

**EXECUTIVE  
BOARD  
MEETING**

EBS/22/75  
Correction 1

**CONFIDENTIAL**

August 25, 2022

To: Members of the Executive Board

From: The Secretary

Subject: **Pakistan—Seventh and Eighth Reviews Under the Extended Arrangement Under the Extended Fund Facility; Requests for Waivers of Nonobservance of Performance Criteria, and for Extension, Augmentation, and Rephasing of Access**

Board Action: The attached corrections to EBS/22/75 (8/16/22) have been provided by the staff:

**Evident Ambiguity** **Pages 7, 18 (para. 23, line 7, "at end-June 2022")**

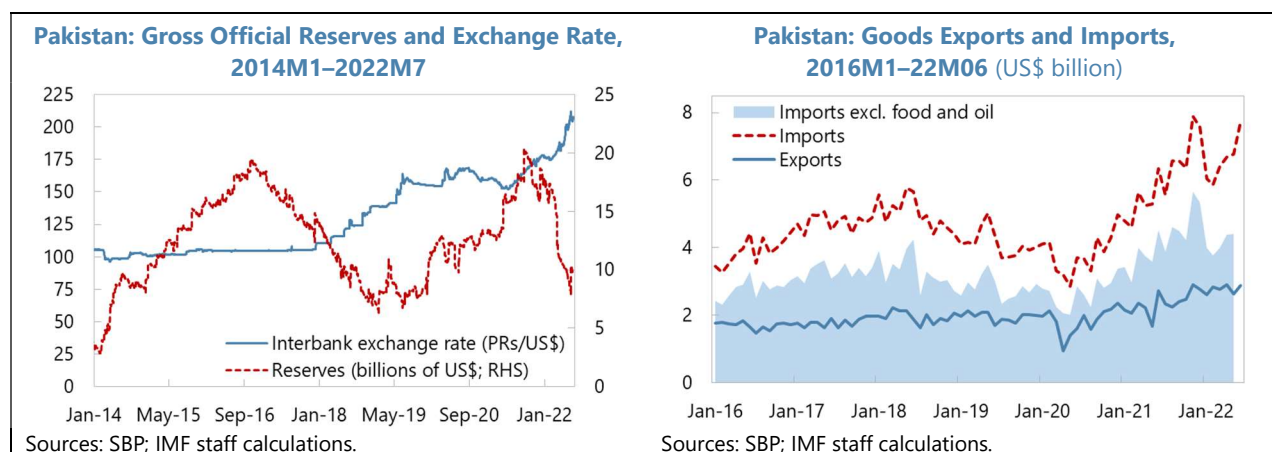
**Factual Errors Not Affecting the Presentation of Staff's Analysis or Views** **Pages 5, 12, 18 (para. 23, line 7, "17.4"), 76**

Questions: Mr. Porter, MCD (ext. 37316)  
Ms. Gerling, MCD (ext. 39733)  
Mr. Acevedo, MCD (ext. 38792)  
Mr. Moeller, MCD (ext. 36814)



growth to 6 percent (authorities' provisional estimate) in FY22 but also led to high and rising inflation (21.3 percent in June).<sup>1</sup> Private credit growth also picked up sharply during FY22, reaching 24 percent growth y-o-y in May 2022 amid strong demand for business credit.

**5. Worsening external conditions, due to spillovers from Russia's war in Ukraine, are compounding domestic challenges.** In the first 11 months of FY22, the trade deficit widened to a record US\$40.1 billion (10.7 percent of GDP) despite robust export growth (25 percent y-o-y). Imports surged dramatically, on the back of continued robust growth in non-oil imports and a 86-percent rise in fuel imports reflecting both higher prices and volumes. The widening trade deficit was only partially offset by remittance inflows (around US\$2.5 billion per month). As a result, the current account deficit widened to about US\$15 billion (4.5 percent of GDP) in FY22, a five-fold increase over FY21.<sup>2</sup> Gross reserves declined from US\$17.6 billion at end-December 2021 to US\$9.8 billion at end-June 2022, equivalent to about 1.5 months of imports coverage, due to **debt repayments and** frequent intervention by the SBP to mitigate exchange rate pressures. Faced with increasing inflationary pressures and eroded reserves, the SBP has hiked policy rates by 525 bps since December 2021 with the rupee seeing greater flexibility (depreciating around 30 percent in FY22). Risk premia have increased considerably, and the EMBIG spreads are close to 2,000 bps since mid-July. During FY22, Pakistan's economy has experienced little impact from COVID-19 waves, including the most recent Omicron wave in January–February 2022.



## PROGRAM PERFORMANCE

**6. Overall program performance has remained weak since the completion of the last review and until recently** (MEFP Tables 1–2). Several quantitative criteria were missed and gaps in implementing particularly the fiscal and structural reform agenda arose amid challenging

<sup>1</sup> Consumer's inflation expectations increased by 7.6 percent in July (relative to May), driven mostly by food inflation (8.7 percent increase), according to the SBP and the Institute of Business Administration survey.

<sup>2</sup> The external assessment published in the February 2022 Article IV suggests that the external position was broadly in line with fundamentals in FY21.

At the same time, the authorities missed seven SBs, as they granted further tax amnesties (*continuous SB*) and new preferential tax treatments (*continuous SB*), most of which lapsed in line with their embedded sunset clauses by the time of the FY23 finance bill (₹11). Their draft PIT law also deviated from the commitment during the sixth EFF review (*end-February 2022 SB*). Finally, despite significant progress in the face of capacity constraints, four SBs remain outstanding and, thus, will be reset (i.e., the parliamentary approval of the new state-owned enterprise (SOE) law, a plan for the phasing out of SBP refinance facilities, first-stage recapitalization of two private sector banks, and establishment of an asset declaration system).

## OUTLOOK AND RISKS

**7. Amid tighter macroeconomic policies and a challenging external environment, the ongoing expansion is set to moderate in FY23, yet risks remain high** (Text Table below and Tables 1–8).

	FY19	FY20	FY21	FY22	FY23	FY24	FY25	FY26	FY27
				Est.			Proj.		
Real GDP growth (%)	3.1	-0.9	5.7	6.0	3.5	4.2	4.6	5.0	5.0
Consumer prices (period average, % change)	6.7	10.7	8.9	12.1	19.9	10.0	7.7	6.5	6.5
Gen. gov. overall balance (incl. grants, %GDP)	-7.8	-7.0	-6.0	-7.0	-4.6	-4.0	-3.7	-3.5	-3.7
Gen. gov. primary balance (underlying, excl. grants, %GDP) 1/	-3.1	-1.6	-0.5	-1.6	0.4	0.5	0.6	0.6	0.2
Gen. gvt. debt (incl. guarantees and IMF obligations, %GDP)	82.0	84.5	77.9	78.9	72.1	66.9	65.3	62.4	60.7
Current account balance (%GDP)	-4.2	-1.5	-0.5	-4.7	-2.5	-2.5	-2.5	-2.5	-2.6
External debt (%GDP)	33.5	37.7	34.9	32.5	37.0	36.2	35.0	32.7	30.2
Gross official reserves (billions of US\$)	7.3	12.2	17.3	9.8	16.2	17.3	18.9	21.0	22.5
Gross official reserves (months of next year's GNFS imports)	1.7	2.4	2.5	1.5	2.2	2.3	2.4	2.4	2.5
Gross official reserves (% IMF reserve adequacy metrics) 2/	34.5	54.1	72.2	40.9	59.7	60.7	62.3	68.8	71.7

Sources: Pakistani authorities; IMF staff estimates and projections.  
 1/ Excludes one-off transactions, including asset sales. In FY21, it excludes PHPL debt clearance, IPP-related arrears clearance, and COVID-19 spending; in FY22, it excludes IPP-related arrears clearance and COVID-19 spending; and in FY23, it excludes IPP-related arrears clearance. 2/ Assumes a flexible exchange rate and no capital controls.

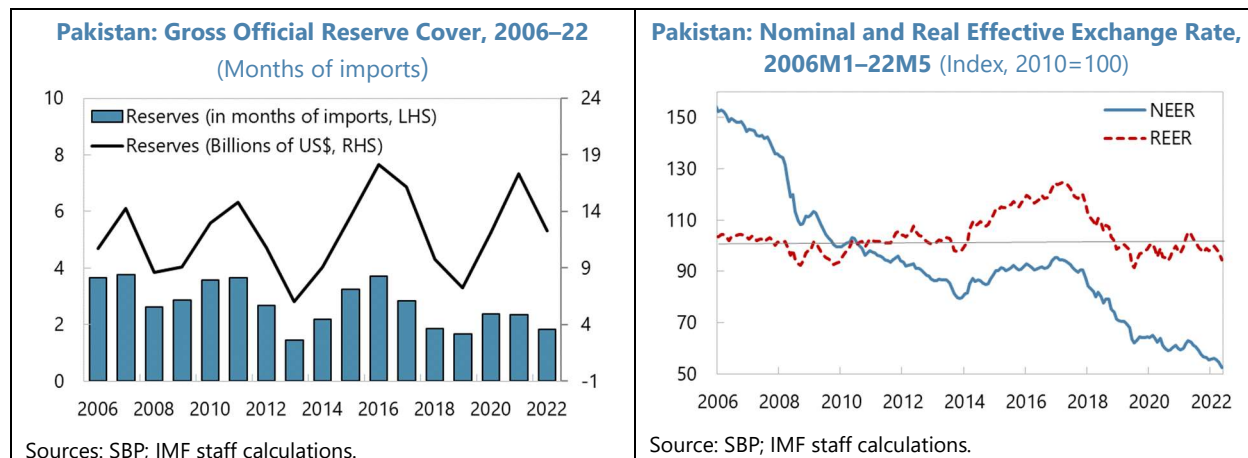
- **Real GDP growth** is projected to decelerate to 3.5 percent in FY23, following two years of above-trend growth as the economy recovered from the COVID-19 pandemic with support by expansionary policies. The pass-through of energy prices will have some dampening effect on activity while fiscal consolidation and the loss of purchasing power due to high inflation are expected to restrain domestic demand notably. Assuming sustained policy and reform implementation, growth is expected to gradually return to its medium-term potential of 5 percent.
- **Average CPI inflation** is expected to surge to 20 percent in FY23 as international commodity prices are passed on to domestic consumers. Core inflation is also projected to remain elevated due to higher energy prices and sizable depreciation. With tighter monetary and fiscal policies firmly entrenched, inflation is expected to fall significantly in FY24, supported by favorable base effects. The SBP is expected to reach its 5–7 percent inflation **target** range gradually with medium-term **inflation** slowing to 6.5 percent.

emphasized the importance of full normalization of fuel prices, including restoring the GST rate from its current level of zero.

- o *Other.* The government has recommitted to not launch any further tax amnesties or grant further tax exemptions or concessions through Statutory Regulatory Orders (SROs) without prior National Assembly approval. Work on the harmonization of service sales tax across provincial jurisdictions will continue with World Bank support.
- **Expenditures.**
  - o *Limiting non-social related spending.* The government has committed to limiting spending to 16.9 percent of GDP, with an additional 0.2 percent of spending to clear IPP arrears, and a contingency reserve of 0.25 percent of GDP has been budgeted to hedge against potential shocks. This accommodates salary and pension increases of 15 and 5 percent, already granted by the government. It also safeguards development spending to the FY22 levels (as a share of GDP).
  - o *Protecting social spending.* The authorities will continue to protect regular BISP spending on the most vulnerable (PRs 316 billion), including through the elevation of the related IT target to a QPC (₹18). They also reviewed their experience with some new programs outside of BISP and decided to (MEFP ¶14.c): (i) retire the Ehsaas Rashan Riyat Program (ERR) and re-focus food subsidies on the Utility Store Corporation (USC); and (ii) maintain as is the Kamyab Pakistan Program (KPP) for subsidized financing for SME, agriculture, and low-cost housing.
  - o *Phasing out untargeted post-tax fuel subsidies.* Following the removal of the price differential claim (post-tax fuel subsidy), the government has committed to fully passing through international oil price changes to consumers. In addition, once fuel taxation is returned to its reference level, the government plans to introduce an automatic pricing mechanism (MEFP ¶19.b).
  - o *Limiting power subsidies.* The federal government has reaffirmed that it is the only spending authority in the country to grant power subsidies (MEFP ¶19.b), which it will limit to PRs 570 billion (₹28) thanks to: (i) power tariff adjustments reducing the tariff differential subsidy (TDS) to PRs 225 billion; and (ii) lower remaining IPP/GPP payments (PRs 130 billion).
- **Other.**
  - o *Provincial fiscal targets.* The provinces have committed, through MOUs they have signed with the federal government in late-July 2022 (PA), to deliver their individual commitment to an aggregate provincial surplus of PRs 7450 billion. While this is a considerable increase from FY22, the central government is confident that the provincial authorities will exercise spending restraint, as needed, and deliver on their commitments. In this regard, quarterly data on fiscal outcomes from provinces will be shared with Staff to monitor implementation of provincial commitments and any likely impact on the Federal budget.
  - o *Revenue administration.* The authorities will seek to expand the PIT tax base by another 300,000 persons through the use of data on the withholding tax of businesses, third-party data, and physical surveys to book new individuals. They will also seek to bring the service

policy in a forward looking and data-driven way to achieve the inflation target range of 5–7 percent over the medium term. Staff and the SBP agreed that the pace of policy rate adjustment should consider the broader policy mix including the degree of fiscal adjustment. To enhance monetary policy transmission and strengthen governance, the authorities have agreed to continuing to reduce the interest rate subsidy provided via the refinancing facilities and phase out SBP’s involvement in these schemes over the medium term (MEFP ¶17), which have ballooned by almost 43 percent y-o-y and now account for 17.44 percent of private credit at end-June 2022. The authorities have advanced work on an initial plan in consultation with other stakeholders, and by bringing the pricing of these schemes closer to market rates will limit their demand and thus facilitate their phasing out with the activity transferred to an appropriate Development Finance Institution (DFI). The authorities have committed to prepare their transition plan by end-2022 (*end-April 2022 SB, reset to end-December 2022*). Finally, the SBP is also committed to managing banks liquidity in line with its monetary policy objectives.

**24. Commitment to maintaining a market-determined exchange rate remains essential to reduce external imbalances and start rebuilding reserves.** A market-determined exchange rate remains a key tool to act as a shock absorber, especially in the context of persistent terms-of-trade shocks and low reserve buffers. Notwithstanding the recent depreciation (text chart), going forward the authorities should continue to allow exchange rate flexibility and avoid suppressing any trend movement. Allowing a greater role for exchange rate flexibility to address external pressures will thus help safeguard and improve reserve buffers towards more prudent levels in line with program targets.



**25. The authorities have partially repealed the import ban on luxury and nonessential items in August 2022 and have committed to removing the remaining import ban, exchange restrictions, and the MCP when BOP conditions stabilize and before end-FY23** (MEFP ¶20). As external conditions became more precarious in FY22H2, the authorities introduced new exchange restriction and import restriction for BOP purposes; and modified one existing exchange restriction and the MCP. Specifically, in early April 2022 the authorities extended the set of items subject to a 100-percent cash margin requirement (CMR) on imports by 177 items, bringing the share of items covered by CMRs to about 20 percent of total import values and missing the relevant PCs on non-intensification of exchange restrictions and on non-modification of MCPs. In May 2022, the

demand for FX from external debt repayments and imports put pressure on the exchange rate, which depreciated by 16 percent between end-December 2021 and end-June 2022, while reserves have fallen to about 1.5 months of imports. In this context, we remain committed to the market determined exchange rate, which has served as an essential buffer protecting economic activity and reserves during this prolonged period of heightened uncertainty, while supporting the smooth function of the market. SBP's interventions will remain guided by market conditions and the objective of rebuilding reserve buffers to bring reserves up to a more prudent level of at least 2.2 months of import coverage by end-FY23 notwithstanding the difficult external environment. Forex sales will not be used to prevent a trend depreciation of the rupee driven by fundamentals.

- b. *Prudent and proactive monetary policy.*** Headline inflation reached 24.9 percent in July 2022 and core inflation is in excess of 10 percent, reflecting strong domestic demand and second-round effects of supply shocks. At the same time, measures of long-term inflation expectations have also ticked up. To ensure that inflation expectations remain anchored and prevent second-round effects becoming entrenched, we acted decisively in raising the policy rate by 125 bps to 15 percent on July 7, 2022, bringing the cumulative tightening since September 2021 to 800 bps. In addition to the policy rate increase, since April 7, 2022, we have also raised the interest rates on the two major refinancing schemes (EFS and LTFF) by 700 bps and 500 bps, respectively. To strengthen monetary policy transmission, these rates have been linked to the policy rate and will adjust automatically. Monetary policy decisions will continue to be guided by the primary goal of safeguarding price stability to ensure the program monetary targets are met and guide inflation to our medium-term objective of 5–7 percent, with the exact pace of future adjustments dependent on inflation data, exchange rate developments, the strength of the external position, and the fiscal-monetary policy mix.

**17. We recognize the need to take further steps to align more closely refinancing rates and market rates and to phase out SBP's involvement in the refinancing schemes.** As of end-~~May~~ ~~June~~ 2022, the outstanding amount for all facilities was PRs 1,607 billion, or 17.4 percent of private sector credit. Although our assessment of the Export Refinancing Scheme (EFS) in February 2022 found that this program boosts exports, we recognize that aligning refinancing rates closer to market rates should lift the efficiency of the use of these funds and help to allocate credit in a fairer, more transparent manner as beneficiary firms are generally large, well established, and concentrated in a few sectors, which already dominate access to private sector credit. In addition, raising refinancing rates reduces the subsidy requirement for operating the schemes outside of SBP's balance sheet (see below). To this end, we have reduced the gap between the policy rate and the interest rate on the LTFF/EFS facilities to 5 percentage points. We see that a clear dividing line between SBP operations and the refinancing schemes is imperative on governance grounds, allowing SBP to focus on its core objectives. Such a structural change will allow support to the export sector transparently through an on-budget subsidy. In this regard, the Ministry of Finance and SBP have advanced work on an initial plan in consultation with other stakeholders to establish an appropriate Development Finance Institution to support the eventual phasing out of the refinance facilities (**end-April 2022 SB, reset to end-December 2022**). The plan, which was approved by the Acting Governor on May 17, 2022;