to do much better. Pakistan needs sustained higher and inclusive growth to reduce poverty and meet its large employment challenge. Growth prospects hinge on improving the policy mix and relieving infrastructural bottlenecks, especially in the energy sector, strengthening human capital, and ensuring a competitive business environment. In designing its reform strategy, the government will need to maintain a robust social safety net to support vulnerable parts of the population.

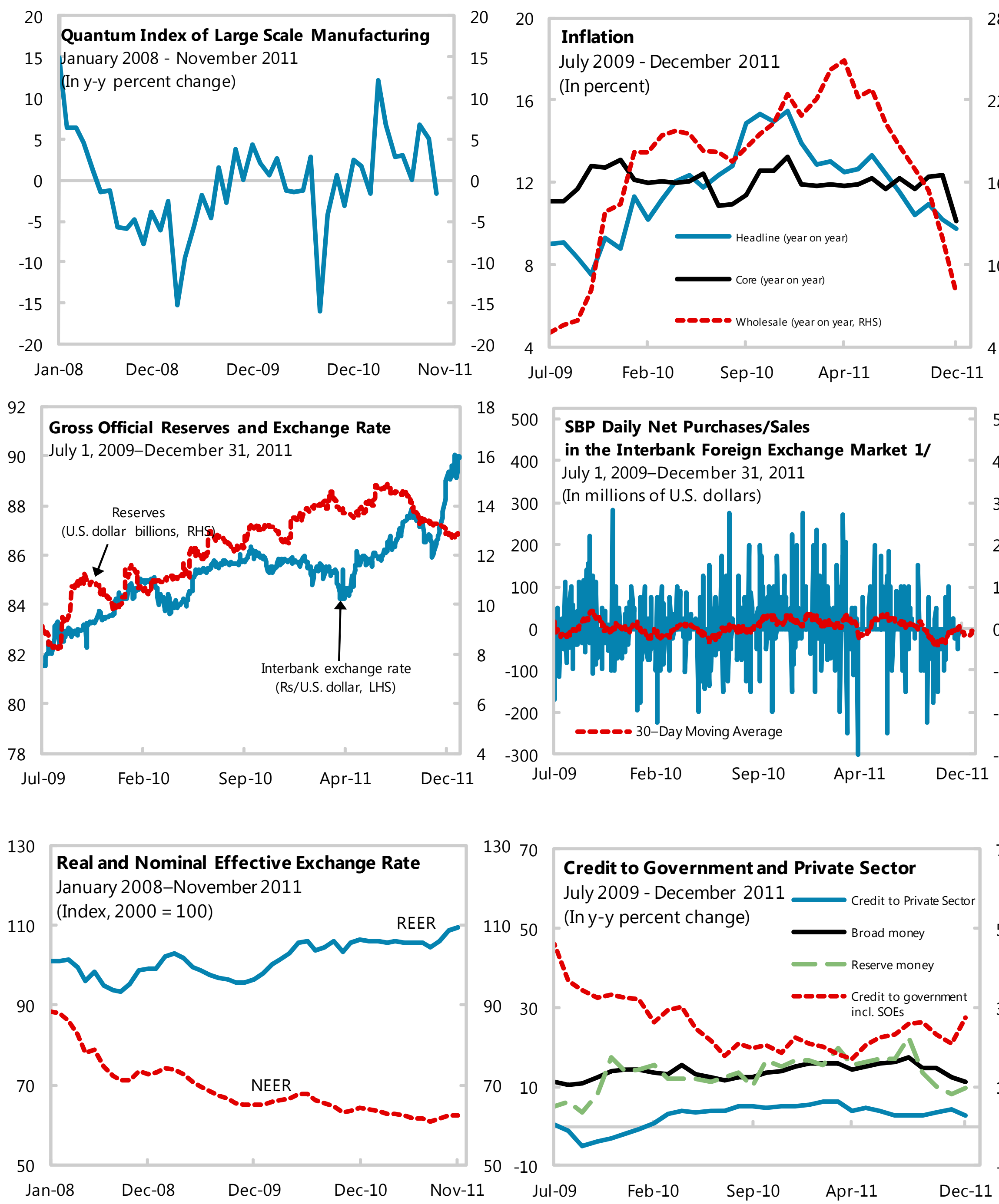
55. It is recommended that the next Article IV Consultation with Pakistan take place on the standard 12-month cycle.

Figure 1. Pakistan: Selected Indicators—Regional Comparisons, 1980–2011



Sources: Pakistani authorities; and IMF staff estimates.

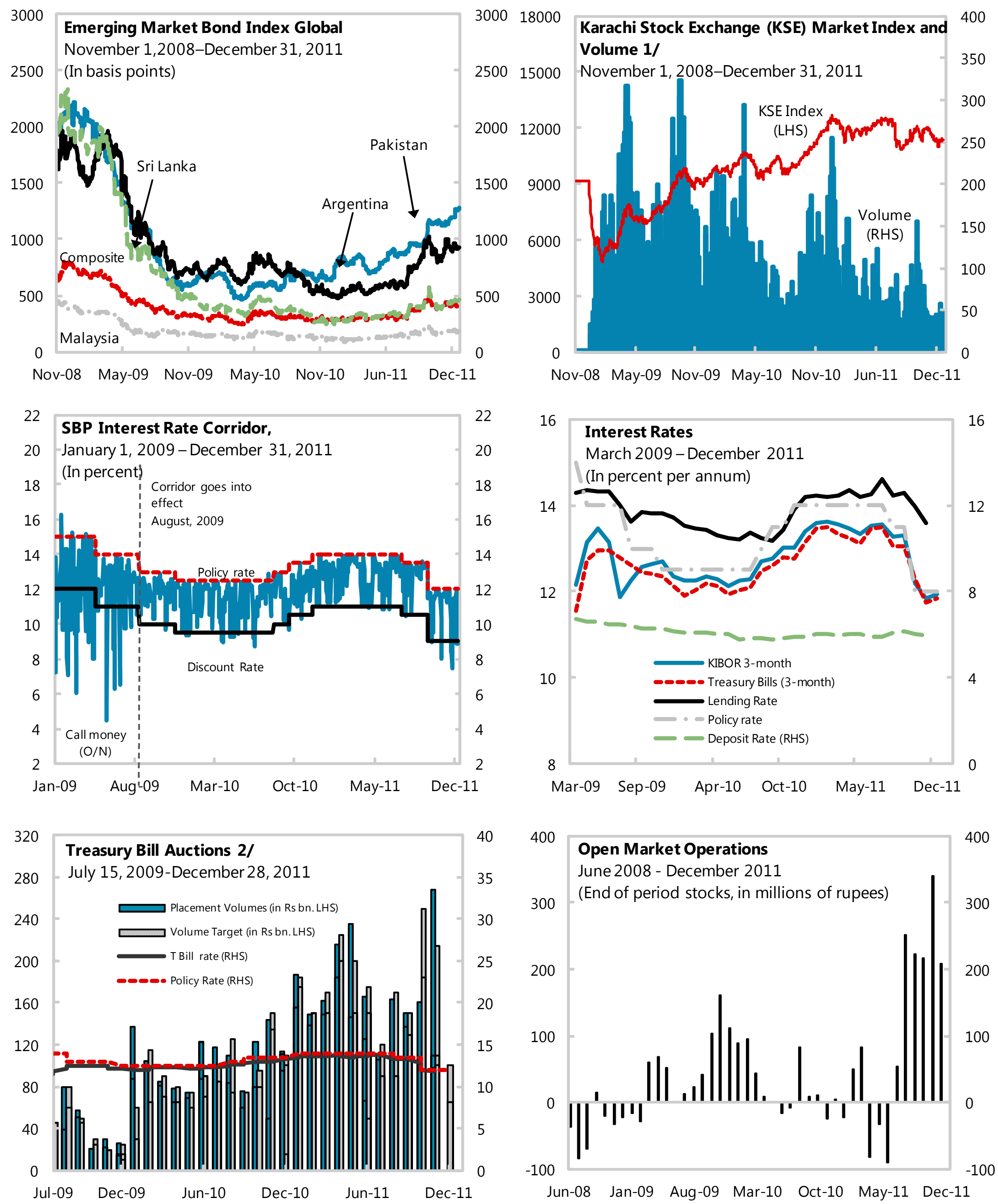
Figure 2. Pakistan: Selected Economic Indicators, 2008–11



Sources: Pakistani authorities; and IMF staff estimates.

1/ Positive values indicate net purchases in the interbank foreign exchange market.

Figure 3. Pakistan: Selected Financial Indicators, 2008–11



Sources: Pakistani authorities and Bloomberg.

1/ Daily traded volumes are in millions of shares.
2/ Placement volumes are for all maturities and the Treasury Bill rate is a weighted average.

Figure 4. Pakistan: External Debt Sustainability: Bound Tests, 2007/08–2015/16 1/ 2/

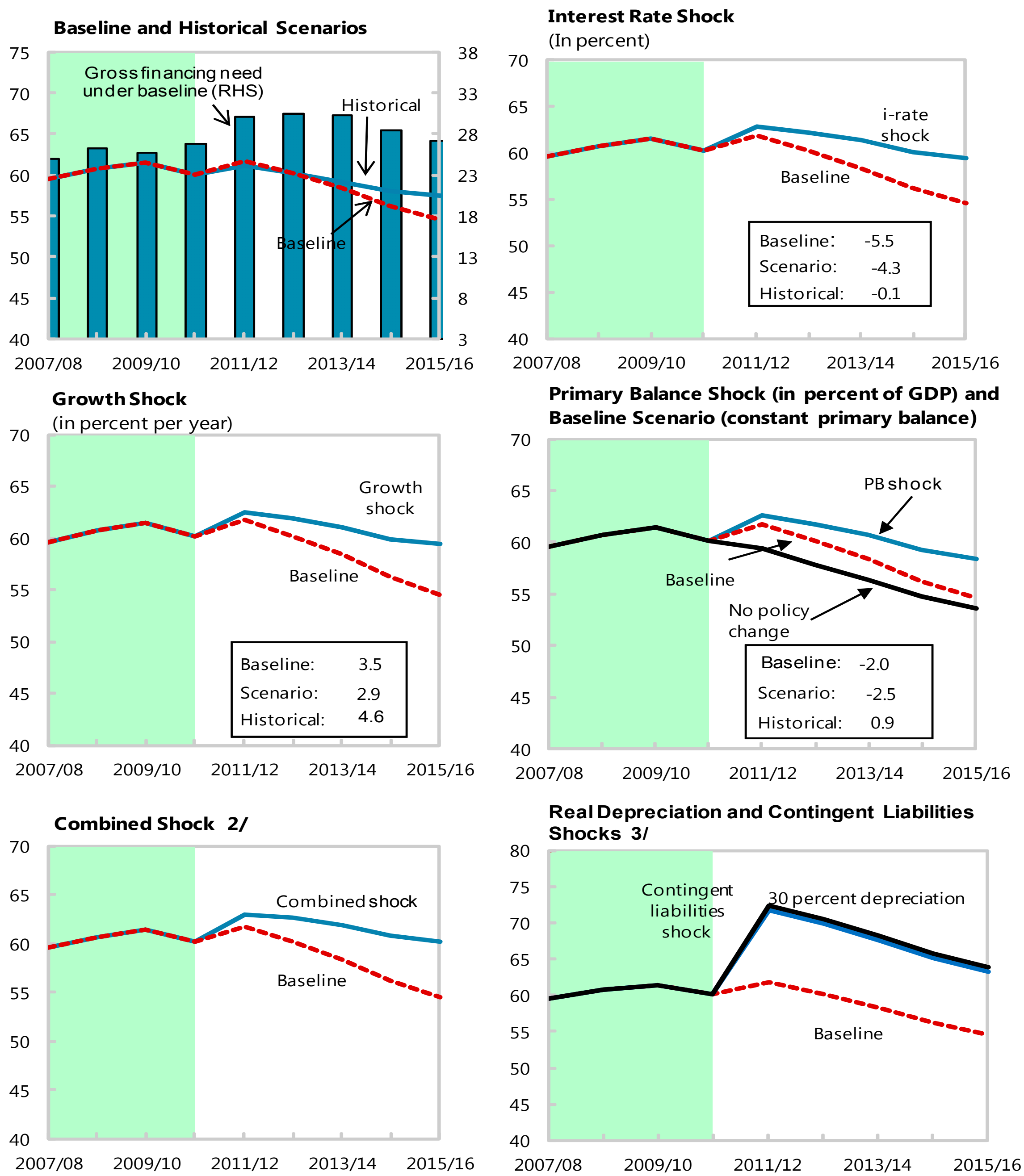
(External debt in percent of GDP)

Sources: IMF staff estimates and projections.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.
3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
4/ One-time real depreciation of 30 percent occurs in 2012/13.

Figure 5. Pakistan: Public Debt Sustainability: Bound Tests, 2007/08–2015/16 1/

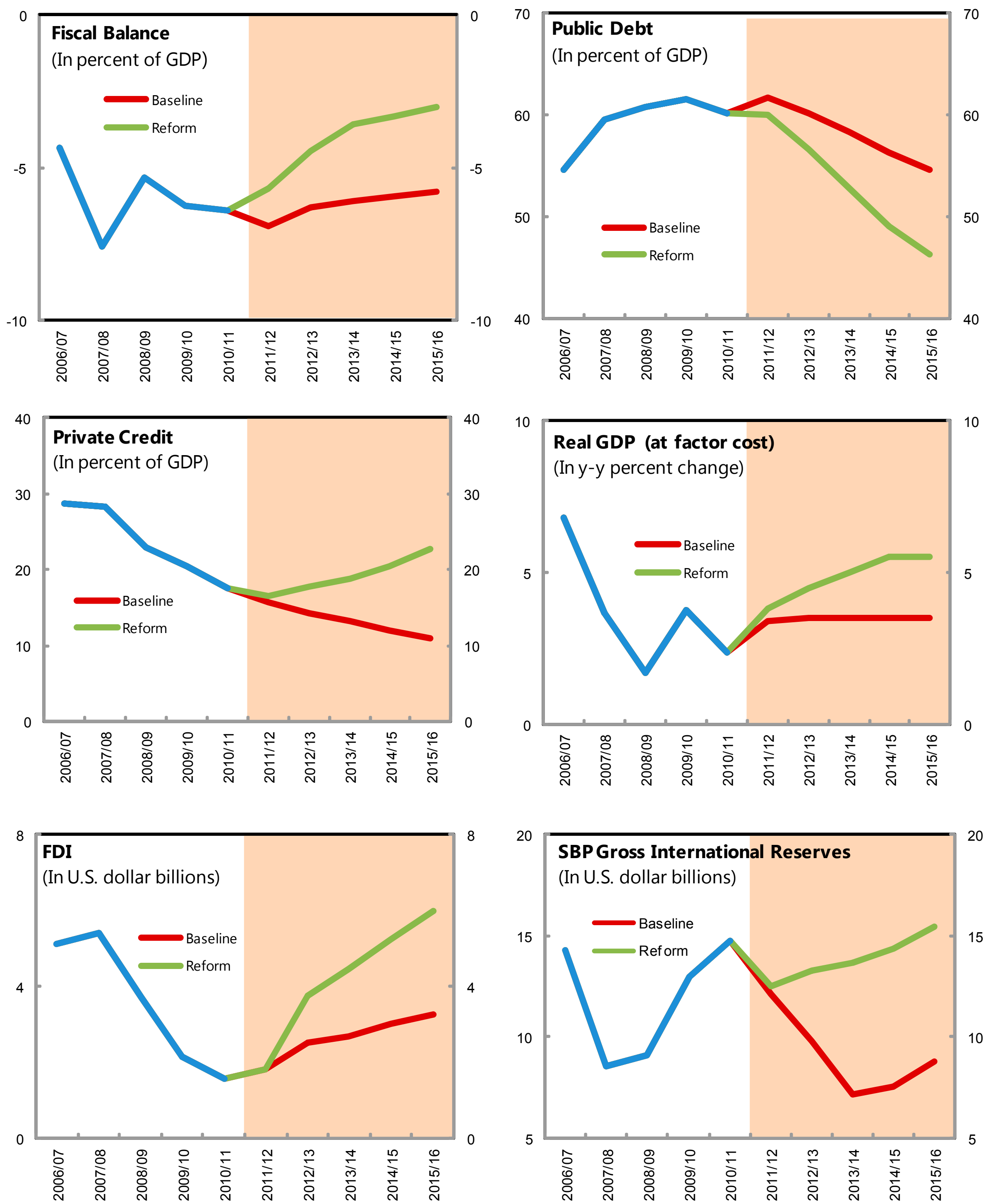
(Public debt in percent of GDP)



Source: IMF staff estimates and projections.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.
3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2011/12, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Figure 6. Pakistan: Baseline and Reform Scenarios, 2006/07–2015/16



Sources: Pakistani authorities; and IMF staff estimates.

Table 1. Pakistan: Selected Economic Indicators, 2008/09–2011/12 1/

(Population: 173.5 million (2010/11)

(Per capita GDP: US$1,179 (2010/11)

(Poverty rate: 17.2 percent (2007/08)

	2008/09	2009/10	Estimate 2010/11	Projection 2011/12
	(Annual percentage change)			
Output and prices				
Real GDP at factor cost	1.7	3.8	2.4	3.4
GDP deflator at factor cost	20.0	11.9	18.8	12.0
Consumer prices (period average) 2/	17.6	10.1	13.7	12.0
Consumer prices (end of period) 2/	9.6	11.8	13.3	11.0
Pakistani rupees per U.S. dollar (period average)	25.8	6.7	2.3	…
	(In percent of GDP)			
Saving and investment				
Gross saving	12.5	13.1	13.6	11.4
Government	-2.1	-2.4	-3.6	-3.6
Nongovernment (including public sector enterprises)	14.5	15.5	17.2	15.0
Gross capital formation 3/	18.2	15.4	13.4	13.4
Government	3.1	3.5	2.6	3.1
Nongovernment (including public sector enterprises)	15.1	11.9	10.8	10.3
Public finances				
Revenue and grants	14.7	14.4	12.8	12.7
Expenditure (including statistical discrepancy)	19.9	20.3	18.9	19.5
Budget balance (including grants)	-5.2	-5.9	-6.1	-6.7
Budget balance (excluding grants)	-5.3	-6.2	-6.6	-6.9
Primary balance	-0.2	-1.6	-2.3	-2.9
Total general government debt 4/	60.7	61.5	60.1	61.7
External general government debt	30.4	30.1	26.8	24.9
Domestic general government debt	30.3	31.4	33.3	36.9
	(Annual changes in percent of initial stock of broad money, unless otherwise indicated)			
Monetary sector				
Net foreign assets	-3.2	0.5	4.1	-3.3
Net domestic assets	12.8	11.9	11.8	18.2
Broad money	9.6	12.5	15.9	14.9
Reserve Money	1.9	11.4	17.1	13.3
Private credit (percentage change)	0.7	3.9	4.0	3.4
Six-month treasury bill rate (period average, in percent)	13.1	12.2	13.7	…
External sector				
Merchandise exports, U.S. dollars (percentage change)	-6.4	2.9	29.3	-1.8
Merchandise imports, U.S. dollars (percentage change)	-10.3	-1.7	14.5	9.2
Current account balance (in percent of GDP)	-5.7	-2.2	0.2	-2.0
	(In percent of exports of goods and services, unless otherwise indicated)			
External public and publicly guaranteed debt	182.2	177.3	153.4	158.5
Debt service	21.6	23.0	13.8	18.3
Gross reserves (in millions of U.S. dollars) 5/	9,110	12,958	14,784	12,086
In months of next year's imports of goods and services	2.9	3.6	3.7	2.9
Memorandum items:				
Real effective exchange rate (annual average, percentage change)	-2.1	1.0	6.1	…
Terms of trade (percentage change)	1.9	4.5	-3.2	…
Real per capita GDP (percentage change)	-2.6	1.6	0.3	1.3
GDP at market prices (in billions of Pakistani rupees)	12,724	14,837	18,063	20,918
GDP at market prices (in billions of U.S. dollars)	161.8	176.9	210.6	233.5

Sources: Pakistani authorities; and IMF staff estimates and projections.

1/ Fiscal year ends June 30.
2/ Inflation after 2009/10 based on new CPI weights, recalculated in September 2011.
3/ Including changes in inventories. Investment data recorded by the Pakistan Federal Bureau of Statistics are said to underreport true activity.
4/ Excludes military debt, and commercial loans.
5/ Excluding gold and foreign currency deposits of commercial banks held with the State Bank of Pakistan.

Table 2. Pakistan: Balance of Payments, 2008/09–2015/16

(In millions of U.S. dollars; unless otherwise indicated)

			Est	Projections				
	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16
Current account	-9,261	-3,946	437	-4,771	-4,978	-7,656	-8,852	-10,378
Balance on goods	-12,627	-11,536	-10,287	-14,043	-14,691	-15,764	-16,486	-17,350
Exports, f.o.b.	19,121	19,673	25,440	24,981	26,090	27,034	28,148	29,317
Imports, f.o.b.	-31,747	-31,209	-35,727	-39,024	-40,780	-42,798	-44,635	-46,667
Services (net)	-3,381	-1,690	-2,147	-3,279	-2,682	-3,960	-4,222	-4,724
Services: credit	4,106	5,229	5,473	5,045	6,103	5,352	5,586	5,633
Services: debit	-7,487	-6,919	-7,620	-8,323	-8,785	-9,312	-9,808	-10,357
Income (net)	-4,407	-3,282	-2,952	-3,392	-3,730	-4,578	-5,166	-5,686
Income: credit	874	561	714	777	784	779	787	856
Income: debit	-5,281	-3,843	-3,666	-4,170	-4,515	-5,356	-5,953	-6,542
Of which: interest payments	-2,030	-2,500	-1,665	-1,821	-1,960	-2,025	-2,170	-2,368
Of which: income on direct investment	-3,192	-1,330	-1,998	-2,346	-2,538	-3,322	-3,778	-4,171
Balance on goods, services, and income	-20,415	-16,508	-15,386	-20,714	-21,103	-24,301	-25,875	-27,760
Current transfers (net)	11,154	12,562	15,823	15,944	16,125	16,645	17,023	17,382
Current transfers: credit, *of which:*	11,256	12,672	15,905	16,026	16,209	16,730	17,110	17,471
Official	210	606	843	404	172	247	237	200
Workers' remittances	7,811	8,906	11,201	11,761	12,098	12,467	12,775	13,092
Other private transfers	3,235	3,160	3,861	3,861	3,938	4,017	4,097	4,179
Current transfers: debit	-102	-110	-82	-82	-84	-85	-87	-89
Capital account	455	175	171	104	358	316	400	400
Capital transfers: credit	460	180	171	104	358	316	400	400
Of which: official capital grants	427	157	170	104	358	316	400	400
Capital transfers: debit	-5	-5	0	0	0	0	0	0
Financial account	5,351	4,866	805	3,623	5,608	8,308	10,424	11,396
Direct investment abroad	-25	-76	-43	-60	-80	-100	-120	-150
Direct investment in Pakistan	3,720	2,151	1,574	1,800	2,500	2,700	3,000	3,250
Of which: privatization receipts	0	0	0	800	1,000	700	500	250
Portfolio investment (net), *of which:*	-1,073	-65	341	300	850	1,385	1,924	1,966
Eurobond/GDR	-500	-622	-22	0	500	1,000	1,500	1,500
Other investment assets	305	252	-1,702	-200	100	90	81	73
Monetary authorities	-255	263	-729	0	0	0	0	0
General government	8	-6	-5	0	0	0	0	0
Banks	346	386	-47	-100	50	45	41	36
Other sectors	206	-391	-921	-100	50	45	41	36
Other investment liabilities	2,424	2,604	635	1,783	2,238	4,233	5,540	6,257
Monetary authorities	-1	1,257	3	-100	-100	-100	0	0
General government, *of which:*	1,922	1,467	-114	1,233	688	633	790	1,007
Disbursements	4,190	3,840	2,189	3,703	3,307	3,483	3,703	3,968
Amortization	-2,268	-2,373	-2,303	-2,469	-2,619	-2,849	-2,913	-2,961
Banks	291	-226	64	300	450	200	250	250
Other sectors	212	106	682	350	1,200	3,500	4,500	5,000
Net errors and omissions	144	-58	6	-52	0	0	0	0
Reserves and related items	3,311	-1,037	-1,319	1,095	-1,002	-975	-1,973	-1,418
Reserve assets, *of which:*	-380	-4,326	-1,496	2,297	1,951	2,406	-636	-1,358
Foreign exchange (State Bank of Pakistan)	-446	-4,213	-1,385	2,697	2,271	2,662	-431	-1,194
Foreign exchange (deposit money banks)	66	-113	-111	-400	-320	-256	-205	-164
Use of Fund credit and loans	3,691	3,290	177	-1,202	-2,953	-3,381	-1,338	-59
Memorandum items:								
Current account (in percent of GDP; including official transfers)	-5.7	-2.2	0.2	-2.0	-2.0	-3.0	-3.3	-3.7
Current account (in percent of GDP; excluding fuel imports)	0.5	3.7	6.1	4.2	4.0	2.9	2.4	1.9
Exports f.o.b. (growth rate, in percent)	-6.4	2.9	29.3	-1.8	4.4	3.6	4.1	4.1
Imports f.o.b. (growth rate, in percent)	-10.3	-1.7	14.5	9.2	4.5	4.9	4.3	4.6
Oil imports (in million US$, cif)	10,032	10,463	12,317	14,528	14,718	15,001	15,359	15,850
Crude oil price ($/bbl)	79.3	74.7	92.7	101.8	97.4	93.9	91.8	90.6
Workers' remittances and other private transfers (growth rate, in percent)	-0.8	9.2	24.8	3.7	2.7	2.8	2.4	2.4
External debt (in millions of U.S. dollars)	52,000	55,901	60,116	59,010	57,644	56,199	57,560	60,656
Gross external financing needs (in millions of U.S. dollars) 1/	12,196	7,749	2,631	8,236	10,536	13,880	13,102	13,898
End-period gross official reserves (millions of U.S. dollars) 2/	9,110	12,958	14,784	12,086	9,816	7,153	7,584	8,779
(In months of next year's imports of goods and services)	2.9	3.6	3.7	2.9	2.3	1.6	1.6	1.7
GDP (in millions of U.S. dollars)	161,819	176,870	210,566	233,476	244,899	256,918	269,838	283,781

Sources: Pakistani authorities; and IMF staff estimates and projections.

1/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

2/ Excluding foreign currency deposits held with the State Bank of Pakistan (cash reserve requirements) and gold.

Table 3a. Pakistan: General Government Budget, 2008/09–2011/12

(In billions of Pakistani rupees)

	2008/09	2009/10	2010/11	2011/12		
				Authorities	Staff Baseline	Staff Reform
Revenue and grants	1,872	2,130	2,306	2,878	2,663	2,674
Revenue	1,851	2,079	2,261	2,768	2,627	2,638
Tax revenue	1,331	1,500	1,738	2,158	2,128	2,139
Federal	1,285	1,445	1,673	2,069	2,040	2,051
FBR revenue	1,157	1,329	1,558	1,952	1,923	1,934
Direct taxes	440	529	602	744	732	734
Federal excise duty	116	121	137	166	149	149
Sales tax/VAT	452	517	633	837	831	840
Customs duties	148	161	185	206	211	210
Petroleum surcharge	112	89	83	90	90	90
Gas surcharge and other	16	28	32	27	27	27
Provincial	46	55	65	89	89	89
Nontax revenue	520	579	523	610	499	499
Federal	436	512	461	545	434	434
Provincial	84	68	62	65	65	65
Grants	22	51	46	110	36	36
						0
Expenditure	2,531	3,006	3,454	3,753	4,070	3,834
Current expenditure	2,093	2,482	2,900	3,095	3,412	3,176
Federal	1,547	1,855	2,115	2,175	2,356	2,256
Interest	638	642	698	795	795	795
Domestic	559	578	630	719	719	719
Foreign	79	64	68	76	76	76
Other	909	1,213	1,417	1,380	1,561	1,461
Defense	330	375	450	495	495	495
Other	579	838	966	885	1,066	966
Of which: subsidies	244	227	381	190	371	271
Of which: tariff differential subsidy 1/	…	…	285	125	193	206
Of which: grants	136	361	259	357	357	357
Provincial	546	627	786	920	1,057	920
Development expenditure and net lending	404	558	469	658	658	658
Public Sector Development Program	398	519	462	650	650	650
Federal	196	260	216	300	300	300
Provincial	202	258	246	350	350	350
Net lending	7	39	7	8	8	8
Statistical discrepancy ("+" = additional expenditure) 2/	34	-35	46	0	0	0
Overall Balance (excluding grants)	-680	-926	-1,194	-985	-1,443	-1,195
Overall Balance (including grants)	-659	-876	-1,148	-875	-1,407	-1,160
Financing	693	876	1,148	875	1,407	1,160
External	116	138	62	35	182	203
Of which: privatization receipts	1	0	0	0	72	71
Of which: IMF	…	92	69	0	0	0
Domestic	577	737	1,086	840	1,225	957
Bank	349	301	615	366	750	482
Nonbank	227	436	471	475	475	475
Memorandum items:						
Primary balance (excluding grants)	-77	-284	-496	-191	-648	-401
Primary balance (including grants)	-55	-233	-450	-81	-612	-365
Augmented fiscal balance (excluding grants) 3/	…	-1,203	-1,306	-985	-1,443	-1,195
Total security spending	424	568	585	645	645	645
Total government debt 4/	7,306	8,429	10,092	11,802	12,186	11,894
Domestic debt	3,860	4,654	6,014	7,329	7,714	7,446
External debt 4/	3,446	3,775	4,077	4,473	4,473	4,449
Total government debt including IMF obligations	7,725	9,120	10,860	12,301	12,914	12,594
Nominal GDP (market prices)	12,724	14,837	18,063	21,045	20,918	20,999

Sources: Pakistani authorities; and IMF staff estimates and projections.

1/ Total power sector subsidies in FY 2011/12 without policy adjustment are estimated at PRs 305 billion.
2/ The statistical discrepancy is believed to arise mainly from double-counting of spending at the provincial level.
3/ Reflects assumption of electricity sector debt by the budget.
4/ Excludes obligations to the IMF except budget financing, military debt, commercial loans, and short-term debt.

Table 3b. Pakistan: General Government Budget, 2008/09–2011/12

(In percent of GDP; unless otherwise indicated)

	2008/09	2009/10	2010/11	2011/12		
				Authorities	Staff Baseline	Staff Reform
Revenue and grants	14.7	14.4	12.8	13.7	12.7	12.7
Revenue	14.5	14.0	12.5	13.2	12.6	12.6
Tax revenue	10.5	10.1	9.6	10.3	10.2	10.2
Federal	10.1	9.7	9.3	9.8	9.8	9.8
FBR revenue 2/	9.1	9.0	8.6	9.3	9.2	9.2
Direct taxes	3.5	3.6	3.3	3.5	3.5	3.5
Federal excise duty	0.9	0.8	0.8	0.8	0.7	0.7
Sales tax/VAT	3.6	3.5	3.5	4.0	4.0	4.0
Customs duties	1.2	1.1	1.0	1.0	1.0	1.0
Petroleum surcharge / Carbon tax	0.9	0.6	0.5	0.4	0.4	0.4
Gas surcharge and other	0.1	0.2	0.2	0.1	0.1	0.1
Provincial	0.4	0.4	0.4	0.4	0.4	0.4
Nontax revenue	4.1	3.9	2.9	2.9	2.4	2.4
Federal	3.4	3.4	2.6	2.6	2.1	2.1
Provincial	0.7	0.5	0.3	0.3	0.3	0.3
Grants	0.2	0.3	0.3	0.5	0.2	0.2
Expenditure	19.9	20.3	19.1	17.8	19.5	18.3
Current expenditure	16.4	16.7	16.1	14.7	16.3	15.1
Federal	12.2	12.5	11.7	10.3	11.3	10.7
Interest	5.0	4.3	3.9	3.8	3.8	3.8
Domestic	4.4	3.9	3.5	3.4	3.4	3.4
Foreign	0.6	0.4	0.4	0.4	0.4	0.4
Other	7.1	8.2	7.8	6.6	7.5	7.0
Defense	2.6	2.5	2.5	2.4	2.4	2.4
Other 2/	4.6	5.6	5.3	4.2	5.1	4.6
Of which: subsidies	1.9	1.5	2.1	0.9	1.8	1.3
Of which: tariff differential subsidies 1/	…	…	1.6	0.6	0.9	1.0
Of which: grants	1.1	2.4	1.4	1.7	1.7	1.7
Provincial	4.3	4.2	4.3	4.4	5.1	4.4
Development expenditure and net lending	3.2	3.8	2.6	3.1	3.1	3.1
Public Sector Development Program	3.1	3.5	2.6	3.1	3.1	3.1
Federal	1.5	1.8	1.2	1.4	1.4	1.4
Provincial	1.6	1.7	1.4	1.7	1.7	1.7
Net lending	0.1	0.3	0.0	0.0	0.0	0.0
Statistical discrepancy ("+" = additional expenditure) 2/	0.3	-0.2	0.3	0.0	0.0	0.0
Overall Balance (excluding grants)	-5.3	-6.2	-6.6	-4.7	-6.9	-5.7
Overall Balance (including grants)	-5.2	-5.9	-6.4	-4.2	-6.7	-5.5
Financing	5.4	5.9	6.4	4.2	6.7	5.5
External	0.9	0.9	0.3	0.2	0.9	1.0
Of which: privatization receipts	0.0	0.0	0.0	0.0	0.3	0.3
Of which: IMF	…	0.6	0.4	0.0	0.0	0.0
Domestic	4.5	5.0	6.0	4.0	5.9	4.6
Bank	2.7	2.0	3.4	1.7	3.6	2.3
Nonbank	1.8	2.9	2.6	2.3	2.3	2.3
Memorandum items:						
Primary balance (excluding grants)	-0.6	-1.9	-2.7	-0.9	-3.1	-1.9
Primary balance (including grants)	-0.4	-1.6	-2.5	-0.4	-2.9	-1.7
Augmented fiscal balance (excluding grants) 3/	…	-8.1	-7.2	-4.7	-6.9	-5.7
Total security spending	3.3	3.8	3.2	3.1	3.1	3.1
Total government debt 4/	57.4	56.8	55.9	56.1	58.3	56.6
Domestic debt	30.3	31.4	33.3	34.8	36.9	35.5
External debt 4/	27.1	25.4	22.6	21.3	21.4	21.2
Total government debt including IMF	60.7	61.5	60.1	58.5	61.7	60.0
Nominal GDP (market prices, billions of Pakistani rupees)	12,724	14,837	18,063	21,045	20,918	20,999

Sources: Pakistani authorities; and IMF staff estimates and projections.

1/ Total power sector subsidies in FY 2011/12 without policy adjustment are estimated at 1.5 percent of GDP.
2/ The statistical discrepancy is believed to arise mainly from double-counting of spending at the provincial level.
3/ Reflects assumption of electricity sector debt by the budget.
4/ Excludes obligations to the IMF except budget financing, military debt, commercial loans, and short-term debt.

Table 3c. Pakistan: General Government Budget GFSM 2001 Presentation, 2009/10–2011/12
(In billions of Pakistani rupees)

	2009/10	2010/11	2011/12		
			Authorities	Staff Baseline	Staff Reform
Revenue	2,130	2,306	2,878	2,663	2,678
Taxes	1,500	1,738	2,158	2,128	2,143
Taxes on income, profits and capital gains	529	602	744	732	734
Taxes on goods and services	494	577	708	699	705
Taxes on international trade and transactions	422	494	618	609	615
Other taxes	55	65	89	89	89
Grants	51	46	110	36	36
Other revenues	579	523	610	499	499
Total expenditure	2,966	3,455	3,744	4,061	3,824
Expenses	2,482	2,947	3,095	3,412	3,176
Compensation of employees	557	699	782	782	782
Purchases of goods and services	520	648	745	745	745
Interest	642	698	791	795	795
Social benefits	175	235	270	270	270
Other expenses	588	667	507	821	584
Net acquisition of nonfinancial assets	519	462	649	649	649
Net lending/borrowing	-836	-1,149	-866	-1,398	-1,147
Net acquisition of financial assets	89	81	91	20	-63
Domestic	89	81	91	20	-63
Currency and deposits	50	73	84	84	84
Loans	39	7	8	8	8
Equity and investment fund shares	0	0	0	-72	-71
Foreign	0	0	0	0	0
Net incurrence of liabilities	926	1,221	959	1,419	1,085
Domestic	787	1,159	923	1,308	953
Debt securities	787	1,159	923	1,308	1,037
Loans	0	0	0	0	0
Foreign	138	62	35	110	132
Loans	138	62	35	110	132

Sources: Pakistani authorities; and IMF staff estimates and projections.

Table 4. Pakistan: Monetary Survey, 2008/09–2011/12

	2008/09	2009/10	Sep. 2010/11	Dec. 2010/11	Mar. 2010/11	Jun. 2010/11	Proj. 2011/12
	(in billions of Pakistani rupees, unless otherwise indicated)						
Monetary survey							
Net foreign assets (NFA)	517	545	587	672	708	780	557
Net domestic assets (NDA)	4,620	5,232	5,226	5,624	5,612	5,915	7,137
Net claims on government, *of which: 2/*	1,997	2,403	2,497	2,664	2,604	2,983	4,046
Budget support, *of which:*	1,630	1,935	2,056	2,221	2,251	2,523	3,726
Banks	500	763	766	969	1,096	1,369	3,726
Commodity operations 1/	336	413	387	363	292	397	319
Credit to nongovernment	3,190	3,389	3,325	3,569	3,649	3,547	3,401
Private sector	2,924	3,037	2,990	3,201	3,267	3,159	3,266
Public sector enterprises	266	352	336	367	381	388	135
Privatization account	-3	-3	-3	-3	-3	-3	-3
Other items, net	-564	-557	-594	-607	-637	-612	-307
Broad money	5,137	5,777	5,813	6,296	6,320	6,695	7,693
Currency outside scheduled banks	1,152	1,295	1,389	1,515	1,510	1,501	1,725
Rupee deposits	3,705	4,136	4,067	4,408	4,442	4,819	5,537
Foreign currency deposits	280	345	357	372	368	375	431
State Bank of Pakistan (SBP)							
NFA	324	379	409	483	548	614	372
NDA	1,183	1,301	1,367	1,452	1,404	1,352	1,854
Net claims on government	1,144	1,187	1,307	1,282	1,176	1,184	1,243
Of which: budget support	1,130	1,171	1,290	1,252	1,155	1,155	1,220
Claims on nongovernment	-7	-6	-6	-5	-6	-6	-8
Claims on scheduled banks	303	313	294	334	324	315	362
Privatization account	-3	-3	-3	-3	-3	-3	-3
Other items, net	-254	-190	-225	-156	-88	-139	260
Reserve money, *of which:*	1,508	1,679	1,777	1,935	1,951	1,966	2,227
Banks' reserves	274	290	289	326	341	349	402
Currency	1,229	1,383	1,479	1,601	1,600	1,606	1,825
	(Annual percentage change, unless otherwise indicated)						
Broad money	9.6	12.5	12.3	14.9	16.0	15.9	14.9
NFA, banking system (in percent of broad money) 3/	-3.2	0.5	-1.4	0.8	2.4	4.1	-3.3
NDA, banking system (in percent of broad money) 3/	12.8	11.9	13.7	14.2	13.6	11.8	18.2
Budgetary support (in percent of broad money) 3/	6.5	5.9	7.5	8.8	7.5	10.2	18.0
NFA, banking system	-22.5	5.4	-10.9	7.0	22.5	43.1	-28.7
NDA, banking system	14.9	13.2	15.7	16.0	15.3	13.1	20.7
Budgetary support	23.0	18.7	23.2	27.8	22.3	30.4	47.7
Commodity operations	164.3	22.9	15.6	10.7	8.0	-3.8	-19.6
Private credit	0.7	3.9	4.9	5.1	6.4	4.0	3.4
Currency	17.3	12.4	10.1	16.8	18.2	15.9	14.9
Reserve money	1.9	11.4	10.0	16.6	19.7	17.1	13.3
NFA, SBP (in percent of reserve money) 3/	-10.5	3.6	-4.0	1.9	9.1	14.0	-12.3
NDA, SBP (in percent of reserve money) 3/	12.4	7.8	14.0	14.7	10.6	3.0	25.6
Net claims on government (in percent of reserve money) 3/	8.6	2.6	14.0	10.4	0.2	-0.1	47.7
Memorandum items:							
Velocity	2.5	2.6	3.1	2.9	2.9	2.7	2.7
Money multiplier	3.4	3.4	3.3	3.3	3.2	3.4	3.5
Currency to broad money ratio (percent)	22.4	22.4	23.9	24.1	23.9	22.4	22.4
Currency to deposit ratio (percent)	28.9	28.9	31.4	31.7	31.4	28.9	28.9
Foreign currency to deposit ratio (percent)	7.0	7.7	8.1	7.8	7.7	7.2	7.2
Reserves to deposit ratio (percent)	6.9	6.5	6.5	6.8	7.1	6.7	6.7
Budget bank financing (change from the beginning of the fiscal year; in Rs billions), *of which:*	305	305	121	286	316	589	1,203
By commercial banks	191	263	3	206	333	606	1,137
By SBP	114	42	118	80	-16	-17	66
NFA of SBP (change from beginning of the year; in billions of U.S. dollars) 4/	-3.1	0.4	0.3	1.2	2.0	2.7	-3.2
NFA of commercial banks (millions of U.S. dollars)	2,370	1,948	2,057	2,208	1,875	1,934	1,959
NDA of commercial banks (billions of Pakistani rupees)	3,437	3,931	3,859	4,171	4,209	4,563	5,282
Excess reserves in percent of broad money	0.3	-0.2	0.1	0.1	0.3	0.2	…

Sources: Pakistani authorities; and IMF staff estimates and projections.

1/ Authorities plan to securitize Rs78 billion on commodity operations during 2011/12.
2/ Difference between monetary and fiscal tables on banking sector claims on government and bank financing in 2011/12 reflects Rs313 billion PSE securitization of debt to commercial banks.
3/ Denominator is the stock of broad (reserve) money at the end of the previous year.
4/ Includes valuation adjustments.

Table 5. Pakistan: Financial Soundness Indicators for the Banking System, 2004–11

	Dec. 2004	Dec. 2005	Dec. 2006	Dec. 2007	Dec. 2008 1/	Dec. 2009 1/	Dec. 2010	March 2011	June 2011	Sept. 2011
Capital adequacy										
Regulatory capital to risk-weighted assets	10.5	11.3	12.7	12.3	12.2	14.0	14.0	13.6	14.1	14.9
Tier I capital to risk-weighted assets	7.6	8.3	10.0	10.0	10.1	11.6	11.8	11.4	11.9	12.6
Capital to total assets	6.7	7.9	9.4	10.5	10.0	10.1	9.8	9.7	9.4	9.7
Asset composition and quality										
Nonperforming loans (NPLs) to gross loans	11.6	8.3	6.9	7.6	10.5	12.6	14.7	15.4	15.3	16.7
Provisions to NPLs	70.4	76.7	77.8	86.1	69.6	69.9	66.7	66.7	67.9	65.8
NPLs net of provisions to capital	29.2	14.3	9.7	5.6	19.4	20.4	26.1	27.4	25.7	27.8
Earnings and profitability										
Return on assets (after tax)	1.2	1.9	2.1	1.5	0.8	0.9	1.0	1.4	1.4	1.4
Return on equity (after tax)	20.3	25.8	23.8	15.4	7.8	8.9	9.8	14.4	14.3	14.1
Net interest income to gross income	62.8	72.0	70.9	68.2	70.3	72.4	74.7	76.6	75.9	76.5
Noninterest expenses to gross income	52.0	41.5	40.3	43.2	50.1	51.2	53.0	50.3	51.0	51.1
Liquidity										
Liquid assets to total assets	36.6	33.7	31.9	33.6	28.2	32.7	35.0	35.7	38.2	40.5
Liquid assets to total deposits	46.5	43.5	42.7	45.1	37.7	44.5	45.9	47.3	49.5	54.5

Source: State Bank of Pakistan.

1/ Data for end-2008 and end-2009 have been restated on the basis of annual audits.

Table 6. Pakistan: Medium-Term Macroeconomic Framework, 2008/09–2015/16

	2008/09	2009/10	2010/11	Projections 2011/12	2012/13	2013/14	2014/15	2015/16
	(In percent of GDP)							
Saving and investment								
Current account balance	-5.7	-2.2	0.2	-2.0	-2.0	-3.0	-3.3	-3.7
Gross national saving	12.5	13.1	13.6	11.4	11.2	10.6	10.2	9.9
Government	-2.1	-2.4	-3.6	-3.6	-2.7	-2.5	-2.3	-1.9
Nongovernment (including public enterprises)	14.5	15.5	17.2	15.0	13.9	13.2	12.5	11.9
Gross capital formation	18.2	15.4	13.4	13.4	13.2	13.6	13.5	13.6
Government	3.1	3.5	2.6	3.1	3.2	3.3	3.5	3.7
Nongovernment (including public enterprises)	15.1	11.9	10.8	10.3	10.0	10.3	10.0	9.8
	(In billions of U.S. dollars, unless otherwise indicated)							
Balance of payments								
Current account balance	-9.3	-3.9	0.4	-4.8	-5.0	-7.6	-8.9	-10.4
Net capital flows, *of which:* 1/	0.6	1.0	1.3	1.5	1.5	1.5	1.5	1.5
Foreign direct investment 2/	3.7	2.2	1.6	1.8	2.5	2.7	3.0	3.3
Gross official reserves	9.1	13.0	14.8	12.1	9.8	7.2	7.6	8.8
In months of imports 3/	2.9	3.6	3.7	2.9	2.3	1.6	1.6	1.7
External debt (in percent of GDP)	32.1	31.6	28.5	25.3	23.5	21.9	21.3	21.4
	(In percent of GDP)							
Public finances								
Revenue and grants	14.7	14.4	12.8	12.7	13.2	13.3	13.5	13.8
of which: tax revenue	10.5	10.1	9.6	10.2	10.5	10.8	11.1	11.5
Expenditure	19.9	20.3	19.1	19.5	19.3	19.1	19.3	19.5
Current	16.4	16.7	16.1	16.3	15.9	15.8	15.8	15.7
Development	3.2	3.8	2.6	3.1	3.3	3.4	3.5	3.8
Overall fiscal balance, including grants	-5.2	-5.9	-6.1	-6.7	-5.9	-5.9	-5.8	-5.7
Overall fiscal balance, excluding grants	-5.3	-6.2	-6.6	-6.9	-6.3	-6.1	-5.9	-5.8
Total government debt 4/	57.4	56.8	55.9	58.3	58.1	57.8	56.2	54.6
	(Annual changes in percent)							
Output and prices								
Real GDP at factor cost	1.7	3.8	2.4	3.4	3.5	3.5	3.5	3.5
Consumer prices (period average)	17.6	10.1	13.7	12.0	12.5	13.0	13.5	14.0
Memorandum item								
Real per capita consumption (percentage change)	7.4	5.4	8.9	3.4	2.5	2.4	2.0	1.9

Sources: Pakistani authorities; and IMF staff estimates and projections.

1/ Difference between the overall balance and the current account balance.
2/ Including privatization.
3/ Ratio of gross official reserves to next year's imports of goods and services (divided by 12).
4/ Excludes obligations to the IMF except budget financing, military debt, commercial loans, and short-term debt.

Table 7. Pakistan: Indicators of Fund Credit, 2008/09–2015/16 1/
(In millions of SDRs unless otherwise specified)

	2008/09	2009/10	2010/11	Projections 2011/12	2012/13	2013/14	2014/15	2015/16
				(Projected Debt Service to the Fund based on Existing Drawings)				
ECF								
Principal 2/	137.7	155.1	172.3	163.7	120.6	51.7	17.2	0.0
Interest and charges 2/	4.0	1.7	0.0	0.0	0.0	0.0	0.0	0.0
Stand-By Arrangements and ENDA								
Principal	0.0	0.0	0.0	587.9	1,726.1	2,062.5	819.4	37.1
Interest and charges	42.9	55.5	105.6	104.1	67.0	24.3	6.5	0.4
				(Projected Level of Credit Outstanding based on Existing Drawings)				
Total	3,316.4	5,461.5	5,586.2	4,834.6	2,987.9	873.7	37.1	0.0
ECF Arrangements	680.5	525.5	353.2	189.5	68.9	17.2	0.0	0.0
Stand-By Arrangements and ENDA	2,635.9	4,936.0	5,233.0	4,645.1	2,919.0	856.5	37.1	0.0
				(Projected Debt Service to the Fund based on Existing Drawings)				
Total 2/	184.6	212.3	277.9	855.7	1,913.7	2,138.5	843.1	37.6
Of which:								
Principal	137.7	155.1	172.3	751.6	1,846.7	2,114.2	836.6	37.1
Interest and charges	46.9	57.2	105.6	104.1	67.0	24.3	6.5	0.4
In percent of exports of goods and non-factor services	1.2	1.3	1.4	4.4	9.1	10.1	3.8	0.2
In percent of GDP	0.2	0.2	0.2	0.6	1.2	1.3	0.5	0.0
In percent of end-period gross international reserves	3.0	2.4	3.0	11.3	31.0	47.4	17.6	0.7
Memorandum items								
Exports of goods and NFS (in millions of U.S. dollars)	23,227	24,902	30,913	30,026	32,193	32,386	33,734	34,949
Quota	1,034							
GDP (in millions of U.S. dollars)	161,819	176,870	210,566	233,476	244,899	256,918	269,838	283,781
Fund credit outstanding (in percent of GDP)	3.2	4.5	4.2	3.3	1.9	0.5	0.0	0.0
Of which: SBA and ENDA	2.5	4.1	4.0	3.2	1.9	0.5	0.0	0.0
Gross international reserves (in millions of U.S. dollars)	9,110	12,958	14,784	12,086	9,816	7,153	7,584	8,779

Source: IMF staff projections.

1/ Including purchase under the ENDA.
2/ For 2008/09, debt service includes payments related to EFF.

Table 8. Pakistan: Selected Vulnerability Indicators, 2008/09–2015/16

	2008/09	2009/10	2010/11	Projections 2011/12	2012/13	2013/14	2014/15	2015/16
Key economic and market indicators								
Real GDP growth (factor cost, in percent)	1.7	3.8	2.4	3.4	3.5	3.5	3.5	3.5
CPI inflation (period average, in percent) 1/	17.6	10.1	13.7	12.0	12.5	13.0	13.5	14.0
Emerging market bond index (EMBI) secondary market								
spread (basis points, end of period)	1,039	603	857	…	…	…	…	…
Exchange rate PRs/US$ (end of period)	81.4	85.5	86.0	…	…	…	…	…
External sector								
Current account balance (percent of GDP)	-5.7	-2.2	0.2	-2.0	-2.0	-3.0	-3.3	-3.7
Net FDI inflows (percent of GDP)	2.3	1.2	0.7	0.7	1.0	1.0	1.1	1.1
Exports (percentage change of U.S. dollar value; GNFS)	-3.3	7.2	24.1	-2.9	7.2	0.6	4.2	3.6
Gross international reserves (GIR) in billions of U.S. dollars	9.1	13.0	14.8	12.1	9.8	7.2	7.6	8.8
GIR in percent of ST debt at remaining maturity (RM) 2/	287.4	179.8	153.8	113.5	103.8	107.8	228.6	347.3
GIR in percent of ST debt at RM and banks' foreign exchange (FX) deposits 2/	137.8	115.2	105.8	79.3	69.6	63.0	94.1	120.3
Total gross external debt (ED) in percent of GDP, *of which:*	32.1	31.6	28.5	25.3	23.5	21.9	21.3	21.4
ST external debt (original maturity, in percent of total ED)	1.3	1.4	0.9	1.5	1.7	1.8	1.7	1.6
ED of domestic private sector (in percent of total ED)	0.0	1.2	1.3	0.9	1.6	1.8	1.7	1.6
ED to foreign official sector (in percent of total ED)	100.0	98.8	98.7	99.1	98.4	98.2	98.3	98.4
Total gross external debt in percent of exports	223.9	224.5	194.5	196.5	179.1	173.5	170.6	173.6
Gross external financing requirement (in billions of U.S. dollars) 3/	12.2	7.7	2.6	8.2	10.5	13.9	13.1	13.9
Public sector 4/								
Overall balance (including grants)	-5.2	-5.9	-6.1	-6.7	-5.9	-5.9	-5.8	-5.7
Primary balance (including grants)	-0.2	-1.6	-2.3	-2.9	-1.6	-1.4	-1.2	-1.1
Debt-stabilizing primary balance 5/	-2.3	-2.9	-6.5	-2.2	-2.0	-2.0	-2.0	-2.0
Gross PS financing requirement 6/	26.2	25.7	26.8	30.0	30.3	30.3	28.5	27.1
Public sector gross debt	57.4	56.8	55.9	58.3	58.1	57.8	56.2	54.6
Public sector net debt 7/	53.7	53.3	52.6	55.0	54.9	54.6	53.2	51.6
Financial sector 8/								
Capital adequacy ratio (in percent)	13.5	13.9	14.1	…	…	…	…	…
Nonperforming loans (NPLs) in percent of total loans	11.5	12.9	15.3	…	…	…	…	…
Provisions in percent of NPLs	70.2	73.2	67.9	…	…	…	…	…
Return on average assets (after tax, in percent)	1.0	1.1	1.4	…	…	…	…	…
Return on equity (after tax, in percent)	9.7	10.9	14.3	…	…	…	…	…
FX deposits held by residents (in percent of total deposits)	7.0	7.7	7.2	…	…	…	…	…
Government debt held by FS (percent of total FS assets)	38.9	41.6	44.6	…	…	…	…	…
Credit to private sector (percent change)	0.7	3.9	4.0	…	…	…	…	…
Memorandum item:								
Nominal GDP (in billions of U.S. dollars)	161.8	176.9	210.6	233.5	244.9	256.9	269.8	283.8

Sources: Pakistani authorities; and IMF staff estimates and projections.

1/ Inflation after 2009/10 based on new CPI weights, recalculated in September 2011.
2/ Debt at remaining maturity is defined as maturing short-, medium-, and long-term external official debt.
3/ Current account deficit plus amortization of external debt.
4/ Public sector covers general (consolidated) government.
5/ Based on the end of period debt stock in year t-1, and the baseline assumptions for the relevant variables (i.e., growth, interest rates, inflation, exchange rates) in year t.
6/ Overall balance plus debt amortization.
7/ Net debt is defined as gross debt minus government deposits with the banking system.
8/ Financial sector includes all commercial and specialized banks; for government debt also includes nonbanks, but excludes State Bank of Pakistan.

Table 9. Pakistan: External Debt Sustainability Framework, 2008/09–2015/16

(In percent of GDP, unless otherwise indicated)

	Actual		Estimate			Projections					
	2008/09	2009/10	2010/11			2011/12	2012/13	2013/14	2014/15	2015/16	**Debt-stabilizing non-interest current account 6/**
Baseline: External debt	32.1	31.6	28.5			**25.3**	**23.5**	**21.9**	**21.3**	**21.4**	**-1.6**
Change in external debt	5.0	-0.5	-3.1			-3.3	-1.7	-1.7	-0.5	0.0	
Identified external debt-creating flows	4.1	-2.1	-6.2			0.3	0.0	1.0	1.3	1.6	
Current account deficit, excluding interest payments	4.5	0.8	-1.0			1.3	1.2	2.2	2.5	2.8	
Deficit in balance of goods and services	9.9	7.5	5.9			7.4	7.1	7.7	7.7	7.8	
Exports	14.4	14.1	14.7			12.9	13.1	12.6	12.5	12.3	
Imports	24.2	21.6	20.6			20.3	20.2	20.3	20.2	20.1	
Net non-debt creating capital inflows (negative)	-2.0	-1.5	-0.9			-0.9	-1.2	-1.2	-1.3	-1.3	
Automatic debt dynamics 1/	1.6	-1.3	-4.3			-0.1	0.0	0.0	0.1	0.1	
Contribution from nominal interest rate	1.3	1.4	0.8			0.8	0.8	0.8	0.8	0.8	
Contribution from real GDP growth	-0.9	-1.7	-0.3			-0.9	-0.8	-0.8	-0.7	-0.7	
Contribution from price and exchange rate changes 2/	1.2	-1.0	-4.8			...	...	...	...	...	
Residual, incl. change in gross foreign assets 3/	0.9	1.5	3.1			-3.5	-1.8	-2.7	-1.8	-1.6	
External debt-to-exports ratio (in percent)	223.9	224.5	194.5			196.5	179.1	173.5	170.6	173.6	
Gross external financing need (in billions of US dollars) 4/	12.2	6.9	2.6			8.2	10.5	13.9	13.1	13.9	
in percent of GDP	7.5	3.9	1.2	10-Year	10-Year	3.5	4.3	5.4	4.9	4.9	
Scenario with key variables at their historical averages 5/						**25.3**	**20.6**	**15.4**	**11.5**	**8.0**	**-2.3**
Key Macroeconomic Assumptions Underlying Baseline				Historical Average	Standard Deviation						
Real GDP growth (in percent)	3.2	5.9	1.1	4.7	2.3	3.5	3.5	3.5	3.5	3.5	
GDP deflator in US dollars (change in percent)	-4.4	3.2	17.8	6.5	6.8	7.2	1.3	1.4	1.5	1.6	
Nominal external interest rate (in percent)	4.6	4.8	3.0	4.1	0.9	3.0	3.3	3.5	3.9	4.1	
Growth of exports (US dollar terms, in percent)	-3.3	7.2	24.1	11.9	8.5	-2.9	7.2	0.6	4.2	3.6	
Growth of imports (US dollar terms, in percent)	-13.7	-2.8	13.7	14.6	18.7	9.2	4.7	5.1	4.5	4.7	
Current account balance, excluding interest payments	-4.5	-0.8	1.0	-0.3	4.5	-1.3	-1.2	-2.2	-2.5	-2.8	
Net non-debt creating capital inflows	2.0	1.5	0.9	2.0	1.4	0.9	1.2	1.2	1.3	1.3	

Sources: Pakistani authorities; and IMF staff estimates and projections.

1/ Derived as $[r - g - \rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, ε = nominal appreciation (increase in dollar value of domestic currency), and α = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as $[-\rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock. ρ increases with an appreciating domestic currency ($\varepsilon > 0$) and rising inflation (based on GDP deflator).

3/ For projection, line includes the impact of price and exchange rate changes.

4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Table 10. Pakistan: Public Sector Debt Sustainability Framework, 2008/09–2015/16

(In percent of GDP, unless otherwise indicated)

	Actuals			Projections					Debt-stabilizing
	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16	primary balance 9/
Baseline: Public sector debt 1/	60.7	61.5	60.1	61.7	60.2	58.3	56.2	54.6	-1.9
Of which: Foreign-currency denominated	27.1	25.4	22.6	21.4	20.9	20.6	20.5	20.5	
Change in public sector debt	1.1	0.8	-1.3	1.6	-1.6	-1.8	-2.1	-1.7	
Identified debt-creating flows	-2.4	-2.4	-4.2	-1.4	-2.7	-2.7	-2.7	-2.6	
Primary deficit	0.2	1.6	2.5	2.9	1.7	1.4	1.2	1.1	
Revenue and grants	14.7	14.4	12.8	12.7	13.2	13.3	13.5	13.8	
Primary (noninterest) expenditure	14.9	16.0	15.3	15.7	14.9	14.6	14.7	14.9	
Automatic debt dynamics 2/	-2.3	-4.3	-7.1	-4.4	-4.3	-4.2	-4.0	-4.0	
Contribution from interest rate/growth differential 3/	-6.6	-4.3	-7.1	-4.4	-4.3	-4.2	-4.0	-4.0	
Of which: Contribution from real interest rate	-5.0	-1.2	-6.6	-2.6	-2.5	-2.4	-2.3	-2.3	
Of which: Contribution from real GDP growth	-1.6	-3.1	-0.5	-1.8	-1.9	-1.8	-1.7	-1.7	
Contribution from exchange rate depreciation 4/	4.3	…	…	…	…	…	…	…	
Other identified debt-creating flows	-0.3	0.3	0.4	0.1	0.0	0.1	0.2	0.3	
Privatization receipts (negative)	0.0	0.0	0.0	-0.3	-0.4	-0.3	-0.2	-0.1	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Build-up of bank deposits	-0.2	0.3	0.4	0.4	0.4	0.4	0.4	0.4	
Residual, including other asset changes 5/	3.5	3.1	2.9	3.0	1.1	0.9	0.6	1.0	
Public sector debt-to-revenue ratio 1/	412.6	428.2	470.9	484.8	454.8	439.7	415.2	394.3	
Gross financing need 6/	26.2	25.7	26.8	30.0	30.3	30.3	28.5	27.1	
In billions of U.S. dollars	42.3	45.5	56.5	70.1	74.3	77.7	76.8	76.8	
Scenario with key variables at their historical averages 7/	60.7	61.5	60.1	61.2	60.2	59.2	58.1	57.6	-2.2
Scenario with no policy change (constant primary balance) in 2011/12–2015/16	60.7	61.5	60.1	59.4	57.9	56.3	54.7	53.6	-1.9
Key Macroeconomic and Fiscal Assumptions Underlying Baseline									
Real GDP growth at market prices (in percent)	3.2	5.9	1.1	3.5	3.5	3.5	3.5	3.5	
Average nominal interest rate on public debt (in percent) 8/	10.5	8.3	7.7	7.3	8.2	8.7	9.3	9.6	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	-9.9	-1.8	-12.8	-4.6	-4.3	-4.3	-4.2	-4.4	
Inflation rate (GDP deflator, in percent)	20.3	10.1	20.5	11.9	12.5	13.0	13.5	14.0	
Growth of real primary spending (deflated by GDP deflator, in percent)	-12.0	13.5	-3.3	6.2	-1.3	1.6	3.9	5.2	
Primary deficit	0.2	1.6	2.5	2.9	1.7	1.4	1.2	1.1	

Sources: Pakistani authorities; and IMF staff estimates and projections.

1/ General government gross debt; includes obligations to the IMF, excludes external military debt, commercial debt, short-term loans, and debt of public enterprises.
2/ Derived as [(r - p(1+g) - g + ae(1+r)]/(1+g+p+gp)) times previous period debt ratio, with r = interest rate; p = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).
3/ The real interest rate contribution is derived from the denominator in footnote 2/ as r - π (1+g) and the real growth contribution as -g.
4/ The exchange rate contribution is derived from the numerator in footnote 2/ as ae(1+r).
5/ For projections, this line includes exchange rate changes. For 2009/10, it reflects, inter alia, the assumption by the government of electricity sector debt of Rs. 277 billion (1.9 percent of GDP).
6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.
8/ Derived as nominal interest expenditure divided by previous period debt stock.
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Appendix 1. Fiscal Decentralization in Pakistan: Too Much, Too Fast?[1]

The 7th National Finance Commission (NFC) Award and the passage of the 18th Constitutional Amendment represent a major step towards transferring more funds and spending responsibilities to the provinces. This stepped-up move to fiscal decentralization is happening at a time when Pakistan is struggling with bringing fiscal deficits under control, and if not well-managed, it could seriously complicate this effort. Similarly, the effort to improve the quality of public services could be compromised. Therefore, it is of key importance to get the design of the system of intra-governmental relationships right.

NFC Awards and 18th Constitutional Amendment

Pakistan has been a federation since the adoption of the 1973 Constitution, which also created the Council of Common Interest (CCI) to deal with disputes between the center and the provinces. The National Finance Commission (NFC) was set up to determine the common pool of resources from federal tax receipts, and to distribute these resources under so-called Awards.[2]

The most recent 7th NFC Award agreed in 2009 represents a major step toward fiscal decentralization. The share of the divisible pool of resources allocated to the provinces has increased from 47 percent in 2008/09 to 56 percent in 2010/11 (65 percent of total FBR tax collection in that year), and to 57.5 percent in 2011/12 and thereafter. Other transfers to the provinces (straight transfers, special grants) were also increased sharply in 2010/11 (Table 1). The share of transfers to the provinces in total federal tax collection has almost doubled (Figure 1). In addition to population size (82 percent), new criteria for determining the share of the provinces were added under the 7th NFC Award: poverty (10.3 percent), revenue collection (5 percent), and inverse population density (2.7 percent); the share of the poorest province Baluchistan almost doubled, with corresponding reduction in the share of Punjab.

Table 1. Transfers to Provinces
(Rs. Billion)

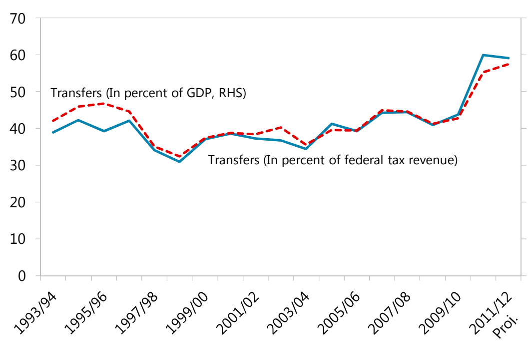
	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11
Divisible pool	215	244	326	390	458	565	866
Straight transfer	42	56	75	68	67	68	168
Special grants and grant in aid	10	10	28	32	38	43	86
Total	289	339	428	490	563	677	1120

Source: Pakistani Ministry of Finance, Fiscal Policy Statement 2010–11.

[1] Prepared by Jiri Jonas.

[2] The common or divisible pool of resources consists of federal income tax, sales tax, capital value tax, custom duties and excise tax net of gas. Over 99 percent of federally collected taxes go to the pool.

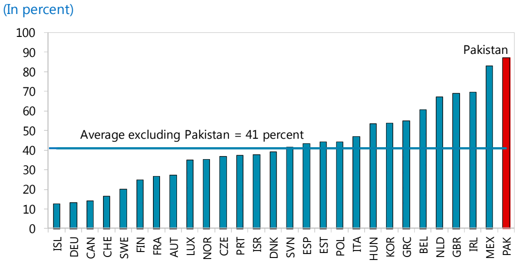
Figure 1. Transfer of Tax Revenue to Provinces



Source: Pakistani authorities; and IMF staff calculations and projection.

While transfers from the divisible pool have increased rapidly, tax collection by the provinces has remained very low, less than 0.5 percent of national GDP.[3] As a result, the share of provincial spending covered by the provinces' own resources remains very low and Pakistan's vertical fiscal imbalance (the share of subnational own spending, excluding transfers paid, not financed through own revenue, excluding transfers received) is very large (Figure 2).

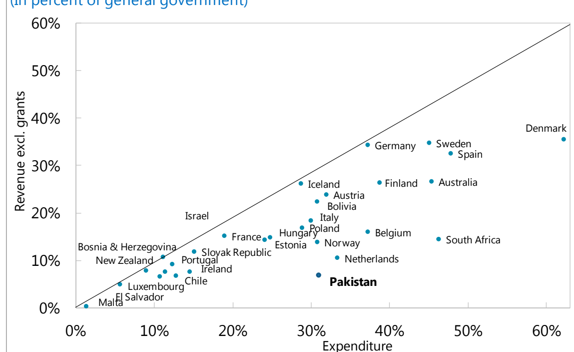
Figure 2. Vertical Fiscal Imbalance[1]
(In percent)



Sources: Euraud, Karpowics and Lusinyan (2011); and IMF staff calculations.
[1] Vertical fiscal imbalance is defined as the share of sub-national own spending (excluding transfers paid) not financed through own revenue (excluding transfers received).

The share of provincial spending in total general government spending (about 30 percent) is not exceptionally high, but the share of the provincial own revenue in total general government revenue is low compared to other countries (Figure 3). The low share of provincial spending financed by provincial taxes makes taxpayers less aware of the link between what they pay to, and what they get from, their local governments. As a result, they may not hold their provincial officials accountable for the quality of provided services.

Figure 3. Subnational Expenditure and Revenue
(In percent of general government)



Source: GFS data; and IMF staff calculations.

The transfer of additional funds under the 7th NFC Award was accompanied by the transfer of more spending responsibilities to the provinces under the 18th Constitutional Amendment. The 18th Amendment unbundled the previously overlapping spending responsibilities to the provinces, and an increasing number of functions are now under provincial responsibility, including health, education, and population welfare. A significant share of development spending was also shifted to the provinces.[4]

Finally, after the passage of the 18th Amendment, an article has been inserted in the Constitution which stipulates

[3] Provinces rely mainly on property taxes and on taxes on professions and motor vehicles. See Bath et al., 2008.

[4] For details, see Ghaus-Pasha, A., 2011, Fiscal Implication of the 18th Amendment: The Outlook for Provincial Finances, World Bank Policy Note Series on Pakistan No. 1, (Washington: World Bank).

that provincial governments' borrowing in domestic or international markets is subject to limits and conditions specified by the National Economic Council (NEC). Thus, any province that may want to borrow will have to make a case for such borrowing to the NEC.

Benefits and Risks of Fiscal Decentralization

While fiscal decentralization can improve the quality of provided services, it can also pose risks to macroeconomic stability. Therefore, a number of preconditions for successful decentralization have been laid out in the literature.[5] Ideally, decentralization would start with a clear assignment of responsibilities at different levels of government, and proceed at a speed corresponding to the implementation of necessary preconditions.[6] However, in Pakistan, political considerations have been an important driving force behind fiscal decentralization, and as a result, the risks and costs of decentralization may have been underestimated. A too-extensive, too-fast or badly managed fiscal decentralization carries several risks:

First, extensive decentralization limits the ability of the center to conduct counter-cyclical stabilization policies. If the federal government controls only a limited share of spending, or if it does not control an important tax instrument, its ability to use discretionary fiscal policy could be seriously limited. If the central government raises taxes or boosts tax collection by improving tax administration and tax compliance, a significant portion of additional revenue may need to be transferred to the provinces where it could be spent, rather than used to reduce the deficit. This could be especially problematic when fiscal vulnerability calls for sizable fiscal adjustment, as is the case in Pakistan.

Second, the large dependence of the provinces on shared revenues and transfers from federal government can create incentive problems. As most of their spending is covered by funds received from the federal government, the provinces face little incentive to raise revenue to finance their spending. The beneficiaries of provincial spending face little, if any, of the costs of financing this spending, and thus have less incentive to pressure the local governments to economize on spending or collect more revenue. This could lead to overspending, low revenue and weaker fiscal balance. Federal government, too, may have little incentive to raise more revenue: if it keeps only part of the collected taxes, it receives lesser benefits, while incurring political and other costs of collection.

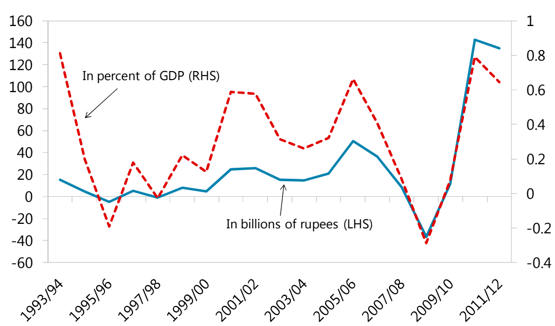
Third, unsynchronized and unbalanced devolution of funds and spending responsibilities to the provinces could exacerbate the fiscal strains. The devolution of resources to the provinces under the 7th NFC Award preceded the devolution of spending. In addition, the amount of additional devolved resources to the provinces, estimated at about Rs 200 billion, was higher than the amount of

[5] See Ter Minassian, T., (ed), 1997: *Fiscal Federalism in Theory and Practice*, (Washington: International Monetary Fund), Fedelino, A. and T. Ter-Minassian, 2010, Making Fiscal Decentralization Work, IMF Occasional Paper No. 271.

[6] Some argue that decentralization could accelerate the putting in place of these conditions. For example, giving local governments more autonomy would accelerate the learning-by-doing and strengthen local capacity—see Usui, 2007.

devolved spending, estimated at Rs 67–Rs 91 billion.[7] To avoid weakening of the general government balance, the federal government successfully pressed the provinces to keep their 2010/11 budgets in surplus.[8] The pressure on the federal budget from the unbalanced devolution of funds and spending continues in 2011/12, and the provinces are again asked to run aggregate surplus, even as provincial parliaments have approved provincial budgets that in aggregate show a small deficit (Figure 4).

Figure 4. Provincial Budget Balance, 1994–2012



Source: Pakistani authorities; and IMF staff data.

Fourth, rapid augmentation of resources allocated to the provinces could stretch their ability to spend these effectively. A too fast devolution carries the risk of future disruption of services in key areas such as health and food. The absence at the provincial level of well-developed expenditure control systems and public finance management adds to the risk of misallocation and waste, and, consequently, to a failure to reach the objectives of devolution—improved provision of public goods and services.

Fifth, fast and poorly designed decentralization could result in increased—perceived or actual—regional inequality. Such an outcome, together with a failure to achieve improved macroeconomic performance and better provision of public goods and services, would complicate policy cooperation and coordination between the central government and the provinces. As a result, the effort to bring the provinces on board in order to restore fiscal sustainability would suffer. In sum, the rapid and far-reaching fiscal decentralization in Pakistan carries with it many risks and pitfalls that could complicate macroeconomic management and adversely affect economic performance, while failing to improve the delivery of services and reduce fiscal inequality among the provinces.

How Can Decentralization Work Better in Pakistan?

Making decentralization work is a key precondition for improving fiscal outcomes and mitigating risks to fiscal sustainability. Pakistan's stepped-up fiscal decentralization is taking place in a time of significant fiscal challenges, further underscoring the need for prudent fiscal behavior on the part of both the federal government and the provinces. The following are the key issues that need to be addressed:

First, fiscal decentralization and revenue sharing with the provinces should not weaken the federal government's ability to reduce the fiscal deficit and public debt. Very low tax collection in Pakistan, and the limited scope for sustained spending cuts imply that revenue mobilization will have to play a key role in restoring fiscal stability and ensuring that decentralization produces better service

[7] Ghaus-Pasha, A. (2011).

[8] However, following the example of the federal government, provinces introduced a sizable salary increase in FY 2010/11, which absorbed a large share of additionally transferred revenue.

delivery. Therefore, it is important that the federal government be able to use additional revenue resulting from tax measures or improvements in tax administration and enforcement to reduce the deficit. If the preponderance of additional tax revenue were to accrue to the divisible pool of resources and eventually be spent by the provinces, instead of being used to reduce the deficit, the federal government would have both less incentive and less ability to undertake fiscal consolidation.

Avoiding this risk could require a modification of the rules governing the divisible pool. An option would be to apply, at the margin, a lower provincial share of the pool; for example, when the growth of the pool exceeds a specified floor (say, nominal GDP growth). A more rigorous and perhaps more stable version of this approach would be to define the provincial receipts from the pool—not as a share—but as a "fixed" nominal amount that is indexed annually with a relevant price index.[9] This "cap" on how much provinces receive from the pool could stay in place until the general government deficit is reduced to a certain level, e.g., to government's medium-term target of 3 percent of GDP.

Second, given their large share in total government spending, the provinces need to play their part in supporting sound fiscal policy. To that effect, it is important that the provinces significantly improve their own revenue collection, and continue avoiding irresponsible borrowing.

At about 0.5 percent of GDP, provincial own revenue is very low. There are several reasons for this (Bahl et al., 2008): (i) provincial taxable capacity is low and the tax base is hard to reach (rural and informal sectors are large); (ii) provinces have a limited administrative capacity; (iii) the tax base is reduced as a result of exemptions and preferential treatment; and (iv) political considerations prevent pressure on property owners and other potential taxpayers to pay taxes. There are several areas with potential to bring in additional revenue to the provinces, including: (i) GST on services—though the potential varies significantly among the provinces; (ii) agriculture income tax; and (iii) strengthening of tax on immoveable property.[10] Moreover, the failure to implement the reformed GST, which was seen as key to the success of devolution of spending responsibilities to provinces, also does not help the effort to raise additional provincial revenue.[11]

At the same time, provincial borrowing needs to be tightly controlled. As noted, Pakistan's Constitution requires that borrowing provinces seek National Economic Council's approval. This is a step in the right direction, and needs to be firmly observed. Control of provincial borrowing should cover not only borrowing in domestic and international markets, but also

[9] A system that has been used in, for example, Denmark to regulate the size of general grants to local governments.

[10] See Bahl, R., S. Wallace, and M. Cyan, 2008, Pakistan: Provincial Government Taxation. International Studies Program, Working Paper No. 08–07, (Atlanta: Georgia State University).

[11] Pakistan's experience with the reform of the GST confirms the observation that a decentralized fiscal structure often becomes a major impediment to tax reform because of the difficulty of coordination among independent jurisdictions. See Tanzi, V., 2002, "Pitfalls on the Road to Decentralization," In E. Ahmad and V. Tanzi, (eds), *Managing Fiscal Decentralization,* (London, New York; Routledge).

domestic bank borrowing, including borrowing from the central bank and particularly from the provincial banks which could become a captive source of financing. One possibility would be to introduce the provincial equivalent of the 2005 federal Fiscal Responsibility and Debt Limitation Act (Ghaus-Pasha 2011). An attractive option would be a borrowing rule that would link the permitted amount of provincial borrowing to their tax and nontax revenue.

In the near term, provincial borrowing is not on the agenda. Rather, reflecting the above-noted asymmetric transfer of funds and spending responsibilities, the provinces are likely to be required to run temporary surpluses to help limit the general government deficit. To achieve provincial surpluses would require a cooperative agreement between the federal government and the provinces. A variety of international experience is available with regard to the arrangements that different countries have put in place to ensure conformity between sub-national policies and macroeconomic objectives. Some success has been achieved in Nordic countries with a cooperative approach that builds on annual negotiations between local government associations and the national government.[12] In Pakistan, such cooperation could be promoted under the umbrella of the CCI. The Council's role as an institutional mechanism for resolving conflicts has been strengthened as a result of the 18th Amendment, and it could play an important role.

Looking beyond the near term, it would not be optimal if a reasonable level of general government deficit should require the provinces to run surpluses, to compensate for large federal government deficits. Rather, the provinces should run broadly balanced budgets, with eventual borrowing limited to financing high-return investment projects.[13] Mobilization of additional revenue by the provinces could then be used to further improve the delivery of services and financing of growth-enhancing infrastructure investment.

Finally, to reduce the risk that the decentralization would weaken the quality of service delivery, the capacity of the provinces to manage effectively increased spending responsibilities needs to be beefed up. Two key prerequisites need to be met: strong accountability of service providers and policymakers, and administrative capacity to handle the new spending responsibilities effectively. Accountability has been identified as key condition for efficient delivery.[14] Reducing the overlap of spending responsibilities and assigning clear responsibility for the provision of public goods and services at different levels of government are two important priorities. The third priority is to strengthen data provision on provincial

12 See Lotz, Joergen, 2006, *Local Government Organization and Finance: Nordic Countries*, in Anwar Shah (ed.), *Local Governance in Industrial Countries* (Washington: World Bank).

13 However, to prevent a weakening of the general government balance, the move of provincial budgets from a surplus to a balance would require a corresponding structural improvement in the federal budget.

14 See International Monetary Fund, 2009, *Macro Policy Lessons for a Sound Design of Fiscal Decentralization*, Washington.

spending.[15] The lack of functional classification data and data on actual—as compared to budgeted—spending makes it more difficult to assess the implementation of the budget and compare the spending and "outcomes" of spending among jurisdiction. Better data availability and reporting would improve the ability of the electorate to held provincial officials more accountable.

Conclusion

The stepped-up fiscal decentralization as a result of the 7th NFC Award and the 18th Constitution Amendment provides additional significant resources and responsibilities to the provinces and, if well managed, has the potential to improve the delivery of public goods and services. However, as a result of persistent weakness in tax collection and spending pressures, Pakistan's fiscal vulnerability is high and needs to be addressed urgently. This task has been made more difficult as a result of the large and unbalanced devolution of funds and spending responsibilities to the provinces which left the federal budget in a weaker structural position. Therefore, substantial strengthening of fiscal discipline at both the federal and the provincial levels is crucial for restoring fiscal sustainability. Without stronger tax revenue and sounder public finance, the decentralization is unlikely to deliver the expected benefits. At the same time, a clear assignment of responsibilities at different levels of government and better provision of data on budget implementation are needed to strengthen accountability and the quality of service delivery.

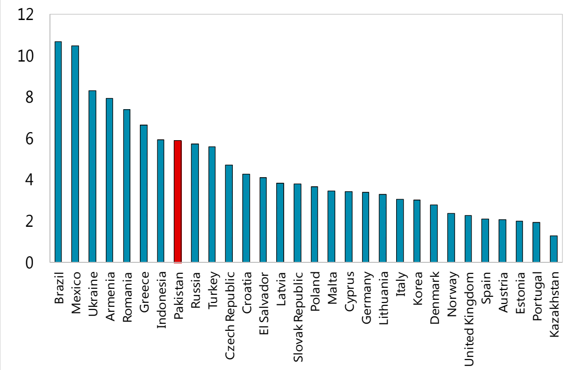
[15] Ahmad, E., 2011, Political Economy of Improved Governance: Making Decentralization Work in Pakistan, Presentation at the IMF Seminar, Washington, December 7.

Appendix 2. Financial Sector Competition[1]

The financial sector in Pakistan is dominated by banks. Developing the nonbank sector and capital markets could have several favorable outcomes for the overall economy. A greater variety of savings instruments could help stimulate domestic savings, which would expand sources of credit available to the private sector. A well-developed financial sector could also help transfer asset risk away from bank balance sheets to investors willing to bear it for the sake of commensurate return. The authorities are encouraged to lower barriers to the development of capital markets, especially from national savings instruments, and to continue to improve transparency of information in both equity and debt markets. Further progress in the development of commodities markets, particularly in the agricultural sector, could help producers hedge price risk and contribute to greater stability of banking sector deposits.

Banking sector spreads between lending and deposit rates are relatively wide on a cross-country basis. Averaging more than 650 bps for the overall banking sector over a two-year period through September 2011, the spread is relatively wide compared with the median for a large number of countries for which data are available (Figure 1). Although this spread has generally increased in recent years, it has come down sharply during 2011 after 200 bps of policy rate cuts (Figure 2). The existence of a relatively wide spread has prompted allegations that banks are charging excessive rates for lending.

Figure 1. Spread Between Lending and Deposit Rates
(Percentage points)



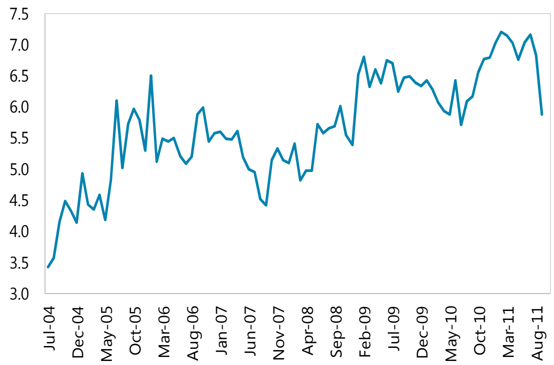
Sources: State Bank of Pakistan; and IMF FSI (Q4 2011).

Relatively wide banking sector spreads could reflect lack of competition within the financial sector. A wide spread might be the result of low deposit rates, high lending rates, or both. Low deposit rates may be explained in two ways. First, deposits are mainly held with banks for transactional purposes while savings are invested in the National Savings Scheme (NSS). Second, limited competition in rural areas and small towns means that banks can offer the legal minimum deposit rate of 5 percent per year and still attract deposits. On the lending side, rates might be high because corporations are forced to borrow from banks in the absence of capital markets financing and because there are high risk premia associated with corporate governance and transparency issues. Separately, recent empirical work suggests that the present composition of bank balance sheets, with rising holdings of government securities and a large share of rate-insensitive deposits, might be driving the wide banking sector spread.[2]

[1] Prepared by Mustafa Saiyid.

[2] "Interest Margins and Banks' Asset-Liability Composition," Idrees Khwaja, *The Lahore Journal of Economics*, 16: SE (September 2011): pp. 255-270.

Figure 2. Lending-Deposit Spread
(Percentage points)



Source: State Bank of Pakistan.

Increased competition with banks could help to lower spreads. At present, alternatives to bank deposits for savings are the following:

- the NSS;
- managed funds ;
- direct holdings of equities and bonds (via brokers); and,
- investment products offered by insurance companies.

The NSS is an attractive alternative to bank deposits but may be hurting the development of capital markets. As of October 2011, the profit rate on the NSS is set at 12.4 percent for a term of six months.[3] There is no upper limit on investment, no management fee, no redemption penalty, and no tax implication. It is not surprising that the overall size of the schemes is almost one-fourth that of bank deposits.[4] In the past, the administered rate of return on the NSS for a six-month period has sometimes exceeded that on a five-year Pakistan Investment Bond, as is the case in October 2011 (Figure 3). In March 2000, the government decided to restrict institutional investment in the NSS to reduce distortions in the term structure of interest rates.

Managed funds are an alternative to the NSS but face several challenges to growth. At present, these have assets of only one-fifth the NSS, so there is scope for future growth, which could support capital markets development. However, there are several challenges. First, managed funds find it difficult to compete with the NSS in performance after fees and liquidity because performance varies considerably across funds and fees are high at 1-3 percent. Second, the pension system in Pakistan is fragmented and mostly unfunded (pay-as-you-go), which means that it does not provide a significant investor base for managed funds as in other countries.[5] Third, the closure of the stock market during August through December 2008 led to the failures of many funds and a loss of investor confidence, particularly since a number of lawsuits are stuck in courts in the absence of tribunals administered by the Securities and Exchange Commission of Pakistan (SECP)[6]. Finally, managed funds are subject to the

[3] As of October 2011, mandatory rates of return are: Special Saving Certificate, 12.4 percent; Regular Income Certificate, 12.6 per cent; Defense Saving Certificate, 12.7 per cent; and Bahbood Saving Certificate, 14.4 per cent. Further details are available from http://www.savings.gov.pk

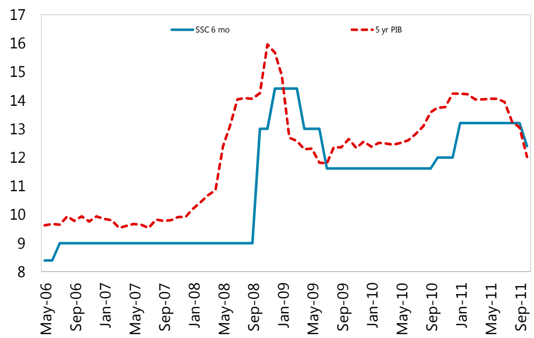
[4] Banking sector deposits, excluding interbank balances, are Rs 5.2 trillion (about one-quarter of GDP).

[5] Funded corporate schemes are estimated at Rs 200 billion (US$2.4 billion); while, recently initiated public schemes amount to Rs 1.3 billion (US$15.5 million).

[6] The market fell by more than 40 percent when it reopened in December 2008 and was down 70 percent between mid-April 2008 and end-January 2009. Problems were experienced not just by equity funds but by fixed income funds as well. This was attributed to liquidity problems, owing to the lack of collateral that could be priced by the market.

corporate tax rate of 35 percent, which is higher than the 25 percent rate applicable to associations of persons, a discrepancy that may be pushing investment activity out to unregulated and unlicensed operations.

Figure 3. Yield Comparison
(In percent)



Source: State Bank of Pakistan.

Despite some advantages, there are several hurdles to direct investment in equity markets. On the positive side, the listed market is deep and liquid, with a capitalization of Rs 3.3 trillion (24 percent of GDP); and it has appreciated significantly, by about 130 percent over a two-year period through November 2011. Also, capital gains taxes on equity investments are relatively low.[7] On the other hand, despite regular filing requirements, there is still a problem with transparency of listed company information, and there are market concerns that shareholder funds from listed companies may be directed to unlisted affiliates.[8] In addition, changes to the "badla" system of informal margin financing are in the process of being finalized. It is important that the new rules provide adequate safeguards to investors and brokers, in light of the losses suffered in 2008 when the market was closed for four months.

The domestic debt market suffers from limited activity. On the demand side, banks would rather buy government than corporate debt because of favorable impact on capital and liquidity positions and there are few significant institutional buyers. From a supply perspective, corporates prefer to get financing from banks than from capital markets since there are onerous listing and reporting requirements for the latter. Operational issues also affect market liquidity. First, the bulk of corporate issuance, which is listed on the Karachi Stock Exchange (KSE), may only be traded by Karachi brokers. Second, in the absence of trading activity, reference prices for bonds are artificially based on a "matrix approach," in which actual pricing data are interpolated using rating and maturity as reference criteria.[9] However, the recent development of an online bond trading system could overcome some of these challenges, as it offers a price-discovery mechanism and reports trades in listed and unlisted bonds.

[7] Capital gains taxes are 10 percent for holding periods less than six months, 7.5 percent for six months to one year; and none for more than one year.

[8] Compared with only 651 listed companies, there are some 10,000 unlisted companies, with assets of more than Rs 7.5 million. Of these companies only a small number are providing filing information to the SECP, much of it rudimentary and incomplete. The SECP says that it has limited capacity to perform adequate supervision of the unlisted market.

[9] There are at least three problems with this approach. First, it assumes that other characteristics of bonds being priced (for example, coupon and sector) are essentially the same as those of reference bonds. Second, the credit risk premium, which varies on an intra-day basis due to market information on the creditor, is tied directly to a much more stable rating measure for the bond. Third, there are two agencies providing ratings on corporate debt, and with different ratings it is unclear which one should be used in the matrix.

The insurance industry, which could also provide investment alternatives to bank deposits, is relatively insignificant in size. Altogether, the industry provides coverage of Rs 87 billion (0.6 percent of GDP) and is dominated by a state-owned life insurer.

Separately, the development of commodities futures contracts could also help lower banking sector spreads. Such contracts could benefit hedgers reducing the need for protective cash positions in bank deposits. At present, the Pakistan Mercantile Exchange (PME) has developed futures contracts in two precious metals (gold, silver); three agricultural products (rice, palm oil, wheat); crude oil; and three-month KIBOR. There are several challenges to the future development of commodity markets. First, there is a storage and delivery problem for some agricultural contracts, particularly for cotton and sugar. The PME is exploring alternate solutions, for instance, storing sugar at the mills where it is refined. Second, it is difficult to get impartial grading of reference commodities, and grading vendors identified by the PME are not always considered neutral by market participants. Third, contracts based on local definitions of weights and measures are not as actively traded as those based on international specifications. This is likely due to comparability of pricing across markets globally.

Policy recommendations

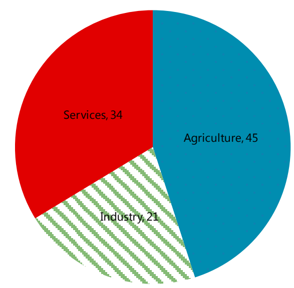
The authorities should seek to develop capital markets in order to increase financial sector competition. Broad recommendations are the following:

- **Rationalize profit rates on NSS instruments**. This would involve pricing the government guarantee and liquidity appropriately.
- **Improve transparency of company information**. Explore ways to improve the quality of information on listed companies to include links with unlisted subsidiaries and strengthen supervision in the area of unlisted companies.
- **Continue to improve transparency in the pricing of debt instruments**. Strengthen processes for reporting defaulted bonds to exchanges. Improve the pricing mechanism for debt, in part, by reducing reliance on a matrix system, potentially by identifying specialized market makers who could offer two-way quotes.
- **Deepen the opportunity set for equity investment**. Encourage listed companies to expand free float, and explore ways to bring unlisted companies into the listed market.
- **Establish regulations for equity derivatives**. The availability of options and warrants in the market would help corporates lower the cost of share issuance, and allow investors to hedge positions in the market more efficiently.
- **Allow cross-listing of bonds on multiple exchanges**. Allowing brokers outside Karachi to transact in bonds locally would help increase liquidity.
- **Encourage development of managed funds**. Encourage fund providers to offer products classified by risk tolerance. Seek consistency in the corporate tax rate applied to the managed funds industry with that applied to associations of persons.

Appendix 3. Creating Jobs for the Growing Labor Force[1]

Labor force participation in Pakistan is the lowest in the region, and agriculture is the largest employer (Figure 1). Pakistan's population has grown by an average 2.2 percent per annum over the past decade, and is estimated to amount to 177 million.[2] Its labor force was estimated to amount to 58 million in 2010/11; participation was 33 percent,[3] which is very low compared to 45 percent for other South Asia countries and over 50 percent for advanced economies. Wide wage differentials and declining real wages have marked the wage structure in Pakistan in recent years. *Labour Force Survey 2010/11* reports significant nominal wage disparities by area and by gender. Average nominal wages in urban areas exceed wages in rural areas by one-third, reflecting the higher share of urban employment in the nonagricultural and formal sectors. Furthermore, nominal wages have not kept pace with the rise in inflation in past four years, with real wages falling by an average 1.5 percent during 2007/08–2010/11.

Figure 1. Employed Labor Force by Sector, 2010/11
(Share in percent)



Source: Labor Force Survey, 2010/11.

Although there is a legal minimum wage, it is not enforced across all sectors.[4]

While recorded unemployment is low, a large part of the employed labor force is unpaid, works less than 35 hours a week, and works in the informal sector.[5] The unemployment rate is 6 percent (Figure 2).[6] The young (under 24) and the older segments (over 60) have the highest rates of unemployment (10.2–11.9 percent).[7] There are indications that a large part of the employed labor force could be available for alternative or additional employment, i.e., were

[1] Prepared by Tasneem Alam, Omer Javed, and Paul Ross. The appendix has benefitted from comments by and contributions from Sakib Sherani, Aliya Khan, the ILO, and Andrew Berg and Yorbol Yakhshilikov.

[2] This appendix uses the population estimate from the *Economic Survey of Pakistan 2010/11*, which is slightly different from those reported in *Labour Force Survey 2010/11* which uses population estimated on January 1, 2011.

[3] This Appendix uses a crude participation rate throughout, rather than a refined participation rate, because a refined participation rate creates cross-country comparability issues arising from different definitions of the labor force used by various countries.

[4] The minimum wage was raised to Rs 7,000 per month on May 1, 2010, but the *Labour Force Survey 2010/11* indicates 30 percent of wage earners received Rs 5,000 per month or less.

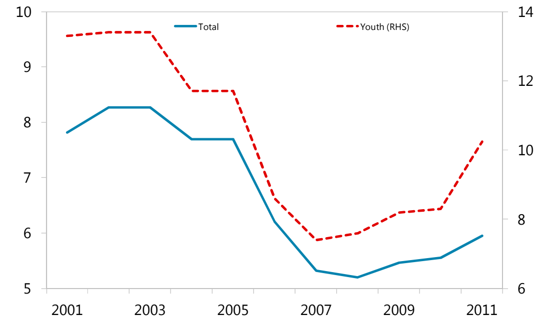
[5] Data problems limit analysis of how much unemployment and underemployment are cyclical, but the floods in 2010 and 2011 and supply constraints due to energy shortages over past years suggest that cyclical unemployment and underemployment may be on the rise.

[6] The definition of unemployment used in Pakistan is in line with international standards.

[7] Source: *Labour Force Survey 2010/11, Federal Bureau of Statistics, Pakistan* http://www.statpak.gov.pk/fbs/labour_force_publications.

underemployed.[8] Of the employed, 28 percent are unpaid family helpers and 10 percent of the employed earned up to Rs 5,000 per month, below the legal minimum. In terms of hours worked, around 8.3 million or 15.1 percent of the total employed were working less than 35 hours a week, a 1.7 percentage point increase since 2002. The prevalence of unpaid helpers, wages below the legal minimum, and people working less than 35 hours per week suggests these workers could be available for alternative or additional work. Additionally, informal employment is very high—accounting for more than seven-tenths of the nonagricultural employment in 2010/11—and has been on the rise, indicating that more jobs have been created in the informal sector. Moreover, 75 percent of informal workers were either in unskilled occupations (18 percent) or low-skilled occupations (57 percent), suggesting Pakistan's economy needs major investments in human capital and technology.

Figure 2. Unemployment Rate
(Percent)



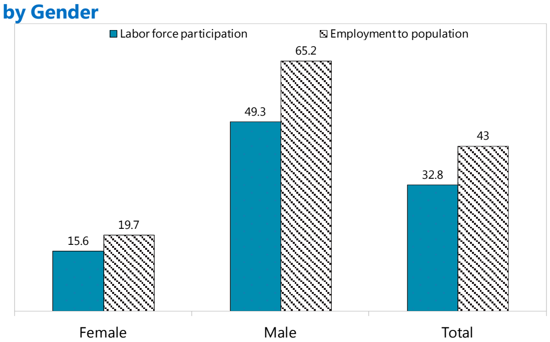
Source: Labor Force Surveys.

A gender gap in the labor market persists despite increased participation by women.

The labor force is 77 percent male and 23 percent female. Although the female participation rate has increased, from 9.3 percent in 2000 to 15.6 percent in 2011, it is less than one-third that of males in Pakistan and the lowest in South Asia, where it averages 44 percent (Figure 3). While labor market access for women has improved over the years, this has not gone hand in hand with the creation of equal work opportunities for them. The share of women working in wage employment has declined from 33 percent in 2000 to 21 percent in 2011 (Table 1); female employees earn around 63 percent of the average wage of males, and over 63 percent of employed women work as (unpaid) contributing family workers. Unemployment rates are also higher for females (8.9 percent) than males (4.5 percent). The low female participation rate and share in wage employment reflects both cultural and societal preferences and, despite improvements in recent years, much lower education and literacy levels for women than for men. Thus, increasing female education and literacy levels should help improve female participation and employment opportunities.

[8] Underemployment accounts for employed workers who during a specified period worked below their desired capacity, whether in terms of reduced hours of work (visibly underemployed) or reduced income (invisibly underemployed) as a result of inadequate technology, misuse of skills and low productivity. Visibly or time-related underemployed are defined by Pakistan Labor Force Survey as comprising of all employed persons who worked less than 35 hours a week and also sought or were available for alternative or additional work.

Figure 3. Employment and Labor Force Participation by Gender



Source: Labor Force Survey, 2010/11.

Table 1. Gender Gap in Labor Market

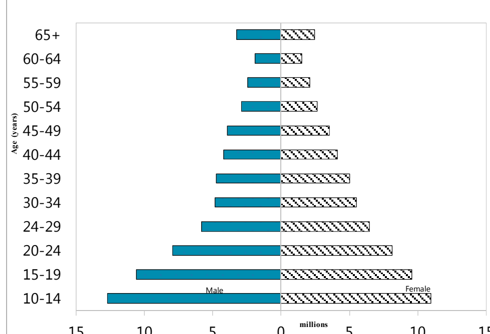
	Both Sexes		Male		Female	
	2000	2011	2000	2011	2000	2011
Labor force participation rate	29.0	32.8	47.6	49.3	9.3	15.6
Employment to population ratio	39.1	43.0	65.0	65.2	11.3	19.7
Share in wage employment	35.6	36.0	36.0	40.4	33.1	20.9
Share in non-agriculture employment	51.6	54.9	55.6	63.8	27.1	24.6

Source: Labor Force Survey.

Pakistan's labor market is less efficient than those of other countries in the region, and continues to be a constraint to Pakistan's competitiveness.[9] Pakistan has been ranked 136 out of 142 countries in labor market efficiency in the World Economic Forum's *Global Competitiveness Report 2011/12*, slipping further behind 23 countries since 2007/08. The *Report* suggests Pakistan needs to increase female participation in the labor force significantly, reduce redundancy cost, and improve the linkage between pay and productivity. It also highlights inflexibility in wage determination as wages are generally set outside a centralized bargaining process. Improvement in labor market efficiency is critical if jobs are to be created in the formal private sector. Reform of labor laws and institutions is needed, with the objective of striking a balance between ensuring fundamental rights to workers and increased efficiency and productivity of the labor market.

Generating employment for a young and fast-growing population is a key policy challenge. Pakistan's population growth rate of 2.2 percent (annual average) over the last decade is almost twice the average rate for emerging and developing economies and four times that in advanced economies. Furthermore, with more than 40 percent of the population below the age of 14, the number of new entrants to the labor force is growing rapidly (Figure 4). During 2000/01–2006/07, youth unemployment rate decreased from 13.3 percent to 7.5 percent. However, since then it has increased to over 10 percent in 2010/11, about 2.6 times the unemployment rate for adults aged over 25 years, indicating difficulty in absorbing the new labor market entrants. The youth are at a disadvantage because they lack experience; the dynamic process of matching jobs with job seekers needs to be institutionalized in order to address youth unemployment. Pakistan has also been an exporter of labor since early

Figure 4. Gender and Age Distribution of the Population



Source: Labor Force Survey 2010/11.

[9] The efficiency of the labor market relates to the ability of the labor market to allocate workers to their most efficient use in the economy and provide them with incentives to give their best effort in their jobs. The World Economic Forum ranks countries in terms of labor market efficiency based on indicators such as cooperation in labor-employer relations, flexibility of wage determination, rigidity of employment, hiring and firing practices, redundancy costs, pay and productivity, reliance on professional management, brain drain, and female participation in labor force.

1970s and so far over 5.7 million Pakistanis are registered as working abroad. Remittances by these workers are an important source of foreign exchange for Pakistan (see Appendix 5). The government has sought to create employment and improve skills mainly through microcredit facilities and vocational training programs. These measures have been limited in size by financial and administrative capacity constraints on their ability to create employment and improve labor force quality.

Employing a rapidly growing labor force will require a sustained acceleration in growth. The labor force is projected to grow by 3.4 percent per annum (its average growth rate for the past decade), implying more than 2 million people entering the labor force annually. Given an estimated employment elasticity of GDP growth of 0.5,[10] average GDP growth needs to be 7 percent per annum to absorb new labor market entrants, a significant increase relative to historical trends. Furthermore, based on the staff projections for growth current in the baseline and reform scenarios during 2011/12–2015/16 (an average of 3.5 and 4.7 percent, respectively), the unemployment rate would increase to 10 or 13 percent in 2015/16 (Table 2).

Table 2: Growth and Employment

2010/11	Labor force (in millions)	58.1
	Unemployment rate (in percent)	6.0
2015/16	Labor force (in millions)	68.7
	Average projected annual real GDP growth rate for 2011/12-2015/16 (in percent)	3.5-4.9
	Unemployment rate (in percent)	10.0-13.0
	Required annual real GDP growth rate for 2011-2016 to absorb entrants (in percent)	7.2

Source: Labor Force Survey; and IMF calculations.

To meet its large employment challenge Pakistan needs sustained and inclusive growth and improved human capital. A growing labor force, the large number of unpaid workers, and those employed working less than 35 hours per week show a need to create more and better jobs, which will be facilitated by high, sustained, and more inclusive economic growth. Alleviating key constraints to economic growth—unreliable electricity supply, fiscal and external vulnerabilities, low productivity, poor public service delivery, weak private and public sector governance, and policy uncertainty—will be critical.[11] The presence of a large economically inactive segment of the population is indicative of high dependency on the employed; it calls for policy interventions in health[12] and education to improve skills, close the gender gap, and thereby improve the quality and productivity of Pakistan's human capital. Further, action in these areas is needed to meet the employment needs of Pakistan's young and growing population to ensure improved labor market outcomes.

[10] The employment elasticity of GDP is calculated using data from 1973/74–2010/11. Sub-period and dynamic estimates of elasticity vary between 0.22 and 0.75 percent, and might reflect structural changes and/or measurement issues.

[11] The government of Pakistan has recently formulated a new growth strategy to encourage inclusive and sustained growth.

[12] A significant proportion of the economically inactive population cited illness as the primary reason for their being out of the labor force.

Appendix 4. Banking Sector Vulnerabilities[1]

Pakistan's banking system maintains a capital ratio in excess of the minimum requirement and is relatively liquid and profitable. However, it is vulnerable to risks from significant holdings of government securities and rising NPLs on lending to the private sector. Although holdings of government securities improve banks' capital and liquidity ratios, they remain subject to changes in market valuation and are crowding out private-sector credit. Rapid deposit growth will be needed to support additional holdings of government securities. There is evidence of weak underwriting at some public banks. Problem institutions are a relatively small portion of the banking system and are being restructured, albeit slowly. The authorities are encouraged to strengthen banks' ability to assess credit risk by improving the scope and quality of information available on borrowers. The legal system needs to accommodate faster recovery on defaulted loans. To strengthen confidence in the banking system, particularly in the event of an adverse shock, the authorities should seek to pass explicit deposit insurance legislation.

Pakistan's financial sector is relatively small in relation to its economy. Financial sector assets are only about 40 percent of GDP, whereas in many Asian emerging markets they average around 80 percent. It is comprised largely of banks, which make up nearly 90 percent of the sector (Table 1). Nonbanks are dominated by insurance companies. Within the banking system, there are four main types of institutions: private (76 percent), public (17 percent), foreign (3 percent) and specialized (2 percent). Altogether the banking system has 38 banks, of which there are 23 private and five public banks. The latter include one relatively large national bank and three provincial institutions. Foreign banks are mainly branches. Specialized banks, which are also public institutions, exist to support long-term lending in the agriculture and manufacturing sectors of the economy.

Table 1. Pakistan: Financial Sector Structure

	Number	Assets PKR billion	Percent of Total
Financial sector	328	8,150	100
Banking system:	38	7,138	88
Public	5	1,358	17
Local Private	23	5,404	66
Foreign	6	234	3
Other-Specialized	4	142	2
Nonbank financial institutions:	290	1,013	12
Investment	8	33	0
Insurance	56	453	6
Development finance	8	134	2
Other	218	393	5

Source: State Bank of Pakistan (December 2010).

Pakistan's banking authorities have made some progress toward safeguarding overall financial stability. At nearly 15 percent of risk-weighted assets, the overall banking system maintains capital in excess of the minimum requirement of 10 percent. Banking system liquidity is supported by cash and statutory liquidity requirements for local and foreign currency accounts; and by relatively large holdings of government securities (32 percent of assets), for which there is an active secondary market. On the whole, banks are also profitable, offering an after-tax return on equity of 14.1 percent as of September 2011, supported in part by relative wide net interest margins. Separately, the authorities have put in place a number of

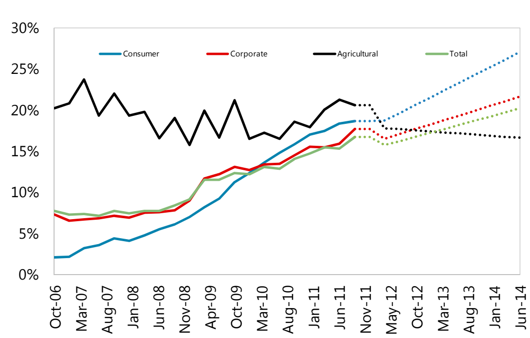
[1] Prepared by Mustafa Saiyid.

macroprudential measures, including dynamic provisioning and limits on the size of credit and foreign currency exposures. Banking authorities have also taken bold steps to restructure some individual problem banks. The SBP and the SECP are developing draft legislation for consolidated supervision of bank holding groups, which are engaged in banking, insurance and investment activities. From the perspective of surveillance, the authorities are using standard data definitions, including definitions for NPLs, which strengthen confidence in data comparability across countries.

However, the banking system remains vulnerable to the following risks:

- rising NPLs on bank loan portfolios;
- rising holdings of government securities; and
- delays in restructuring of problem institutions.

Figure 1. NPL Trends



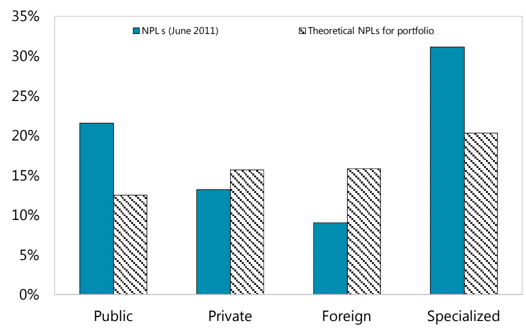
Sources: State Bank of Pakistan (September 2011); and IMF staff calculations.

NPLs remain elevated on bank loan portfolios. Overall NPLs have risen to 16.7 percent as of end-September 2011 (Figure 1). The bulk of bank loans are directed towards corporates, including textiles and food producers; for which NPLs have risen to 17.7 percent of the total through end-September and remain on an upward trend. Textile producers are reportedly experiencing significant difficulties in operating plant equipment on account of frequent energy load-shedding. NPLs also remain elevated on agricultural and consumer loans, although both these categories of loans constitute relatively small proportions of overall bank lending. While banks usually lend only against collateral, cash recovery in case of default appears relatively low, with the cumulative rate estimated at roughly 30 percent of NPLs over time. Average system provisions were at 66 percent of NPLs.

Rising NPLs can be traced to weak underwriting as well as deterioration in the macroeconomic environment. Comparing the actual performance of loan portfolios with theoretical performance based on loan portfolio composition suggests that public and specialized banks have been less successful than other banks in assessing borrower creditworthiness (Figure 2).[2] This suggests that the authorities could usefully review data quality and coverage in the existing online credit registry.

[2] The theoretical NPL for a particular type of bank is computed by weighting its mix of corporate, agricultural and consumer loans with systemwide NPLs for each of these loan types. The difference between the theoretical and actual NPLs for a particular bank type is a measure of its quality of underwriting relative to the system average.

Figure 2. Bank Underwriting Quality



Sources: State Bank of Pakistan; and IMF staff calculations.

Table 2. Estimate of Bank Capital Needs (billions of PKR)

	Public Banks	Local Private Banks	Foreign Banks	Specialized Banks	All Banks
Total Capital (End-June 2011)	124	508	42	9	682
Assets	1,438	5,923	258	143	7,763
Risk Weighted Assets	940	3,380	142	121	4,583
CAR (percent)	13.2	15.0	29.4	7.3	14.9
Dividend Payout Ratio Under Stress	-	-	-	-	-
Estimated After-Tax Return on Assets (percent)	1.1	1.4	1.6	0.3	1.4
Estimated Earnings over 3 Years	48	255	13	1	317
Capital Formation Since End-June 2011	-	-	-	-	-
Potential losses (net of provisions)	58	41	4	1	104
Minimum CAR (percent)	10	10	10	10	10
Capital Need	-	-	-	3	-

Sources: State Bank of Pakistan; and IMF staff estimates (December 2011).

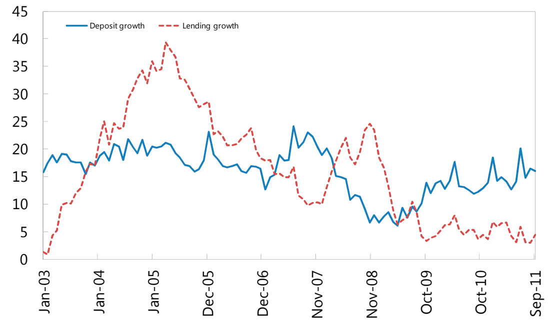
Higher levels of NPLs could increase solvency pressures for some banks. If recent trends in NPLs were to continue in the medium term (three years), banks could face significant additional losses above and beyond existing provisions (Table 2).[3] Even though the overall system is expected to be able to absorb such credit deterioration in the medium term, individual banks could come under pressure. This assessment is based on a number of assumptions, including, expected future earnings and larger projected levels of NPLs on loan portfolios of banks with weaker underwriting practices relative to the overall system. Specialized banks, which are presently undercapitalized, could require an additional Rs 3 billion in capital, even taking into consideration potential earnings on existing assets.

In the face of rising NPLs, banks are increasing holdings of government securities. As private-sector NPLs rise, banks have an incentive to increase holdings of government securities, which carry zero risk weights, offer relatively high nominal yields, may be easily traded in the secondary market, and used to satisfy liquidity requirements. Private-sector credit has indeed declined in recent quarters.

Significant bank holdings of government securities pose a risk for the financial sector and for the overall economy. Although these securities help improve bank capital adequacy and liquidity ratios, they remain subject to changes in market valuation (if held in trading accounts), such as might result from higher inflation. Also, they pose a risk for the overall economy by crowding out the ability of banks to extend credit to the private sector.

[3] Extrapolation of the five-year NPL trend would lead to system-wide NPLs of 21 percent by 2014. NPLs are already 25.2 percent at public banks and 30.9 percent at specialized banks as of September 2011.

Figure 3. Growth in Lending and Deposits
(In y-y percent change)



Source: State Bank of Pakistan.

Table 3. Estimate of Maximum Bank Holdings of Government Securities

Capacity	System Advances to Deposits Ratio (ADR) in percent	63.0
	Regulatory Limit for ADR (percent)	70.0
	ADR buffer (percentage points)	7.0
	Deposits	5,418
	Lending Space from ADR Buffer	378
	Projected Deposit Growth	16.0
	Lending Space from Deposit Growth	865
	Total Additional Capacity	1,243
Needs	Private Sector Credit	3,432
	Private Sector Credit Growth (percent)	3.6
	Private Sector Credit Needed	123
	Circular Debt	310
	Additional government debt banks could absorb	810
	Present Bank Holdings of Government Securities	2,259
	Maximum Holdings of Government Securities	3,068

Sources: State Bank of Pakistan; and IMF Staff Estimates (December 2011).
*All amounts in billions of Pakistani rupees.

There is an upper limit to the amount of government securities that banks might be able to absorb. For now, bank lending to the government could be supported by the high deposit growth of 16 percent in recent years along with a tiny cushion for existing advances to deposits ratio (60 percent) relative to the statutory requirement for a max of 70 percent (Figure 3). Staff estimates suggest that current holdings of Rs 2.2 trillion in government securities could approach Rs 3 trillion before the banking system would be forced to cut back private-sector credit (Table 3). In principle, this could happen much sooner. The critical factor supporting holdings of government securities is deposit growth, which has been fairly steady for several years and has benefited from structural developments, including progress in online/mobile banking and expansion of bank branches in rural areas.

Lengthy or delayed restructuring of problem banks is another source of risk for the system. Such banks remain especially vulnerable to adverse macroeconomic shocks in the interim. One public bank is only expected to meet the minimum capital requirement in five years' time; and a decision to restructure the two largest specialized banks has only been taken recently after being several years overdue.

In the past, the SBP was not sufficiently empowered to address the known issues of a problem bank. Known problems at the bank included imprudent and fraudulent lending, including one loan of Rs 10 billion advanced without collateral. The SBP says that it had identified governance and lending problems before fraud came to light in 2008, but was unable to take remedial action because of political resistance. The SBP notes that, in hindsight, it could have set tighter limits on credit exposure at the bank and sought an increase in provisioning beyond statutory requirements, as these steps might have helped to reduce public costs. This is a case for bolstering the independence of the bank supervisory authority and expanding its enforcement powers.

Policy Recommendations

The authorities should consider a swift restructuring of problem banks. While banks undergoing restructuring should be given enough time to repair balance sheets, the authorities may wish to consider the case for speedier resolution, taking into consideration costs borne by related counterparties and creditors.

Undertake comprehensive review of the coverage and quality of borrower credit data available to banks. This review should seek to ensure that banks have access to sufficiently detailed information on corporations and individuals, which allows them to make appropriate determination of aggregate debt and ability to make payments on such debt based on a reasonable projection of future income. Such a review could analyze the data quality and coverage of the existing online credit registry (e-CIB) and assess whether it is effectively used by banks.

Review dynamic provisioning approach. The SBP has introduced a macroprudential measure that allows banks to take lower (general) provisions during periods when their profits are lower. The SBP has discretion over the threshold of bank profitability, which could make the provision requirement uncertain for banks. At present, the after-tax return on equity of 14.1 percent is below that in the boom years of 2005–06, and (general) provisions are correspondingly lower. The authorities may wish to reconsider this approach as (general) provision requirements are lower at a time when NPLs are high relative to historical norms.

Review macroprudential limits. The goal is not to restrict opportunities for extension of private-sector credit but to ensure that banks are capable of handling risks posed.

- The authorities may wish to review the existing limit on the debt-to-income ratio for loans to individuals to determine if banks are able to capture the full scope of borrower debt payments. At present, the limit on monthly debt payments to income is set at 50 percent, which, in other countries, might include mortgage payments but would still be considered high.

- The existing limit on single credit exposure of 30 percent of equity, which includes loans that are fully secured by collateral, is somewhat higher than in other countries. It might be noted that the Basel Committee on Banking Supervision (BCBS) has recommended that a size limit on individual credit exposure should not exceed 25 percent of regulatory capital of bank or banking group.

Initiate dialogue with relevant players regarding establishment of commercial courts to speed up recovery process for loans in default. Present recovery rates appear much lower than in other countries because of difficulties in the legal process. It may well be useful to undertake a comprehensive review of creditor rights, debt recovery, and the corporate and personal insolvency regime, which would include the effectiveness of courts and the legal process.

To strengthen confidence in the banking system, it is important to pass legislation for explicit deposit insurance. A draft law for deposit insurance has been in the pipeline for a few years but the SBP indicated that passage was unlikely until after the 2012 elections. The authorities should seek to implement the existing proposal, eventually using a risk-based levy on banks. The size of the deposit insurance fund could be on the order of 5 percent of insured deposits, as in many other countries.[4]

Consider strengthening the statutory liquidity requirement for foreign currency accounts. Banking system liquidity is supported by a cash reserve requirement (CRR) of 5 percent and statutory liquidity requirement (SLR) of 19 percent for rupee accounts and 15 percent for foreign currency accounts. The SLR requirement for foreign currency accounts is lower than for rupee accounts because the reserve is held with the SBP rather than at the banks themselves.

Continue to promote deposit growth to create space for government securities and private-sector credit. The tax of 0.2 percent on daily deposit withdrawals exceeding Rs 25,000 is not conducive to banking sector deposit growth and is hurting system liquidity. The authorities may wish to consider elimination of this tax.

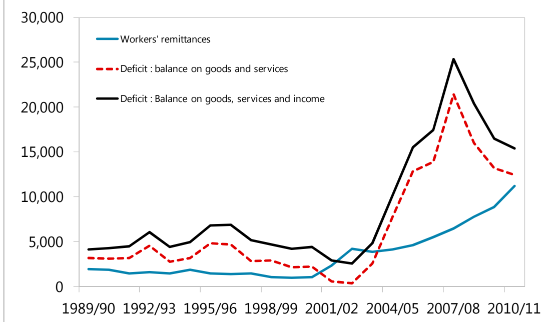
[4] See Hoelscher, Taylor, and Klueh, 2006, "The Design and Implementation of Deposit Insurance Systems," Occasional Paper (International Monetary Fund, Washington, D.C.), pp. 49-56.

Appendix 5. Workers' Remittances: Defying Gravity?[1]

Remittance inflows to Pakistan have increased significantly, recently, and have become instrumental in financing the trade deficits and allowing Pakistan to rebuild its foreign exchange reserves (Figure 1). This has occurred despite a challenging global economic and financial environment. In fact, Pakistan has been one of the few large recipients of remittances to benefit from positive real growth in remittances in 2009–10.[2] In addition, remittances have a positive impact on economic growth and reducing poverty, while being much less volatile than other sources of foreign exchange (FDI and portfolio inflows).[3, 4] Therefore, given their importance in terms of reducing poverty and improving economic performance and external sustainability, it is pivotal to understand what underlies the recent strength of remittances in Pakistan.[5]

It is important to note from the start that it is difficult to assess accurately the level of

Figure 1. Remittances and the Balance of Payments
(In millions of U.S. dollars)



Sources: State Bank of Pakistan; and IMF staff calculations.

workers' remittances.[6] In Pakistan, data on worker's remittances reflect transactions on account of "family maintenance" and routed through official channels only. A recent study by the International Organization for Migration (IOM) based on a survey, 548 Pakistani households with at least one family member working in Saudi Arabia, reported that only approximately 40 percent of remittances go through official channels, while the rest are transferred through unofficial channels, friends and relatives, and migrants themselves.[7] This would suggest that official data significantly underestimate remittances in Pakistan. However, official data on workers' remittances could also include one-time capital transfers from migrants returning permanently to Pakistan, or any

[1] Prepared by Francois Painchaud.

[2] Other large recipients like Bangladesh, India, Mexico, and the Philippines have all seen negative growth in real remittances during the same period. See "Outlook for Remittances Flows 2011-13," World Bank, *Migration and Development Brief*.

[3] See Remittances and Household Welfare: A Case Study of Pakistan, Vaqar Ahmed, Guntur Sugiyarto, and Shikha Jha, Asian Development Bank, February 2010 (Manila).

[4] For example, Iqbal and Sattar found that workers' remittances are the third most important source of capital for economic growth in Pakistan. See The contribution of Workers' remittances to Economic Growth in Pakistan, Zafar Iqbal and Abdus Sattar, Pakistan Institute of Development Economics, 2006.

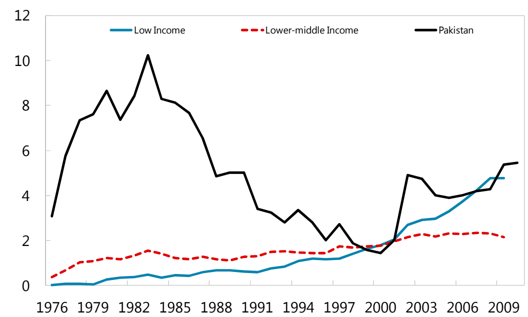
[5] For a detailed discussion on the determinants of remittances, please see "The determinants of migrant remittances," Jorgen Carling, *Oxford Review of Economic Policy*, Volume 24 (3), 2008 pp. 582–99.

[6] The World Bank notes that the worldwide quality and coverage of data on remittances leave much to be desired. See "Global economic prospects 2006: economic implications of remittances and migration," World Bank, 2006.

[7] See "Economic and Social Impacts of Remittances on Households: The Case of Pakistani Migrants Working in Saudi Arabia," International Organization for Migration, December 2009.

other transfers reported by the remitter to be for "family maintenance," including transfers by nonresidents for speculative purposes (which may be reversed rapidly in the event of an adverse shock).[8] These would tend to overestimate remittances in Pakistan. Keeping in mind the possible data weaknesses, the rest of this appendix analyzes recent trends.

Figure 2. Net Remittances
(In percent of GDP)



Sources: World Development Indicators (World Bank); and IMF staff calculations.

There are some indications that the recent performance of remittances in Pakistan could be sustained in the future. First, remittances have historically been quite strong, especially in the 1970s and early 1980s (Figure 2). Second, the decline in remittances as a share of GDP in the 1990s may have reflected a shift by remitters to less costly methods of transferring money, including the hawala system, which is not accounted for in official statistics on remittances. In addition, the liberalization of Pakistan's foreign exchange system in 2000, and greater surveillance of private transfers after 9/11 may explain the large increase in official remittances in 2002. Third, a recent study by Kock and Sun (2011) suggests that the recent performance of Pakistan's remittances reflects: (i) significant worker migration; and (ii) higher skill levels, and hence higher incomes, of migrating workers.[9] In particular, the outflow of workers has increased significantly since 2006, and recent monthly data points to continued strength in outflows.[10] Looking forward, large oil revenues and long-term infrastructure needs in GCC countries, a major destination for Pakistani migrants, are expected to continue to attract migrant workers. While this bodes well for remittances, it is a possible indication of significant weaknesses in the domestic labor market. Finally, the recent strength in remittances could also reflect the impact of the Pakistan Remittance Initiative (PRI), through which the Government of Pakistan introduced measures to facilitate and support the flow of remittances.[11] As a consequence, some of the least costly worldwide corridors for remittances include Saudi Arabia–Pakistan and United Arab Emirates–Pakistan. A recent study by Yang (2011) supports the view that the response of remittances to fee reduction can be quite large.[12]

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[8] It should also be noted that remittances systems are known to be vulnerable to misuse for money laundering as well as for terrorist financing purposes. Pakistan should address the weaknesses identified by the Financial Action Task Force through an appropriate sanctions regime, and increase the range of measures to prevent these activities.

[9] See "Remittances in Pakistan—Why have they gone up, and why aren't they coming down," Kock and Sun, IMF, Working Paper No. 11/200.

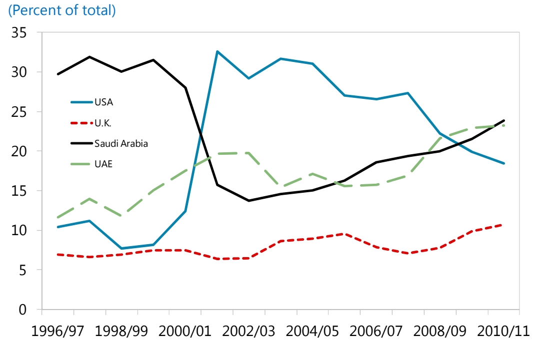
[10] See "Bangladesh: Selected Issues," IMF Country Report No. 10/56, February 2010.

[11] Pakistan Remittance Initiative (PRI) was launched by the Government of Pakistan with the purpose of facilitating faster and cheaper flow of workers' remittances into Pakistan. In particular, PRI includes (i) reimbursement by the Government of Pakistan through the SBP of 25 Saudi Riyal equivalent per transaction to banks in Pakistan so that no charges for remitting are asked of the remitter or the beneficiary; and (ii) reimbursement of some marketing expenses by banks to facilitate home remittance flows through official channels.

[12] Migrant Remittances, Dean Yang, *Journal of Economic Perspectives*, Vol. 25 (3), Summer 2011, pp. 129–152.

However, the strength of remittances could also reflect temporary factors. In particular, it may partly reflect the typical countercyclical behavior of remittances observed by Chami et al. (2009), especially following the earthquake in 2008 and the devastating floods in 2010.[1] In addition, roughly ¾ of Pakistan's remittances come from Saudi Arabia, the United Arab Emirates, the United States, and the United Kingdom, which makes them relatively dependant on the vagaries of local economic and financial developments (Figure 3). In particular, the relative stability of the Pakistan rupee against the U.S. dollar, coupled with relatively high domestic interest rates in Pakistan, may have resulted in higher-than-normal remittances. Kock and Sun (2011) also note that remittances have been supported by the relative return on investments in the host and home countries, including Pakistan's agricultural output. Moreover, the IOM's 2009 study notes in their household survey that close to 17 percent of remittances are used to finance real estate and agricultural machinery,

Figure 3. Sources of Remittances to Pakistan
(Percent of total)



Sources: State Bank of Pakistan; and IMF staff calculations.

while 21 percent goes to savings. In the event of a change in returns on investment in Pakistan, perhaps as a result of a significant change in monetary policy stance (e.g., a sharp decline in the policy rate as has occurred in October 2011), these remittances could decline abruptly. As seen recently, remittances can adjust quite rapidly, declining from US$1.3 billion in August 2011 to slightly below US$900 million in September.

Overall, there are some indications that the high level of remittances to Pakistan reflects fundamental factors. However, temporary factors may also have played a role, and may reverse, suggesting that a cautious approach should be taken to relying on remittances to safeguard external stability. Given the possible downside, the staff's macroeconomic framework for Pakistan forecasts only modest increases in remittances over the medium term.

[1] See "Macroeconomic Consequences of Remittances," Ralph Chami, Adolfo Barajas, Thomas Cosimano, Connel Fullenkamp, Michael Gapen and Peter Montiel, IMF Occasional Paper 259, 2008.

PAKISTAN

STAFF REPORT FOR THE 2011 ARTICLE IV CONSULTATION AND PROPOSAL FOR POST-PROGRAM MONITORING—INFORMATIONAL ANNEX

January 2012

Prepared By

Middle East and Central Asia Department
(In Consultation with Other Departments)

CONTENTS

ANNEX I: RELATIONS WITH THE FUND

(As of November 30, 2011)

Membership Status

Joined: 07/11/1950; Article VIII

General Resources Account

	SDR Million	Percent Quota
Quota	1,033.70	100.00
Fund Holdings of Currency	6,266.60	606.23
Reserve Tranche Position	0.12	0.01

SDR Department

	SDR Million	Percent Allocation
Net cumulative allocation	988.56	100.00
Holdings	686.66	69.42

Outstanding Purchases and Loans

	SDR Million	Percent of Quota
Stand-by Arrangements	4,936.04	477.51
Emergency Assistance	296.98	28.73
ECF arrangements 1/	284.26	27.50

1/ Formerly PRGF.

Latest Financial Arrangement

In millions of SDR, (mm/dd/yyyy)

Type	Approval Date	Expiration Date	Amount Approved	Amount Drawn
Stand-by	11/24/2008	09/30/2011	7,235.90	4,936.04
ECF	12/06/2001	12/05/2004	1,033.70	861.42
Stand-by	11/29/2000	09/30/2001	465.00	465.00

Projected Payments to Fund

(SDR million; based on existing use of resources and present holdings of SDRs)

	Forthcoming				
	2011	2012	2013	2014	2015
Principal	17.23	1,418.11	2,399.61	1,379.29	303.04
Charges/Interest		90.27	45.05	14.52	2.61
Total	17.23	1,508.37	2,444.65	1,393.81	305.65

Current Status of Safeguards Assessment

An update of the March 2009 safeguards assessment was completed in March 2010 in relation to the augmentation of access under the Stand-By Arrangement. The assessment found that: (i) efforts are continuing to strengthen the safeguards framework at the State Bank of Pakistan (SBP), including improved transparency and a more proactive role by the Audit Committee; (ii) the SBP's legal framework continues to present a safeguards risk due to unclear timetable for enacting amendments to the SBP Act; and (iii) the treatment and use of Fund resources for budgetary support has been clarified in an agreement between the SBP and the Ministry of Finance. The authorities have implemented some recommendations, but the latest amendment to the SBP Act does not cover safeguards risks raised in the previous assessments.

Exchange Rate Arrangement

On May 19, 1999, the dual exchange system was unified, with all international transactions conducted at the interbank market exchange rate (FIBR). The *de facto* exchange rate arrangement is classified as "floating". *De Jure* exchange rate arrangement is managed floating with no predetermined path. The SBP does not make any explicit or implicit commitment with respect to an exchange rate target or path. The SBP intervenes in the foreign exchange market, but does not publish information regarding its interventions. Pakistan has accepted the obligations of Article VIII, sections 2, 3, and 4. Pakistan is maintaining an exchange system free of restrictions on the making of payments and transfers for current international transactions.

Last Article IV Consultation

The last Article IV consultation (Country Report 09/123) was discussed by the Executive Board on March 23, 2009.

FSAP Participation and ROSCs

FSAP. The last FSAP was conducted in September 2008, however, the report was not published. The previous FSAP was conducted in February and April 2004. The report has been published and is available on the web through the following link:

http://www.imf.org/external/pubs/ft/scr/2004/cr04215.pdf

Monetary and Financial Policy Transparency and Data Dissemination. Data Module, Reassessment of Monetary Statistics and Detailed Assessment Using Quality Assessment Framework were completed in November 2006. The report has been published and is available on the web through the following link: http://www.imf.org/external/pubs/ft/scr/2007/cr0774.pdf. The previous data dissemination monetary and financial policy transparency ROSCs were conducted in December 2004 and July 2004, respectively.

Fiscal Transparency. The last updated report of the fiscal module on Observance of Standards and Codes for Pakistan was prepared in April 2008. The report has been published and is available on the web through the following link: http://www.imf.org/external/pubs/ft/scr/2008/cr08129.pdf. The original fiscal ROSC was conducted in November 2000 with a subsequent update in December 2004.

Resident Representative

In November 2011, Mr. Paul Ross ended his term as Resident Representative, but the office remains open. A successor to Mr. Ross is in the process of being selected.

Recent Technical Assistance

FAD

January 2002: Fiscal data management, quality, and transparency.
January 2003: Tax administration.
February/March 2003: Customs administration.
April 2004: Fiscal reporting.
April 2007: Public financial management.
July and November 2009: Valued Added Tax law.
July 2010: Review of Budgeting Accounting and Reporting System.

MCM

November/December 2004: Public debt reform and capacity building program (joint with World Bank).
March/April 2005: Development of the Insurance Sector.
December 2006: Monetary policy framework.
April 2007: Monetary policy framework, the SBP's balance sheet, and the Banking Services Corporation.
April 2011: Capital markets development issues.
October 2011: Stress testing framework.

STA

February 2002: External sector statistics/SDDS subscription.
April/May 2005: National accounts and consumer price statistics.
May 2007: Statistics on the international investment position.
October 2009: Multisector statistics (remote technical assistance).
March 2011: Price statistics.
January 2012: SDDS Assessment mission.

LEG

July 2008: Deposit Protection Fund.
July 2008: Central Bank Law.
August 2008: Banking Law.

ANNEX II: RELATIONS WITH THE WORLD BANK

(As of January 2012)

1. Pakistan is among the largest recipients of World Bank financial assistance. The World Bank Group program in Pakistan consists of an integrated package of financial support, including IBRD lending, concessional IDA credits, Trust Funds and Grants administered by the Bank on behalf of other development partners, Multi-Donor Trust Fund (MDTF) for Khyber Pakhtunkhwa (KP), Federally Administered Tribal Areas (FATA) and Balochistan, IFC investments, and MIGA guarantees, along with complementary analytical and advisory services.

2. The Country Partnership Strategy (CPS) outlines the Bank's strategic approach to helping Pakistan achieve its development goals over a four year period. The Bank Group's Board of Directors endorsed a Country Partnership Strategy for Pakistan on July 8, 2010, covering fiscal years 2010 through 2013. The goal of the strategy is to help steer Pakistan's economy back onto a path of high growth by addressing key long-term constraints to growth: weak revenue mobilization, unreliable energy supply, and a fragile security situation.

3. A CPS Progress Report was presented to the World Bank's Board on December 20, 2011. The Progress Report confirms that the overall strategic goal remains valid and consistent with the priorities of the Government of Pakistan as articulated in its New Framework for Growth Strategy (NFGS). The partnership remains centered on the existing strategic pillars of the CPS: economic governance; human development and social protection; infrastructure; and security and conflict risk reduction. It was agreed with the Government to extend the CPS period to include FY14.

4. The four strategic pillars of the CPS are described below:

- Improving Economic Governance. Addressing the shortcomings of Pakistan's economic management is critical not only for restoring macroeconomic stability but also for reducing the likelihood of reversals leading to another cycle of growth giving way to stagnation. Enhancing domestic revenue mobilization is an urgent priority for the Bank during the CPS period. Strengthening public expenditure management at all levels of government will complement this focus. The strategy also focuses on governance of markets with a view to strengthening Pakistan's competitiveness by addressing barriers to competition, and factor market rigidities (including constraints in access to finance).

- Improving Human Development and Social Protection. Improvement in human development, including social protection, is critical to the goal of building resilience at the level of families and individuals. The focus of Bank Group efforts is to support increased spending on human development along with reforms to improve governance and accountability in the provision of services. In education, the Bank supports government programs that combine supply side interventions and demand-side measures to improve access to education with a focus on equity to address regional and gender imbalances. In social protection, the Bank is supporting the Benazir Income Support Program (BISP), the country's national safety net program with a focus on increasing its targeting efficiency and strengthening its operation. The Bank aims to scale up support to strengthen health management systems and improve service delivery. Given increased frequency of natural disasters, the Bank will bring additional focus and assistance on the Disaster Risk Management (DRM) agenda.

- Improving Infrastructure to Support Growth. Supply expansion and improving reliability and efficiency of power and gas systems are central to Pakistan's growth and development. At present, power is the most pressing need in infrastructure and the Bank Group supports adoption of policies that bring about financial sustainability, expansion of generation in a least cost manner, and improvement in the efficiency of transmission and distribution.

- Improving Security and Reducing the Risk of Conflict. The persistence of conflict in KP and FATA poses a threat to some of the most vulnerable and marginalized populations in Pakistan, while also challenging economic stability across the country. The Bank is seeking to help Pakistan cope with the consequences of conflict while reducing the prospects of future conflicts. The MDTF for KP, FATA and Balochistan is the Bank's principal instrument for strategic engagement in crisis hit regions in partnership with other development partners.

5. IFC is an integral part of the World Bank Group's program in Pakistan. The IFC strategy in Pakistan seeks to continue expanding investments in the sectors with the highest potential development impact and opportunities, including infrastructure (e.g. renewable energy, ports), financial markets (e.g. SME support through access to finance, housing finance), and manufacturing and services (e.g. agribusiness, technical education). IFC is also focused on successful implementation of its advisory programs designed to improve the business enabling environment, strengthen financial markets, and support development of small businesses.

6. Pakistan is also a focus country for MIGA, where it has already provided guarantees in hydropower and microfinance. Going forward, MIGA's strategy seeks to support investments into IDA countries, South-South investments, complex infrastructure projects, and investments into conflict-affected areas.

7. Going forward, the Bank's key principles of engagement in Pakistan include (i) delivering fewer but larger operations to allow the Bank to focus its limited resources on strategic areas where the needs are the greatest; (ii) increasing the use of performance-based instrument; (iii) strengthening attention to implementation, results and communications; (iv) deepening the engagement with the provinces, which will require significant attention to capacity support; (v) leveraging partnerships for shared objectives; and (vi) for MDTF, start small and scale up success. The Bank does not expect to provide policy support in the near term given the weak conditions for macro-economic reform, but will remain engaged in the critical issues of revenue mobilization and power through analytical work, ongoing projects and exploring results based operations.

8. IBRD/IDA financial operations since FY2006 are summarized below:

Pakistan: World Bank Group Financial Operations

(In millions of U.S. dollars)

	FY2006	FY2007	FY2008	FY2009	FY2010	FY2011
Commitments						
IBRD	315	100	174	0	0	261
IDA	1,161	726	296	1,609	300	1,292
Disbursements						
IBRD	149	154	56	91	86	34
IDA	1,061	1030	267	848	697	773
Repayments						
IBRD	289	265	270	253	205	158
IDA	117	170	143	224	165	169

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emarinova@worldbank.org.

ANNEX III: RELATIONS WITH THE ASIAN DEVELOPMENT BANK

(As of January 2012)

1. Pakistan is a major recipient of financial support from the Asian Development Bank. Since 1968, the ADB has provided more than $20 billion in assistance through the highly concessional Asian Development Fund (ADF) window and the Ordinary Capital Resources (OCR) window.

2. The ADB's Board of Directors endorsed the Country Partnership Strategy (CPS) covering the years 2009-2013 in January 2009. Consistent with the ADB's long-term strategic framework (Vision 2020), the CPS has the overarching objective of supporting sustainable and inclusive growth in Pakistan as a means of reducing the incidence of poverty and improving welfare. The CPS outlines the ADB's strategic approach to assisting Pakistan in achieving its development goals over the five year period by facilitating structural change, investment and institutional effectiveness.

3. The main areas of current ADB operations in Pakistan reflect the CPS 2009-2013: (i) energy; (ii) infrastructure investments in transport, logistics and irrigation; (iii) reforms in key sectors including energy, finance, agriculture and industry; and (iv) urban services, including water, waste management and transport.

4. Much of ADB lending is under the multi-tranche financing facility (MFFs). At present, there are 8 active MFFs: energy (4, $2.89 billion total); transport (2, $1.67 billion total); irrigation (1; $900 million) and urban services (1, $300 million). Of the total $5.76 for all eight MFFs, $2 billion has been committed for subprojects and tranches, with $3.7 billion available for new projects in these sectors. For 2011, we have also approved two more periodic finance requests (PFR) in the power and irrigation sectors, for a combined amount of about $500 million.

5. The current portfolio is comprised entirely of projects, with a total value of about $3.0 billion, with energy accounting for the largest share ($1.1 billion), followed by emergency assistance (earthquake, floods $1 billion), agriculture and irrigation ($396 million), transport ($400 million), and other ($45 million).

6. In addition to its activities in the areas outlined above, the ADB has provided trade finance support to nine Pakistani banks under its Trade Finance Facilitation Program (TFFP). To date, the TFFP has supported over $2.0 billion in trade in Pakistan through the provision of guarantees, working through 13 participating and 3 issuing banks in Pakistan.

- Post Conflict Needs Assessment for Khyber-Pakhtunkhwa and FATA (September 2010) jointly with the World Bank, European Union and United Nations
- Damage and Needs Assessments (2009, 2010, 2011) jointly with the World Bank
- Co-Chair of the Friends of Democratic Pakistan Energy Sector Task Force, which

produced the Integrated Energy Sector Report and Recovery Plan (2010).

- Co-Chair of the ongoing Friends of Democratic Pakistan Water Sector Task Force (report due December 2011)

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ANNEX IV: STATISTICAL ISSUES

As of December 12, 2011

I. Assessment of Data Adequacy for Surveillance
General: Data provision has some shortcomings, but broadly adequate for surveillance.
National Accounts: In 2004, the Federal Bureau of Statistics (FBS) completed a revision of the national accounts statistics to bring them in line with the concepts and definitions of the 1993 System of National Accounts (1993 SNA). As noted by the December 2004 data ROSC, informal economic activities need to be better captured, while newly emerging activities, such as in the information technology sector, continue to pose challenges. The FBS is currently working on producing quarterly national accounts (QNA), which would be completed with a rebasing of the national accounts to the year 2005/06. With respect to labor market statistics, the FBS has now compiled and started releasing quarterly employment/ unemployment data, the first release being in February 2011 and included 5 years of historical data and is investigating the feasibility of disseminating data on wages/salaries. **Price statistics:** The FBS produces three price indices: the CPI, the wholesale price index (WPI), and the sensitive price indicator (SPI). The CPI and WPI are compiled on a monthly basis. The SPI is compiled on a weekly basis and consists of 46 essential commodities that are consumed by the lowest income group. The concepts and definitions of the CPI and WPI follow international guidelines. FBS introduced the classification of individual consumption by purpose (COICOP) with rebasing of the indices to 2007/08 in August 2011. Aside from the implementation of COICOP, changes to the CPI included updated weights, and expanded item and geographic coverage. These changes reflect international recommendations and best practices. Plans have been made to complete the work to develop a Producer Price Index (PPI); IMF is providing technical assistance in this regard.
Government finance statistics: The concepts and definitions used in compiling government finance statistics are broadly based on the GFSM 1986, except that privatization proceeds are included below the line. The scope of central government data is further limited because it does not cover the activity of extra budgetary funds. Classification and sectorization in source data follow GFSM 1986 standards to a limited extent. The classification of expenditure deviates from GFSM 1986 methodology because the economic and functional classifications are mixed in reporting, in particular, with defense and government administration expenditures not clearly identified according to economic classification. The basis of recording GFS is on, or close to, a cash basis. Transactions are recorded on a gross basis. Corrective transactions are not necessarily made in the original period, as required by GFSM 1986. The authorities have indicated their intent to adopt the methodology of GFSM 2001 over the medium term, and in line with the Board decision (No 14656 of October 2010) to strengthen fiscal analysis, they have compiled with staff assistance fiscal table in GFSM 2001 presentation. However, further improvements in government finance statistics are needed and the authorities are making progress toward that objective in the context of the Project for the Improvement of Financial Reporting and Auditing

(PIFRA). Budgetary central government operations data are regularly reported for publication in the GFS Yearbook, and use the GFSM 2001 framework. However, no data are reported on transactions in nonfinancial and financial assets and liabilities. The authorities do not report higher frequency data for inclusion in the IFS.

Monetary statistics: The ROSC mission found that the scope of the monetary statistics is comprehensive. The classification and sectorization of the monetary survey compiled by the State Bank of Pakistan's (SBP) Statistics Department for reporting to the IMF and for internal use are broadly in line with the *Monetary and Financial Statistics Manual (MFSM)*. The basis for recording flows and stocks is largely consistent with the *MFSM*, and the SBP has indicated its intention to adopt the *MFSM* in order to further improve monetary statistics. The ROSC mission that conducted the reassessment of monetary statistics in November 2006 found that the authorities had implemented the *MFSM* guidelines on the sectorization of institutional units, classification of financial instruments, and the recording of securities repurchase agreements (repos). Also, a new reporting framework for other depository corporations has been designed and is being implemented. Progress has been made in resolving discrepancies in the data on interbank positions between the SBP and scheduled banks. The SBP has reported the Standardized Report Forms for central bank (1SR), other depository corporations (2SR), and monetary aggregates (5SR) to the Fund for publication in the IFS.

Balance of payments: Starting in the third quarter of 2003 (July–September), Pakistan's balance of payments statements have been prepared according to the methodology of the Balance of Payments Manual, fifth edition (BPM5). A 2007 Fund technical assistance mission made recommendations to more closely align some recording practices with the BPM5, including in the areas of residency, sectorization, and consistency across related data sets. Based on these recommendations, a number of improvements have been made. Differences between the two sources of trade data (customs records for FBS and exchange records for SBP) for exports and imports have been widening. Most of the differences can be reconciled ex post (see SBP's Second Quarterly Report for FY2006), and the authorities are working to narrow these differences before the publication of the data.

International investment position: Annual international investment position data are compiled and published on the SBP website. Since 2010 SBP has also started publishing quarterly data on international investment position. Annual data are available back to 2003.

II. Data Standards and Quality

Pakistan participates in the General Data Dissemination System (GDDS) since 2003, meeting the recommendations for the coverage, periodicity, and timeliness of most GDDS data categories. Authorities are keen to subscribe to the Special Data Dissemination Standard (SDDS), and an SDDS assessment mission is scheduled in January 2012. For	The Report on the Observance of Standards and Codes (ROSC)—Data Module, a Response by the Authorities, and a Detailed Assessment Using the Data Quality Assessment Framework (DQAF) were published on the IMF website in December 2004. A ROSC reassessment focusing on monetary statistics was conducted in November 2006 and published on the IMF

subscription to the SDDS, Pakistan will need to disseminate (a) monthly data on central government operations with a timeliness of one month; (b) quarterly data on the national accounts, employment and unemployment, wages/earnings, and external debt, all with a timeliness of one quarter; (c) more detailed breakdown of data on central government debt and external debt; and (d) update and expand the metadata on compilation and dissemination practices.	website in February 2007. An update to the ROSC on fiscal transparency was published on the IMF website in April 2008.

PAKISTAN: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE

AS OF DECEMBER, 2011

	Date of latest observation	Date received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of publication[7]	Memo: Data Quality – Methodological Soundness[7]	Memo: Data Quality Accuracy and Reliability[8]
Exchange Rates	real time	real time	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Oct. 2011	Nov. 2011	M	M	M		
Reserve/Base Money	Oct. 2011	Nov. 2011	M	M	M	O, O, O, LO	O, O, O, O, LO
Broad Money	Oct. 2011	Nov. 2011	M	M	M		
Central Bank Balance Sheet	Nov. 2011	Dec. 2011	M	M	M		
Consolidated Balance Sheet of the Banking System	Nov. 2011	Dec. 2011	M	M	M		
Interest Rate[2]	Nov. 2011	Dec. 2011	M	M	M		
Consumer Price Index	Nov.2011	Dec.2011	M	M	M	O, LO, LO, O	O, LO, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Sep.2011	Nov.2011	Q	Q	Q	LO, LO, LNO, LO	O, O, LO, LO, LO
Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government	Sep.2011	Nov.2011	Q	Q	Q		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Sep. 2011	Nov. 2011	Q	Q	Q		
External Current Account Balance	Oct.2011	Nov.2011	M	M	M	LO, LO, LO, O	O, O, O, O, LNO
Exports and Imports of Goods and Services	Oct.2011	Nov.2011	M	M	M		
GDP/GNP	2010/11	Jul. 2011	A	A	A	LO, LNO, LO, LO	LNO, LNO, O, LNO, O
Gross External Debt	Oct.2011	Nov.2011	M	M	M		
International Investment Position[6]	Mar.2011	Aug. 2011	A/Q	A/Q	A/Q		

[1] Any reserve assets that are pledged or otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means.

[2] Both market-based and officially determined, including discounts rates, money market rates, rates on treasury bills, notes and bonds.

[3] Foreign, domestic bank, and domestic nonbank financing. Only Federal Board of Revenue's outcome is received on monthly basis

[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.

[5] Including currency and maturity composition.

[6] Includes external gross financial asset and liability positions vis-à-vis nonresidents.

[7] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A), Irregular (I); or Not Available (NA)

[8] Reflects the assessment provided in the data ROSC published in December 2004 and its update published in February 2007, and based on the findings of the missions that took place during December 1–16, 2003 for the dataset corresponding to the variable in each row, and during November 1–15, 2006 for monetary statistics, respectively. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O), largely observed (LO), largely not observed (LNO), or not observed (NO).

[9] Same as Footnote 8, except referring to international standards concerning (respectively) source data, assessment of source data, statistical techniques, assessment and validation of intermediate data and statistical outputs, and revision studies..

Public Information Notice (PIN) No. 12/10
FOR IMMEDIATE RELEASE
February 6, 2012

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2011 Article IV Consultation and Proposal for Post-Program Monitoring with Pakistan

On February 3, 2012, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation and Proposal for Post-Program Monitoring with Pakistan.[1]

Background

Pakistan has faced difficult challenges in the past few years, including external and domestic economic shocks, political uncertainty, and security problems. Despite these challenges, the economic policymakers have taken policy actions and implemented several reforms, including those under the recently expired Stand-By Arrangement, which helped the economy avoid a full-blown crisis in 2008/09. These actions and reforms include establishment of an interest rate corridor, implementation of a more market-based exchange rate regime, and a strengthening of the enforcement powers of the State Bank of Pakistan (SBP). In addition, the authorities substantially raised electricity tariffs and domestic prices of the main petroleum products, and the Benazir Income Support Program (BISP) provided basic income support to the poor during the various shocks that have hit Pakistan.

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

More recently, however, unresolved structural problems (especially in the energy sector), two major floods, difficulties in implementing key policy reforms, and a more challenging global environment have combined to limit growth and employment creation and made the economy highly vulnerable, with few buffers to absorb shocks. Indeed, economic performance has weakened and external pressures are mounting. In 2010/11,[2] real GDP expanded by 2.4 percent—far below the estimated 7 percent required to absorb the two million new labor market entrants annually—with inflation persistently in double digits. Unemployment is high when underemployment and unpaid employment are taken into account, while poverty incidence and measures of human development are at worrisome levels. Efforts to boost revenue mobilization were once again frustrated by a lack of political support, and the fiscal deficit widened to 6.6 percent of GDP in 2010/11. Monetary policy has become more accommodative, with the SBP directly or indirectly (through liquidity injections via open market operations) financing fiscal deficits. While the economy is recovering from the floods, the external position, until recently a source of strength on booming exports and workers' remittances, is deteriorating. The rupee has come under some pressure, prompting SBP exchange market intervention. The SBP's foreign exchange reserves have declined by about $2 billion in the last six months.

On current policies, Pakistan's near- and medium-term prospects are challenging. Growth would remain too low to absorb the large number of new entrants into the labor force, inflation would remain high, and the external position would weaken further. In 2011/12, real GDP growth is projected at 3.4 percent and average CPI inflation at 12 percent. A deterioration in the current account balance due to lower cotton/textile prices and a sharp slowdown in remittances growth, continued difficulties in attracting external financing, and the beginning of repayments to the IMF will likely put further pressure on the balance of payments this year, with reserves projected at $12.1 billion by end 2011/12. In the absence of corrective measures, the fiscal deficit is likely to reach 7 percent of GDP, much higher than the government's revised budget target of 4.7 percent. Moreover, there are considerable downside risks to this already difficult baseline, particularly in the context of an increasingly difficult global environment and concerns about policy weakening ahead of senate elections in 2012 and parliamentary elections in 2013.

[2] The fiscal year runs from July 1 to June 30.

Executive Board Assessment

Executive Directors noted that Pakistan continues to fall short of its economic potential, and called for a reorientation of macroeconomic and structural policies to stem near-term risks to macroeconomic stability, and to lay the foundation for durable and inclusive growth over the medium term.

Directors welcomed the authorities' intention to reduce the fiscal deficit in order to preserve macroeconomic stability and reconstitute policy buffers. They encouraged the authorities to take more resolute action to mobilize revenues and rationalize public expenditure. In particular, Directors saw merit in further broadening the tax base, restructuring public enterprises, eliminating poorly targeted subsidies, and phasing out commodity procurement operations. They also recommended strengthening the framework for fiscal devolution and the incentives for provincial governments to raise revenue.

Directors stressed that monetary and exchange rate policies need to better focus on containing inflation and external risks. Monetary policy is now too accommodative, and should be tightened if inflation or external pressures increase. Central bank financing of the budget needs to be curtailed, and greater operational independence of the central bank needs to be secured. Directors also called for more exchange rate flexibility to facilitate external adjustment and safeguard foreign reserves.

Directors noted the adequate capitalization of banks, but considered that rising non-performing loan ratios and other weaknesses in banks' balance sheets present risks to financial stability. Accordingly, they called for stronger supervisory oversight, improved mechanisms for resolving problem banks, and the prompt establishment of a bank-financed deposit insurance scheme. Directors also urged the authorities to address long-standing deficiencies in the regulatory regimes against money laundering and terrorism financing.

Directors welcomed the recent adoption of the New Growth Strategy to guide structural and institutional reforms on a variety of fronts. They endorsed the authorities' objective of further developing private sector's participation in the economy. They attached high priority to improving the business environment, boosting external competitiveness, and upgrading the power sector to remove its burden on the public finances and provide a reliable electricity supply to support growth. Directors welcomed the authorities' decision to subscribe to the Fund's Special Data Dissemination Standard.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

Table 1. Pakistan: Selected Economic Indicators, 2008/09–2011/12 1/

(Population: 173.5 million (2010/11))

(Per capita GDP: US$1,179 (2010/11))

(Poverty rate: 17.2 percent (2007/08))

			Estimate	Projection
	2008/09	2009/10	2010/11	2011/12
	(Annual percentage change)			
Output and prices				
Real GDP at factor cost	1.7	3.8	2.4	3.4
GDP deflator at factor cost	20.0	11.9	18.8	12.0
Consumer prices (period average) 2/	17.6	10.1	13.7	12.0
Consumer prices (end of period) 2/	9.6	11.8	13.3	11.0
Pakistani rupees per U.S. dollar (period average)	25.8	6.7	2.3	…
	(In percent of GDP)			
Saving and investment				
Gross saving	12.5	13.1	13.6	11.4
Government	-2.1	-2.4	-3.6	-3.6
Nongovernment (including public sector enterprises)	14.5	15.5	17.2	15.0
Gross capital formation 3/	18.2	15.4	13.4	13.4
Government	3.1	3.5	2.6	3.1
Nongovernment (including public sector enterprises)	15.1	11.9	10.8	10.3
Public finances				
Revenue and grants	14.7	14.4	12.8	12.7
Expenditure (including statistical discrepancy)	19.9	20.3	18.9	19.5
Budget balance (including grants)	-5.2	-5.9	-6.1	-6.7
Budget balance (excluding grants)	-5.3	-6.2	-6.6	-6.9
Primary balance	-0.2	-1.6	-2.3	-2.9
Total general government debt 4/	60.7	61.5	60.1	61.7
External general government debt	30.4	30.1	26.8	24.9
Domestic general government debt	30.3	31.4	33.3	36.9
	(Annual changes in percent of initial stock of broad money, unless otherwise indicated			
Monetary sector				
Net foreign assets	-3.2	0.5	4.1	-3.3
Net domestic assets	12.8	11.9	11.8	18.2
Broad money	9.6	12.5	15.9	14.9
Reserve Money	1.9	11.4	17.1	13.3
Private credit (percentage change)	0.7	3.9	4.0	3.4
Six-month treasury bill rate (period average, in percent)	13.1	12.2	13.7	…
External sector				
Merchandise exports, U.S. dollars (percentage change)	-6.4	2.9	29.3	-1.8
Merchandise imports, U.S. dollars (percentage change)	-10.3	-1.7	14.5	9.2
Current account balance (in percent of GDP)	-5.7	-2.2	0.2	-2.0
	(In percent of exports of goods and services, unless otherwise indicated)			
External public and publicly guaranteed debt	182.2	177.3	153.4	158.5
Debt service	21.6	23.0	13.8	18.3
Gross reserves (in millions of U.S. dollars) 5/	9,110	12,958	14,784	12,086
In months of next year's imports of goods and services	2.9	3.6	3.7	2.9
Memorandum items:				
Real effective exchange rate (annual average, percentage change)	-2.1	1.0	6.1	…
Terms of trade (percentage change)	1.9	4.5	-3.2	…
Real per capita GDP (percentage change)	-2.6	1.6	0.3	1.3
GDP at market prices (in billions of Pakistani rupees)	12,724	14,837	18,063	20,918
GDP at market prices (in billions of U.S. dollars)	161.8	176.9	210.6	233.5

Sources: Pakistani authorities; and IMF staff estimates and projections.

1/ Fiscal year ends June 30.

2/ Inflation after 2009/10 based on new CPI weights, recalculated in September 2011.

3/ Including changes in inventories. Investment data recorded by the Pakistan Federal Bureau of Statistics are said to underreport true activity.

4/ Excludes military debt, and commercial loans.

5/ Excluding gold and foreign currency deposits of commercial banks held with the State Bank of Pakistan.

Statement by Jafar Mojarrad, Executive Director for Pakistan and Muhammad Sethi, Senior Advisor to Executive Director
February 3, 2012

Our Pakistani authorities would like to thank staff for their engagement, hard work and advice. Discussions during the Article IV mission were helpful and constructive. The authorities broadly concur with the general thrust of the report, including staff assessment of current challenges and the policy recommendations, even though they have somewhat more nuanced views than staff on the extent of vulnerabilities.

Pakistan has braved economic, security and political challenges since the present elected government took office in early 2008. At a time when Pakistan, a non-oil producer and net food importer, was severely hit by the global recession and the food and oil price shocks, the authorities, with Fund support under the SBA, embarked on a bold stabilization and reform program that has helped mitigate the impact of the shocks and achieve significant gains in macroeconomic and financial stability, as well as in economic growth and the fight against poverty. Unfortunately, the devastations caused by two major floods together with resurgence of oil price shock, and continued difficult security situation, deprived the authorities of the needed support and consensus to persevere with the program. However, while the arrangement ended in September 2011, the authorities have remained steadfast in implementing structural reforms while attempting to stabilize the macroeconomic situation. They are also committed to follow the alternative reform scenario over the medium term.

The authorities are cognizant of the need to address political uncertainties and structural impediments to growth, including restoring fiscal sustainability and strengthening and deepening the financial sector, which would guide them towards a sustainable and higher growth trajectory. Enhancing revenues, improving expenditure management and prioritization, restructuring public sector enterprises and resolving problems in the energy sector are key areas of reforms to spur growth, as is improving the business environment for private sector development, including by upgrading infrastructure. Through these policies, the authorities remain committed to improving the lives of the Pakistani people, in particular the most vulnerable segments of the society. The new growth strategy (NGS) recently adopted by the government aims at increasing growth performance in the medium term, well above levels achieved in recent years, so as to absorb the rapidly rising youth labor force. As indicated in Box 1, the NGS identifies the main impediments to growth and advocates close cooperation between the government and the private sector in addressing them.

Economic developments and policies

The economy suffered a significant supply shock in the aftermath of devastating floods in 2010 and 2011, resurgence of the oil shock in November 2010 onward and massive disruptions in energy supply. Deteriorating global conditions and outlook and negative spillovers from the European debt crisis also impacted debt and fiscal sustainability. In addition, security challenges in the region have exacted an extremely high cost on the economy, both as direct costs of the fight against extremism as well as a knock on effect on investment inflows and market confidence. Pakistan has borne a significant collateral impact in terms of the squeezing of fiscal space for critical development and social sector expenditures. As such, deceleration in growth reflects both internal and external headwinds.

Despite these challenges, based on the data available for the first six months of the current fiscal year, there are signs of economic recovery led by agriculture and manufacturing. Thus, economic growth is expected to move closer to the budgeted 4.2 percent. As a result of improvement in supply conditions and restrained monetary growth, inflation is on a declining trend, as reflected in Figure 2 of the staff report, reaching 9.7 percent in December 2011 from 15.5 percent in December 2010.

While fiscal consolidation remains a fundamental challenge, efforts are under way for enhancing revenue mobilization through tax administration efficiency gains and for strengthening expenditure management. The authorities are cognizant of the fact that broadening the tax base through additional revenue measures would help ensure long-term fiscal sustainability. To this end, major reforms have been undertaken by the Federal Board of Revenue (FBR) by bringing in untaxed sectors into the net. Major sales tax exemptions and zero-ratings have been withdrawn and exemptions have been restricted to food, health, education, and agriculture. Improved compliance through better monitoring and risk-based audit has helped detect non-payments and irregular input adjustments of sales tax. A fully automated refund processing system has also been rolled out for taxpayers.

As a result of these measures, revenue collection by FBR during the first half of FY12 indicates an increase of 27.1 percent over the corresponding period in FY11, and the authorities consider that a significant part of this improvement is structural and not a one-time phenomenon. Similarly, total expenditure during July–December 2011 amounted to 45 percent of the budget instead of the allocated 50 percent. This is reflective of the tight fiscal discipline being maintained by the authorities who are confident that maintaining current trends would help them achieve fiscal targets for the year, even though they recognize that the task will not be easy. They are also committed to bringing the deficit down to 3 percent of GDP over the medium term.

Monetary policy conduct has helped inflation to decline during most of 2010, with core inflation falling sharply towards the end of 2011. Our authorities are preemptively assessing monetary conditions and would only loosen policy stance once inflation is on a firm declining trend. Going forward, efforts would continue to be made towards better coordination between the Ministry of Finance and the SBP to maintain an effective monetary policy. Further, the staff report in Figure 2 shows that 30–day moving average of daily net purchases and sales of foreign exchange by the SBP has hovered close to zero since July 2009 suggesting that the authorities are committed to maintaining exchange rate flexibility while safeguarding reserves.

During FY11, the external sector benefited from high international commodity prices and buoyancy in workers' remittances. As a result, for the first time in six years, the current account was in surplus. While exports expanded both in terms of volume and price, growth in workers' remittances was boosted by increasing use of banking instead of informal transfer channels. Authorities expect receiving significant foreign inflows from the auction of 3G mobile licenses in March 2012 and part of the Coalition Support Fund (CSF) due. They recognize that risks to the external sector emanating from the Euro area are real but would have moderate fallout on Pakistan except through yet another oil shock.

Structural reforms

The authorities continue the process of structural reforms, focusing on power sector and three key Public Sector Enterprises (PSEs). As mentioned in the Staff report, having vigorously pursued and institutionalized tariff rationalization, electricity tariffs have been raised by ninety percent since 2008. The focus now under the Power Sector Recovery Plan 2011 is towards improving governance and financial restructuring, including by facilitating recovery of Federal and Provincial government arrears and enforcing collection from the private sector and PSEs. Together with an ambitious investment program, this will help improve supply conditions and reduce the budgetary burden. Governance reforms and restructuring plans have also been adopted and are being implemented for the steel mill, railways, and airlines companies, which should strengthen their financial position and pave the way for consideration of future options. In the external sector, recent steps to promote trade and economic ties between Pakistan and India are important steps towards strengthening regional cooperation and fostering export growth as highlighted in the report.

Fiscal reforms addressing both revenue and expenditure are key to achieving the authorities' fiscal consolidation targets. Tax reform will focus on simplification of the system and improved administration, along with continued reduction in exemptions. Renewed efforts will also be made toward reaching a consensus on a reformed GST. On the expenditure side, key reforms include the medium-term budgetary framework (MTBF) and the project to improve financial reporting and auditing (PIFRA). A Budget Strategy Paper has been introduced to monitor government performance under output based budgeting. After approval of the Cabinet, the authorities have placed the MTBF before the parliament, as required under the Fiscal Responsibility and Debt Limitation Act 2005.

With regard to fiscal decentralization, the authorities agree that there are many challenges and issues requiring attention. These relate to assignment of responsibilities, building capacity, and raising own-source revenues, which are critical for sustaining macroeconomic stability and managing risks and costs of fiscal decentralization during its infancy. The authorities have already requested technical assistance from the Fund, which hopefully would help manage transition and contribute to addressing these challenges.

The authorities are resolved to further strengthen the financial sector, including through enhanced supervision, financial deepening, and increased competition. While capital adequacy levels are strong as highlighted in the staff report, the authorities agree with staff that further steps are needed to strengthen bank supervision and reduce NPLs. However, while gross NPLs are generally expected to rise in the context of a low growth and declining private lending environment, strong supervision and provisioning requirements should help mitigate risks. As regards the relatively low private sector credit, despite weak external demand for textiles, the increase in private sector credit during FY12 is encouraging.

Ensuring that the financial system is in compliance with international standards is crucial. With the enactment of the Anti-Money Laundering Bill in March 2010, the authorities are addressing the deficiencies in the AML/CFT regime, and are bringing it in compliance with FATF standards. A Financial Monitoring Unit has been established and made fully operational. Further, the money exchange companies have been brought under the regulatory fold of the SBP, with on-sight inspections by the law enforcement agencies. Notwithstanding the wide-ranging scope of terrorist financing legislation, the authorities have agreed with FATF to further strengthen existing provisions on criminalization of terrorist financing as well as confiscation of assets. The authorities remain committed to fight terrorism in any form.

Debt sustainability

The authorities are committed to continue to improve debt indicators so as to preserve debt sustainability. The public and external debt-to-GDP ratios are expected to decline in the baseline scenario over the medium term and, even under the combined shock scenario, these ratios are projected only marginally higher than the baseline (Figures 4 and 5). Moreover, the level of external debt projected at around 25 percent for end 2015 is well below emerging markets average. Further, the debt vulnerability appears subdued, with gross financing needs indicating a declining trend, as none of the shocks show a rising debt to GDP ratio (Figure 5).

Besides, even though gross international reserves (GIR) in percent of short-term (ST) debt at remaining maturity is projected to fall in FY12–13, it remains above 100 percent and is projected to increase significantly in outer years (Table 8). However, the authorities intend to follow prudent borrowing and improve assets/liabilities management to mitigate potential risks in this area.

Conclusion

Our authorities remain committed to sound macroeconomic management and to implementing structural reforms despite the expiration of the arrangement with the Fund. This would preserve macroeconomic stability and help harness the growth potential of the economy as aptly pointed out by staff in their appraisal. This is all the more crucial in the run up to the senate and parliamentary elections. They also look forward to continued close cooperation and engagement with the Fund, including in the context of post-program monitoring.