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Pakistan: Letter of Intent, Memorandum of Economic and Financial Policies, and Technical Memorandum of Understanding

November 20, 2008

The following item is a Letter of Intent of the government of Pakistan, which describes the policies that Pakistan intends to implement in the context of its request for financial support from the IMF. The document, which is the property of Pakistan, is being made available on the IMF website by agreement with the member as a service to users of the IMF website.

PAKISTAN: LETTER OF INTENT

November 20, 2008

Mr. Dominique Strauss-Kahn
Managing Director
International Monetary Fund
Washington, D.C. 20431

Dear Mr. Strauss-Kahn:

The Pakistani authorities have held discussions with Fund staff for a 23-month Stand-By Arrangement in support of the government's program for 2008/09–2009/10. Based on these discussions, the attached Memorandum on Economic and Financial Policies (MEFP) reviews economic developments and policies during 2007/08–2009/10, and discusses the underpinning stabilization and structural policies. In support of the policies in the attached MEFP, the government requests that the Executive Board of the Fund approve a Stand-By Arrangement with exceptional access in an amount of SDR 5.169 billion.

The Government of Pakistan will provide the Fund with such information as the Fund may request in connection with Pakistan's progress in implementing its economic and financial policies. The government believes that the policies set out in the attached MEFP are adequate to achieve the objectives of its program, but it will take any further measures that may become appropriate for this purpose. Pakistan will consult with the Fund on the adoption of these measures, and in advance of revisions to the policies contained in the MEFP, in accordance with the Fund's policies on such consultations.

Sincerely yours,

/s/
Shaukat Tarin
Advisor to the Prime Minister
on Finance and Economic Affairs

/s/
Shamshad Akhtar
Governor
State Bank of Pakistan

ATTACHMENT I. PAKISTAN: MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES FOR 2008/09–2009/10

The Government of Pakistan has adopted a comprehensive program of macroeconomic stabilization and sustainable development. This memorandum sets out Pakistan's economic and financial policies for November 2008–June 2010, to be supported by the International Monetary Fund (IMF) under a 23-month Stand-By Arrangement (SBA).

I. RECENT ECONOMIC DEVELOPMENTS

1. **In the last decade, Pakistan's economy witnessed a major economic transformation.** The country's real GDP increased from \$60 billion in 2000/01 to \$170 billion in 2007/08 (fiscal year starts July 1st), with per capita income rising from under \$500 to over \$1,000. During the same period, the volume of international trade increased from about \$20 billion to nearly \$60 billion. For most of this period, real GDP grew at more than 7 percent a year with relative price stability. The improved macroeconomic performance enabled Pakistan to re-enter the international capital markets in the mid-2000s. Large capital inflows financed the current account deficit and contributed to an increase in gross official reserves to \$14.3 billion (3.8 months of imports) at end-June 2007. Buoyant output growth, low inflation, and the government's social policies contributed to a reduction in poverty and an improvement in many social indicators.

2. **This strong macroeconomic performance resulted from the implementation of a series of important structural reforms.** In the early 2000s, with financial support from international financial institutions (IFIs), including the IMF, the World Bank, and the Asian Development Bank, the government expanded the role of markets in the economy, privatized a number of large state-owned enterprises, established market-based regulatory bodies, and took steps to reduce the cost of doing business in Pakistan.

3. **The macroeconomic situation, however, deteriorated significantly in 2007/08 and the first four months of 2008/09** owing to adverse security developments, large exogenous price shocks (oil and food), global financial turmoil, and policy inaction during the political transition to the new government. Specifically:

- Real GDP growth slowed to 5.8 percent in 2007/08 (6.8 percent in 2006/07), reflecting weaker performance of the agricultural and manufacturing sectors.

- Headline CPI 12-month inflation rose to 25 percent in October 2008, with core inflation (excluding energy and food) increasing to 18 percent.

- The external current account deficit widened to about \$14 billion or 8½ percent of GDP in 2007/08. The growth of exports and workers' remittances recovered, but total imports rose by more than 30 percent owing to an increase of \$4 billion

(2½ percent of GDP) in the value of oil imports and strong aggregate demand growth. With the surplus in the financial account of the balance of payments declining to \$7.7 billion, from \$10.1 billion in 2006/07, this led to a decline in the gross international reserves of the State Bank of Pakistan (SBP) of \$5.7 billion, to \$8.6 billion at end-June 2008. Reserves dwindled further to \$3.4 billion (less than one month of imports) as of end-October 2008.

- The fiscal deficit (excluding grants) is estimated to have risen to 7.4 percent of GDP in 2007/08, from 4.3 percent in 2006/07, mainly because of a substantial increase in energy and food subsidies (in a context of rising international prices that were not passed through to consumers), higher than envisaged interest payments, and additional security-related expenditures. The deficit was largely covered through SBP financing.

- To contain inflationary pressures, between July 2007 and July 2008 the SBP increased its discount rate in several steps by 350 basis points, to 13 percent. Despite these increases, SBP financing of the government continued in July–October 2008.

- The banking system was well capitalized and liquid as of end-June 2008, but liquidity problems have emerged recently. Domestic pressures and the global financial crisis led to rising dollarization and an outflow of deposits from the system during July-October, which contributed to a deterioration of liquidity conditions. In response to an escalation of liquidity pressures in October, the SBP recently reduced the reserve requirement by 4 percentage points and eased liquidity requirements. In addition, the SBP has encouraged the merger of four small banks. These measures have stabilized liquidity conditions in recent weeks.

- Financial market indicators have deteriorated. After climbing to new record highs by end-April 2008, the Karachi KSE-100 index dropped by one third, prompting the Karachi Stock Exchange Board to impose a floor on the decline of all stock prices on August 27, 2008. The EMBIG spread has increased to over 2,000 basis points. The rupee has depreciated by 30 percent since end-March 2008, reflecting growing foreign exchange market pressures. In May 2008, the SBP adopted, on a temporary basis, several exchange measures aimed at reducing these pressures. In addition, the government has recently imposed regulatory duties on imports of luxury items.

II. Stabilization policies

A. Macroeconomic outlook and policies

4. **The government's financial policies for the remainder of 2008/09 and for 2009/10 are aimed at stabilizing the macroeconomic situation and restoring investor confidence.** The government's program envisages a significant fiscal consolidation, and the SBP will tighten monetary policy to lower inflation and strengthen the international reserves

position. As a result of these policies, the 12-month inflation rate is projected to decline to 20 percent at end-June 2009, even after taking into account the impact of significant increases in administered energy prices. Real GDP growth would slow further to 3-3½ percent in 2008/09 in response to the tightening of macroeconomic policies and a deceleration of growth in Pakistan's trading partners.

5. **The tighter financial policies, higher disbursements from IFIs, lower commodity prices, and restored confidence are expected to contribute to a significant strengthening of the external position in 2008/09.** Specifically, the external current account deficit is projected to narrow to $10.6 billion (6.5 percent of GDP) owing mainly to slower aggregate demand growth and lower oil import prices. At the same time, the surplus in the financial account would decline to $6.2 billion, as an increase in disbursements from IFIs (to about $4 billion) would be more than offset by weaker FDI and portfolio flows relative to 2007/08, reflecting in part the impact of the global financial turmoil. Given the target to increase gross official reserves to $8.6 billion by end-June 2009 (the level prevailing at end-June 2008), the residual financing gap of $4.7 billion will be covered by drawing on IMF resources. To further bolster confidence, the government is seeking additional financial support from donors.

6. **The government's medium-term strategy seeks to achieve high sustained growth and significantly reduce poverty, while ensuring external and fiscal sustainability.** Following the initial stabilization effort in 2008/09, real GDP growth would increase to 5 percent in 2009/10, and is projected to rise gradually to 6½–7 percent a year by 2012/13, based on a significant increase in investment and further progress in structural reforms. Average inflation is targeted to decline to 13 percent in 2009/10, and to 5 percent by 2012/13. Prudent demand management policies would contribute to a gradual decline in the external current account deficit to 5.7 percent of GDP in 2009/10, and further to 3.6 percent of GDP by 2012/13. This, along with the expected pickup in capital inflows, would help increase gross international reserves to $14.5 billion (2.6 months of projected imports) by 2012/13, while reducing the external debt to 29 percent of GDP. The external financing gap for 2009/10, which is projected at $3.6 billion, will be covered by disbursements from the IMF and GDR proceeds. External financing gaps will be fully eliminated by the end of the SBA.

B. Fiscal policy

7. **The fiscal deficit (excluding grants) is targeted to decline to 4.2 percent of GDP (PRs 562 billion) in 2008/09, from 7.4 percent in 2007/08.** This fiscal effort is necessary to help reduce the external current account deficit, move toward a sustainable fiscal position, and eliminate SBP financing of the government. To achieve the 2008/09 deficit target, the government will increase tax revenue by 0.6 percentage points of GDP and reduce non-interest current expenditure by about 1½ percentage points of GDP, mainly through the elimination of oil subsidies by December 2008 and electricity subsidies by June 2009. At the

same time, domestically-financed development spending will be reduced by about 1 percentage point of GDP through better project prioritization.

8. **The government has already implemented a number of measures consistent with the envisaged fiscal adjustment in 2008/09.** Specifically, petroleum prices have been adjusted three times since June 2008, which has led to the complete elimination of petroleum subsidies. At the same time, electricity tariffs were adjusted by an average of 18 percent effective September 5, 2008. In addition, steps have been taken to slow the pace of development spending, the research and development subsidy for the textile industry has been fully eliminated, wheat procurement prices have been raised to international levels, and the general sales tax (GST) rate has been raised by one percentage point to 16 percent.

9. **The government plans to take additional fiscal measures in 2008/09.** As noted above, electricity tariff differential subsidies will be fully eliminated by end-June 2009. To achieve this objective, the average base tariff will be further increased during 2008/09 according to a schedule to be agreed with the World Bank by end-December 2008 (structural benchmark), and the government will use fuel and other surcharges, as necessary. The implementation of the electricity tariff increases will be followed up in the context of the program reviews. On the revenue side, further steps will be taken during the remainder of the fiscal year to strengthen tax enforcement. Moreover, fuel prices will continue to be adjusted to pass through changes in international prices.

10. **An expanded and effective social safety net constitutes an integral part of the authorities' program.** In this regard, several measures are envisaged to protect vulnerable groups that might be adversely affected by inflation and the economic slowdown. The fiscal program for 2008/09 envisages an increase in social safety net spending of 0.6 percentage points of GDP, to 0.9 percent of GDP. To this end, the government has launched the Benazir Income Support Program (BISP), for which the budget already allocated PRs 34 billion (0.3 percent of GDP). The design of the BISP, in particular the targeting of transfers and the delivery mechanism, will be reviewed in the first half of 2009, in consultation with the World Bank. The government also plans to expand social safety net spending by an additional 0.3 percent of GDP, for which further external assistance (mainly in the form of grants) is being sought from donors. While a more comprehensive and better-targeted social safety net is being designed, these additional funds will be allocated to scale up other existing programs, in particular cash transfers under the Bait-ul-Mal program. Also, part of the additional resources could be used to cover larger than envisaged electricity subsidies for poor households.

11. **Putting in place a more comprehensive and well-targeted social safety net is a key priority under the program.** To that end, in close cooperation with the World Bank, the government will prepare, by end-March 2009, a strategy and a time-bound action plan for the adoption of specific measures. The first program review will assess progress in this area.

The resources allocated to the short-term protection measures described above will be used for funding the newly designed social safety net in 2009/10.

12. **The government will prepare, by end-March 2009, a plan for eliminating the inter-corporate circular debt within the fiscal deficit target.** The plan will clearly identify all elements of circular debt, including (i) the identification of all debts owed and due among the corporations, duly reconciled; (ii) the determination of the validity of the claims; (iii) a schedule by which respective entities will discharge their liabilities to each other; and (iv) a timeframe during which the Federal Adjuster will use his powers to make adjustments, in case of failure, to adhere to the approved schedule.

13. **The targeted reduction in the fiscal deficit in 2008/09 will help eliminate SBP financing of the budget.** The government is committed to limiting SBP financing of the budget to zero on a cumulative basis during October 1, 2008–June 30, 2009. During this period, the fiscal deficit will be fully financed by available external disbursements (which have already been committed), the acceleration of the privatization process, the issuance of treasury bills, and other domestic financing instruments, including Pakistan Investment Bonds, Ijara Sukuk, and National Savings Scheme (NSS) instruments.

14. **A further reduction in the fiscal deficit to 3.3 percent of GDP is envisaged for 2009/10.** The fiscal effort will be facilitated by the full-year effect of the elimination of energy subsidies by end-2008/09 and declining interest payments, following large bullet payments in the three-year period ending in 2009/10.

15. **Consistent with the government's objective of substantially increasing tax revenue, a number of tax policy and administration measures are envisaged during the program period.** Specifically, an integrated tax administration organization on a functional basis will be established at the Federal Board of Revenue (FBR) (integrating both the income tax and sales tax administration). In addition, audits will be reintroduced as part of a risk-based audit strategy that will be implemented by end-December 2008. A full description of the required reforms, together with an action plan will be provided to the IMF by end-December 2008, following a planned seminar to review tax policy and administration. As part of this process, the government plans to harmonize the income tax and GST laws, including for tax administration purposes, and reduce exemptions for both taxes. To that end, it will submit legislative amendments to parliament by end-June 2009. In addition, the excises on tobacco will be increased in the context of the 2009/10 budget. Following the seminar in December 2008, the government will initiate a process to implement a full VAT with minimal exemptions, to be administered by the FBR. Draft legislation for the VAT is expected to be ready for public debate by end-2009. The first program review will focus on the progress in developing the government's tax reform agenda.

16. **The government's fiscal consolidation efforts will continue over the medium term.** The government's fiscal framework assumes a further reduction in the fiscal deficit to

2–2½ percent of GDP by 2012/13. Fiscal consolidation will be supported by a strong tax effort, which will allow for higher spending in infrastructure and the social sectors. Specifically, the government is committed to increasing tax revenue by at least 3½ percentage points of GDP over the medium term as a result of measures to broaden the GST base, significantly reduce income tax exemptions, and further improve tax enforcement.

17. **The government will continue to press ahead with public financial management reforms, in line with fiscal ROSC recommendations.** Immediate priority will be given to completing the on-going gradual implementation of a single treasury account. This will involve the consolidation of government funds in its account with the SBP, from which withdrawals will be made only when actual payments are due. Existing funds held outside the SBP account will be transferred by end-June 2009. Furthermore, the coordination between the Planning Commission, which manages the developmental budget, and the Ministry of Finance will be strengthened in the context of the implementation of the medium-term budget framework.

C. Monetary policy, exchange rate policy, and financial sector issues

18. **The program envisages a significant tightening of monetary policy.** To that end, the SBP recently increased its discount rate by 200 basis points, to 15 percent. Following this first step, interest rate policy will be sufficiently flexible to protect the reserves position, bring down inflation, and allow the government to place T-bills and other securities with commercial banks and non-banks in order to avoid further central bank financing of the budget. A further increase in the discount rate will be considered at the time of the monetary policy statement scheduled for end-January 2009. However, the discount rate will be raised earlier if the actual reserves for end-November and end-December 2008 fall short of the program monthly floors on the SBP's net foreign assets. In addition, if the volume of T-bills placed in the auction scheduled for November 19 falls short of the announced target, understandings will be reached with Fund staff on corrective measures in order to meet the program targets.

19. **The conduct of monetary policy will be facilitated by significant improvements in liquidity management, including by improving the forecasting of the government's cash flow position.** As part of these efforts, the SBP and the Ministry of Finance have agreed on quarterly volumes of treasury bill placements consistent with zero SBP financing of the budget during October 1, 2008–June 30, 2009. The SBP has issued an auction calendar for November-December 2008 on November 1st, 2008, and in the future will issue a calendar every quarter one month in advance. In addition, the SBP will review the current procedures for liquidity management, and will adopt and publicize a transparent liquidity management framework by end-July 2009 as part of its Monetary Policy Statement. This framework will contain the following key elements:

- The announcement of an explicit corridor for money market interest rates: the SBP's reverse repo rate will be the ceiling, and a standing repo facility to absorb excess liquidity from commercial banks will serve as the floor of the proposed explicit corridor;

- The treasury will provide the SBP with T-bills, as needed, to conduct its open market operations.

20. **The SBP is committed to pursuing a flexible exchange rate policy.** To that end, intervention in the foreign exchange market (including the provision of foreign exchange for oil imports) will be aimed at meeting the program's reserve targets. This primary objective will be facilitated by phasing out the SBP's provision of foreign exchange for oil imports according to the following schedule:

- Furnace oil—by February 1, 2009.
- Diesel and other refined products—by August 1, 2009.
- Crude oil—by February 1, 2010.

21. **During the program period, the SBP intends to eliminate any exchange restriction subject to approval under Article VIII of the IMF's Articles of Agreement.** Specifically, the exchange restriction on advance import payments against letters of credit will be eliminated by end-January 2010, subject to a marked improvement in the balance of payments position. No intensification of existing restrictions and no new exchange restrictions or multiple currency practices will be introduced during the program period.

22. The SBP will prepare a contingency plan to deal with problem private banks by end-December 2008. The plan will contain criteria for SBP liquidity support, assessment of bank problems, and intervention procedures. The SBP has already dealt with problem banks through mergers. Looking ahead, if there are severe strains in the interbank market and interbank lending guarantees appear necessary, these guarantees will be provided in limited amounts only to solvent banks.

23. To enhance the effectiveness of SBP enforcement powers, necessary amendments to the Banking Companies Ordinance will be submitted to Parliament by end-June 2009. These amendments will strengthen the SBP's ability to (i) change management in banks; (ii) impose losses on shareholders by writing down their capital; (iii) intervene and take ownership of banks; (iv) appoint administrators to operate banks; and (v) restructure banks.

24. The legal provisions relating to the operational independence of the SBP will be reviewed. These provisions will be strengthened based on the recommendations of an interagency committee that will be established by mid-November 2008, and taking into account technical recommendations from the IMF. The second program review will focus on specific details regarding required legislative changes in this area.

25. The government believes that market confidence will improve significantly once the Fund-supported program is approved and the international reserves position is strengthened. Therefore, it does not intend to remove the current floor on stock prices until after the program is in place. In any event, the timing and terms under which the floor on stock prices will be removed, including any use of public funds to support the stock market, will be decided after reaching understandings with Fund staff.

III. Risks and Contingencies

26. **Larger-than-expected external budget support may become available in 2008/09 and 2009/10.** In such a case, any additional external budget support to cover increased social safety net spending up to $500 million per year (0.3 percent of GDP) will be used to replace non-central bank domestic borrowing assumed under the program. Provided that downside risks do not materialize, the government will use any additional external budget financing beyond the first $500 million per year to further increase spending, up to a fiscal deficit of 4.7 percent of GDP in 2008/09 and 3.8 percent of GDP in 2009/10. Any external financing support exceeding these limits will be used to retire government debt with the SBP and strengthen the SBP's international reserves position.

27. **Key economic and financial downside risks to the program include lower-than-expected private capital inflows, a reversal of the current trend of declining oil prices, and a more severe-than-anticipated economic slowdown in trading partner countries.** If these risks materialize, the government stands ready to adjust its policies, in close consultation with IMF staff, to ensure the achievement of a sustainable external position by the end of the program period.

IV. Program Monitoring

28. The program will be subject to quarterly reviews and quarterly performance criteria as set out in the technical memorandum of understanding (TMU). Completion of the first two reviews scheduled for end-March 2009 and end-June 2009 will require observance of the quantitative performance criteria for end-December 2008 and end-March 2009, respectively, as specified in Table 1.

29. An updated safeguards assessment of the SBP will be conducted in the context of the first review.

30. The government authorizes the IMF to publish the Letter of Intent, its attachments, and the related staff report.

Table 1. Pakistan: Quantitative Targets, december 2008-June 2010

	Outst. Stock end-Sept. 2008	Prog. end-Dec. 2008	Prog. end-Mar. 2009	Prog. end-Jun. 2009
Floor on net foreign assets of the SBP* (stock, in millions of U.S. dollars)	3,953	1,165	671	2,782
Ceiling on net domestic assets of the SBP* (stock, in billions of Pakistani rupees)	1,250	1,346	1,412	1,314
Ceiling on net government borrowing from SBP* (stock, in billions of Pakistani rupees)	1,227	1,274	1,274	1,181
Ceiling on overall budget deficit* (cumulative flow, in billions of Pakistani rupees)	142	261	405	562
Ceiling on outstanding stock of short-term public and publicly guaranteed external debt* (in millions of U.S. dollars)	515	1,500	1,500	1,500
Cumulative ceiling on contracting of nonconcessional medium- and long-term public and publicly guaranteed external debt* (in millions of U.S. dollars) 1/	9,500	9,500	9,500	9,500
Accumulation of external payments arrears (continuous performance criterion during the program period)* (in millions of U.S. dollars)	0	0	0	0
Continuous ceiling on SBP's foreign currency swaps and forward sales* (in millions of U.S. dollars)	1,900	2,750	2,750	2,750
Memorandum items:				
Net external program financing (in millions of U.S. dollars)	-53	137	918	2,503
External project grants (in millions of U.S. dollars)	1	39	95	180
Foreign Exchange cash reserve requirement (CRR, incl. special CRR) deposits in SBP (in millions of U.S. dollars)	832	832	832	832
Weekly cash reserve requirement ratios (in percentage points)				
Rupee deposits (less than one year maturity)	9	5	5	5
Rupee deposits (more than one year maturity)	0	0	0	0
Foreign currency deposits CRR	5	5	5	5
Foreign currency deposits special CRR	15	15	15	15

Notes:
* denotes performance citeria.

1/ Excludes IMF.

Table 2. Pakistan—Prior actions, Structural Performance Criteria and Benchmarks

Prior actions (implemented before Board consideration of the program)

The SBP's discount rate was increased by 200 basis points.

Electricity tariffs were increased by an average 18 percent effective September 5, 2008.

The SBP and the government agreed on quarterly volumes of treasury bills to be issued, and published the expected volume for the remainder of the second quarter of 2008/09.

Performance criteria

Amendments to the banking legislation will be submitted to Parliament by end-June 2009 to enhance the effectiveness of SBP enforcement powers in the area of banking supervision.

The government will submit, by end-June 2009, draft legislative amendments to parliament to harmonize the income tax and GST laws, including for tax administration purposes, and to reduce exemptions for both taxes.

Benchmarks

A contingency plan for handling problem private banks will be finalized by end-December 2008.

A full description of required reforms in the area of tax administration, including an action plan for harmonizing the GST and income tax administration will be finalized by end-December 2008.

In close collaboration with the World Bank, the government will finalize the schedule for further electricity tariff adjustments during 2008/09, by end-December 2008, with a view to eliminating tariff differential subsidies by end-June 2009.

The SBP's provision of foreign exchange for furnace oil will be eliminated by February 1, 2009.

In close collaboration with the World Bank, the government will develop a strategy and a time-bound action plan, by end-March 2009, for the adoption of specific measures to strengthen the social safety net and improve targeting to the poor.

The government will prepare a plan for eliminating the inter-corporate circular debt by end-March 2009.

The transition to a single treasury account will be completed by end-June 2009.

Table 3. Pakistan: SBP Monthly NFA Targets
(In millions of U.S. dollars)

	Sept.	Oct.	Nov.	Dec.	Jan.
Gross reserves 1/	**5,171**	**3,530**	**5,400**	**5,400**	**5,300**
Fund disbursement	...	...	**3,066**	...	...
Cumulative increase in gross reserves since program	...	...	**1,870**	**1,870**	**1,770**
NFA 2/	3,953	2,312	1,117	1,165	1,065
Change in NFA	...	-1,641	-1,196	49	-100
Memorandum items					
Stock of forward/swap	1,900	1,900	1,900	1,900	1,900
Repurchase (of existing Fund credits)	...	...	...	49	...

1/ Excluding gold and foreign deposits of commercial banks held with the State Bank of Pakistan.
2/ End-December target is a performance criterion subject to adjustors as specified in the TMU.

ATTACHMENT II. PAKISTAN: TECHNICAL MEMORANDUM OF UNDERSTANDING (TMU) ON THE PROGRAM SUPPORTED UNDER THE STAND-BY ARRANGEMENT

November 20, 2008

1. With effect from November 1, 2008, this Technical Memorandum of Understanding (TMU) describes the monitoring arrangements under the SBA-supported program. Throughout, unless otherwise stated, "government" is meant to comprise the federal and provincial governments.

I. DEFINITIONS OF MONITORING VARIABLES

Valuation of foreign exchange denominated assets, liabilities, and foreign exchange flows

2. For the purposes of monitoring under the program, all assets and liabilities as well as debt contracted, denominated in SDRs or in currencies other than the U.S. dollar, will be converted into U.S. dollars at the exchange rates prevailing at test dates, as posted by the State Bank of Pakistan (SBP) on its web site. Net external budget financing and external cash grants will be converted into Pakistani rupees at the exchange rates prevailing at the day of the transaction, as posted by the SBP on its web site, unless otherwise indicated.

3. **Reserve money** (RM) is defined as the sum of: currency outside scheduled banks (deposit money banks); scheduled banks' domestic cash in vaults; scheduled banks' required and excess rupee and foreign exchange deposits with the State Bank of Pakistan (SBP); and deposits of the rest of the economy with the SBP, excluding those held by the federal and provincial governments and the SBP staff retirement accounts.

4. **Net foreign assets (NFA) of the SBP** are defined as the difference between its foreign assets and foreign liabilities. Foreign assets of the SBP consist of gold, foreign exchange, balances held outside Pakistan, foreign securities, foreign bills purchased and discounted, the reserve position with the IMF, and SDR holdings. The definition of foreign assets of the SBP will be consistent with the IMF Data Template on International Reserves and Foreign Currency Liquidity. Gold will be valued at $20.27 per troy ounce per fine troy ounce. Foreign liabilities of the SBP include outstanding IMF credits, deposits with the SBP of foreign governments, foreign central banks, foreign deposit money banks, international organizations, and foreign nonbank financial institutions (NBFI).

5. **Net domestic assets (NDA) of the SBP** are defined as the difference between the RM and the NFA of the SBP.

6. **Net borrowing from the banking system by the government** is defined as the difference between the banking system's claims, on a cash basis, on the federal, provincial, and local governments and the deposits of the federal, provincial, and local governments with

the banking system, including district government funds balances. For the purposes of this memorandum, claims on government exclude: credit for commodity operations; government deposits exclude outstanding balances in the Zakat Fund and balances in the various privatization accounts kept by the government in the banking system. The stock of bonds which were issued to banks in substitution of outstanding nonperforming loans to certain public entities, and which are being fully serviced by the government, are included in banking system claims on government. Table 1 summarizes the calculations of **net borrowing from the banking system by the government.**

7. **Net borrowing from the SBP by the government is defined as** SBP claims on the government minus government deposits with the SBP. SBP claims on the government include government securities, treasury bills, ways and means advances, treasury currency, and debtor balances. SBP claims on the government exclude accrued profits on government securities. Government deposits with the SBP exclude the Zakat Fund and Privatization accounts (Table 1).

8. The definition of the **overall budget deficit (excluding grants)** under the program will be the consolidated budget deficit, excluding grants, and including the operations of district governments financed from local funds. It will be measured by the sum of (a) total net financing to the federal, provincial, and local governments; and (b) total external grants to the federal and provincial governments. The former is defined as the sum of (i) net external budget financing (see ¶10); (ii) net borrowing from the banking system (as defined above); and (iii) net domestic nonbank financing (see ¶11). The total external grants are defined as the sum of project grants, cash external grants for budgetary support, capital grants reflecting the principal amounts of external debt cancellation or swaps, and other grants.

9. **Net external program financing** is defined to include external privatization receipts; budget support grants; budget support loans from multilateral (other than the IMF, but including World Bank and Asian Development Bank (AsDB) budget support and structural adjustment loans), official bilateral budget support loans, and private sector sources (e.g., bonds); rescheduled government debt service and change in stock of external debt service arrears net of government debt amortization due on foreign loans, the latter including any accelerated amortization including related to debt swaps or debt cancellation recorded as capital grants. It also includes foreign loans onlent to financial institutions and companies (public or private) and emergency relief lending. Program financing excludes all external financing counted as reserve liabilities of the SBP (defined above). Amounts projected for net external program financing and external grants are provided in Table 2.

10. **Net external budget financing** is defined as net external program financing minus privatization receipts, minus budget support grants, plus all other external loans for the financing of public projects or other federal or provincial budget expenditures, plus transfers of external privatization receipts from the privatization account to the budget.

11. **Net domestic nonbank financing of the budget** is defined as follows: domestic privatization receipts transferred from the privatization accounts to the budget, plus the change, during each reporting period, in the stock of (a) permanent debt, which consists of nonbank holdings of prize bonds, all federal bonds, and securities; plus (b) floating debt held by nonbanks; plus (c) unfunded debt, which consists of National Savings Scheme (NSS) debt, Postal Life Insurance, and the General Provident Fund (GPF); plus (d) net deposits and reserves received by the government (public accounts deposits); plus (e) any other government borrowing from domestic nonbank sources net of repayments; minus (f) government deposits with NBFIs. Nonbank holdings of permanent and floating debt is defined as total debt outstanding, as reported by the SBP, minus holdings of banks as per the monetary survey. Total treasury bill and other relevant government debt is valued at discount value and excluding accrued interest.

External debt

12. The performance criterion on contracting or guaranteeing of medium-term and long-term nonconcessional external debt by the government or the SBP applies not only to debt as defined in point No. 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt (adopted by the IMF Executive Board on August 24, 2000), but also to commitments contracted or guaranteed for which value has not been received.[1] Excluded from this performance criterion are (a) foreign currency deposit liabilities of the SBP; and (b) the outstanding stock of debt of Foreign Exchange Bearer Certificates (FEBCs), Deposit Bearer Certificates (DBCs), and Foreign Currency Bearer Certificates (FCBCs). The performance criterion setting a limit on the outstanding stock of short-term external debt refers to debt (as defined in Footnote 1) with original maturity of up to and including one

[1] The definition of debt set forth in No. 9 of the guidelines reads as follows: "(a) For the purpose of this guideline, the term "debt" will be understood to mean a current, that is, not contingent, liability, created under a contractual arrangement through the provision of value in the form of assets (including currency) or services, and which requires the obligor to make one or more payments in the form of assets (including currency) or services, at some future point(s) in time; these payments will discharge the principal and/or interest liabilities incurred under the contract. Debts can take a number of forms, the primary ones being as follows: (i) loans, that is, advances of money to obligor by the lender made on the basis of an undertaking that the obligor will repay the funds in the future (including deposits, bonds, debentures, commercial loans, and buyers' credits) and temporary exchanges of assets that are equivalent to fully collateralized loans under which the obligor is required to repay the funds, and usually pay interest, by repurchasing the collateral from the buyer in the future (such as repurchase agreements and official swap arrangements); (ii) suppliers' credits, that is, contracts where the supplier permits the obligor to defer payments until some time after the date on which the goods are delivered or services are provided; and (iii) leases, that is, arrangements under which property is provided which the lessee has the right to use for one or more specified period(s) of time that are usually shorter than the total expected service life of the property, while the lessor retains the title to the property. For the purpose of the guideline, the debt is the present value (at the inception of the lease) of all lease payments expected to be made during the period of the agreement excluding those payments that cover the operation, repair or maintenance of the property. (b) Under the definition of debt set out in point 9 (a) above, arrears, penalties, and judicially awarded damages arising from the failure to make payment under a contractual obligation that constitutes debt are debt. Failure to make payment on an obligation that is not considered debt under this definition (for example, payment on delivery) will not give rise to debt."

year. Medium- and long-term external debt comprises debt with initial maturity of over one year.

13. **Nonconcessional borrowing** is defined as borrowing with a grant element of less than 35 percent, following the methodology set out in SM/96/86. The discount rates used to calculate the grant element will be the six-month and ten-year Commercial Interest Reference Rates (CIRRs) averages, as computed by the Strategy and Policy Review Department of the IMF. Six-month CIRRs are updated mid-February and mid-August (covering the six-month period preceding the date of update) and the ten-year CIRRs averages are updated mid-December (covering a period of 10 years preceding the date of the update). Six-month CIRRs averages are to be used for loans whose maturity is less than 15 years, while ten-year CIRRs averages are to be used for loans whose maturity is equal or more than 15 years.

II. ADJUSTORS

Adjustors related to net external program financing

14. **Adjusters to program targets will be implemented if the actual cumulative net external program financing in U.S. dollar terms is different from its projected value.**

15. If the actual cumulative net external program financing in U.S. dollar terms is higher than its projected value by more than $500 million, **the excess net external program financing in U.S. dollar terms** is defined as follows: actual external program financing in U.S. dollar terms minus projected net external program financing in U.S. dollar terms minus $500 million. The excess net external program financing in U.S. dollar terms multiplied by a fixed accounting exchange rate of RPs 80 per $1 represents **the excess net external program financing in rupee terms.**

16. The ceiling on the **consolidated overall budget deficit (excluding grants)** will be adjusted upward for the cumulative excess in net external program financing in rupee terms for up to PRs 27.0 billion at end-December 2008, PRs 67.0 billion at end-March 2009, and PRs 67.0 billion at end-June 2009.

17. The cumulative excess net external program financing in U.S. dollar terms may exceed the cumulative maximum limits specified in paragraph 16 for end-December 2008, end-March 2009, and end-June 2009, when converted into U.S. dollar terms at a fixed accounting exchange rate of PRs 80 per $1. In such a case, the cumulative excesses in net external program financing in U.S. dollar terms minus the maximum cumulative amounts specified for end-December 2008, end-March 2009, and end-June 2009 converted into U.S. dollar terms at a fixed accounting exchange rate of PRs 80 per $1 are defined as **"surplus net external program financing in U.S. dollar terms."** The latter amount multiplied by a fixed accounting exchange rate of PRs 80 per $1 constitutes "surplus net external program financing in rupee terms."

18. The floors on the **NFA of the SBP** will be adjusted upward by the cumulative **surplus net external program financing** in U.S. dollar terms as defined above.

19. The ceilings on the **NDA of the SBP and net borrowing from the SBP by the government** will be adjusted downward by the cumulative **surplus net external program financing in rupee terms** as defined above.

20. If the actual cumulative net external program financing in U.S. dollar terms is lower than its projected value, **the shortfall in net external program financing in U.S. dollar terms** is defined as the difference between its projected and actual values in U.S. dollar terms. In such a case:

a. The floor on the NFA of the SBP is adjusted downward by the amount equivalent to 50 percent of the cumulative shortfall in net external program financing in U.S. dollar terms.

b. The ceiling on the NDA of the SBP is adjusted upward by the amount equivalent to 50 percent of the cumulative shortfall in net external program financing in U.S. dollar terms converted into rupees at a fixed accounting exchange rate of PRs 80 per $1.

c. The ceiling on **net borrowing from the SBP by the government** is not subject to adjustment.

Adjustor related to project grants

21. If the amount of project grants is higher than assumed under the program, the ceiling on the **consolidated overall budget deficit (excluding grants)** will be adjusted upward for the cumulative excess in project grants. This adjustor is applied in addition to any adjustment to the **consolidated overall budget deficit (excluding grants)** that is made under paragraph 16.

Adjustor related to changes in regulations on required reserves

22. The ceilings on the NDA of the SBP will also be adjusted downward/upward by the amount of (a) banks' Pakistani rupee reserves freed/seized by any reduction/increase of the daily CRR relative to the baseline assumption; and (b) any reduction/increase in the reservable deposit base that is related to definitional changes, as per the following formula: $\Delta NDA = \Delta r B_0 + r_0 \Delta B + \Delta r \Delta B$, where r_0 denotes the reserve requirement ratio prior to any change; B_0 denotes the level of the reservable deposits in the initial definition; Δr is the change in the reserve requirement ratio; and ΔB denotes the change in the reservable deposits as a result of definitional changes. In case of significant liquidity and other financial sector pressures, the SBP will engage in consultations with the IMF staff in order to reach understanding on appropriate monetary policy response.

Adjustor related to the SBP's net position under foreign exchange forwards and swaps

23. An adjustor to the NFA target of the SBP will be implemented to reflect changes in the SBP's net position under foreign exchange forwards and swaps. Specifically, the NFA target of the SBP will be adjusted upward/downward by the amount of the increase/decrease in the net SBP's position under foreign exchange forwards and swaps. The maximum SBP's net exposure under foreign exchange forwards and swaps is capped at $2.75 billion as of end-December 2008, end-March 2009, and end-June 2009. The SBP's net exposure under foreign exchange forwards and swaps was $1.9 billion at end-September 2008.

Adjustor related to foreign currency deposits of resident banks with the SBP

24. An adjustor to the NFA target of the SBP will be implemented to reflect changes in foreign currency deposits of resident banks. Specifically, the NFA target of the SBP will be adjusted upward/downward by the amount of increase/decrease in foreign currency deposits of resident banks with the SBP. The stock of foreign currency deposits with resident banks was $832 million at end-September 2008.

III. PROGRAM REPORTING REQUIREMENTS

25. The following information, including any revisions to historical data, will be provided to the Middle East and Central Asia Department of the IMF through the office of the Resident Representative of the IMF in Pakistan, within the timeframe indicated:

- Monthly provisional statements on federal tax and nontax revenue, within one month.
- Deposits into and withdrawals from the privatization accounts for each quarter, within one month. Withdrawals will be reported with the following breakdown (a) those which constitute budgetary use of privatization proceeds; (b) those which constitute costs of privatization; and (c) other (with explanation of the purpose of other withdrawals), as well as with the breakdown between domestic and external privatization receipts.
- Quarterly statements on budgetary capital receipts and disbursements, including repayments of bonds, recovery of loans from provinces and "others," within two months.
- Monthly (unreconciled) provisional data on federal expenditure and net lending (with separate data on disbursements and repayments), within one month.
- Quarterly statement on consolidated budgetary expenditure, with federal data approved by the Accountant General Pakistan Revenue (AGPR), within two months.
- Quarterly numbers on expenditure on social programs.

- Quarterly data on the stock of domestic government debt, broken down by instrument, within one month (Table 3).

- Quarterly data on WAPDA receivables within one month.

- Monthly data on Outstanding Audited Price Differential Claims.

- Monthly data on external budget financing, including (i) loan-by-loan program disbursements in U.S. dollar terms and rupee terms converted at exchange rates prevailing at the time of each transaction; (ii) cumulative amortization in U.S. dollar terms and rupee terms converted at exchange rates prevailing at the time of each transaction; and (iii) cumulative project loan disbursements in U.S. dollar terms and in rupees converted at exchange rates prevailing at the time of each transaction.

- Monthly data on Banks' Budgetary Support (Table 1) within one month.

- The following monthly monetary data on a last-Saturday basis within two weeks:

  (i) monetary survey;
  (ii) accounts of the SBP;
  (iii) consolidated accounts of the scheduled banks;
  (iv) banks' lending to the government;
  (v) detailed table on net foreign assets (both for the SBP and scheduled banks);
  (vi) detailed table of scheduled banks' reserves with the SBP.

- The same tables as in the preceding item, but on an end-month and end-quarter basis (last business day), both at current and program exchange rates, within one month.

- The SBP Table on outstanding stock of foreign currency deposits, amended to include the classification of new FCA according to the residency of the holder.

- Daily data on exchange rates (interbank, retail market, and Telegraphic Transfers for SBP purchases in the retail market), SBP's sales and purchases in the foreign exchange markets, swaps and forward outright sales, within two business days.

- Monthly data on the outstanding stock of the SBP's forward foreign currency operations, including swaps and outright forward sales and purchases, within two weeks. The terms of any new transactions (including rollover/renewal of existing ones) will also be provided.

- Monthly data on the SBP's foreign exchange reserves, with details on the currencies, instruments, and institutions in which the reserves are held, within one month.

- Monthly data on SBP direct or bridge loans to nationalized banks in the context of the restructuring and privatization operation, within four weeks.

- Monthly data on any other quasi-fiscal operations undertaken by the SBP, on behalf of the government.

- Monthly data on SBP holding of discounted export finance credit under the export finance scheme, within one month.

- Monthly data on outstanding credit to agriculture under the Agriculture Mandatory Credit Targets, within one month.

- The following data on external debt, within one month:

    (i) Quarterly stock of public- and publicly-guaranteed external debt (including deferred payments arrangements), by maturity (initial maturities of up to and including one year, and over one year), by creditor and by debtor (central government and publicly guaranteed);

    (ii) Quarterly contracting or guaranteeing of nonconcessional medium- and long-term government debt; and

(iii) Information on any rescheduling on public- and publicly-guaranteed debt reached with creditors.

- Quarterly data on external payments arrears on public and publicly guaranteed debt with details as in (i) of the preceding item within one month.

- Copies of new or revised ordinances/circulars regarding changes in: tax policy, tax administration, foreign exchange market regulations, and banking regulations no later than three days after official issuance, or notification that ordinances have been posted on the Federal Board or Revenue (FBR) and SBP websites.

- Copies of official notification of changes in gas and electricity tariffs and any surcharges (automatic or structural) and in ex-refinery petroleum product prices as well as of gas and petroleum surcharges/levies.

- Monthly data on the import parity prices as well as central depot prices of the six major oil products, within one month.

- Quarterly data on KESC and WAPDA loans and debt outstanding, within one month.

- Upon the adoption of the plan for the elimination of inter-corporate circular debt, monthly reports on inter-corporate circular debt will be reported within 1 month.

Table 1. Pakistan: Budgetary Support, June–November 2008

	30-Jun-08	1-Nov-08
Central Government	1,577,064	1,761,857
Scheduled Banks	509,710	384,579
Government Securities	173,171	166,481
Treasuy Bills	559,825	473,422
Government Deposits	-223,286	-255,324
State Bank	1,067,354	1,377,277
Government Securities	3,167	3,168
Accrued Profit on MTBs	18,200	39,342
Treasury Bills	1,053,122	1,326,510
MTFBs purchased for replenishment of cash balances	1,036,610	1,310,798
Adhoc Treasuy Bills	0	0
Ways and Means Advances	0	0
Treasuy Currency	8,152	8,150
Debtor Balances (Excl. Zakat Fund)	0	0
Government Deposits	-20,748	-5,356
(Excl. Zakat and Privatisation Fund)		0
Special Account-Debt Repayment	0	0
Payment to HBL on a/c of HC&EB	-287	-287
Adjustment for use of Privatisation Proceeds		0
for Debt Retirement	5,749	5,749
Provincial Governments	-212,460	-226,378
Scheduled Banks (a+b-c)	-178,821	-172,430
Government Securities	76	76
Advances to Punjab Government for Cooperatives	1,024	1,024
Government Deposits	-179,921	-173,530
State Bank	-33,639	-53,948
Debtor Balances (Excl. Zakat Fund)	18,719	14,363
Ways and Means Advances	0	0
Government Deposits (Excl.Zakat Fund)	-52,357	-68,311
Net Govt. Budgetary Borrowings		0
from the Banking system	1,364,604	1,535,478
Through SBP	1,033,715	1,323,329
Through Scheduled Banks	330,888	212,149
Memorandum Items		
Accrued Profit on SBP holding of MRTBs	18,200	39,342
Scheduled banks ' deposits of Privitization Commission	-1815	-2487
Outstanding amount of MTBs (Primary market; discounted value)	536,977	442,719
Net Govt. Borrowings (Cash basis)		
(i) From Banking System	1,325,371	1,467,919
(ii) From SBP	1,015,516	1,283,987
(iii) From Scheduled Banks	309,855	183,932

Source: State Bank of Pakistan.

Table 2. Pakistan: External Program Financing For Budget for 2008/09

	Q1	Q2	Q3	Q4	Total
Program Loans	500	840	1,295	700	3,335
World Bank	0	300	500	0	800
ADB	500	340	545	500	1,885
IDB	0	100	200	200	500
Short-term commercial	0	100	50	0	150
Budgetary Grants	59	30	0	0	89
Privatization	0	133	250	256	639
GDRs	0	0	0	1,100	1,100
Securitization					
Amortization	612	813	764	471	2,660
Medium and Long-term	450	257	764	371	1,842
Euro bonds			500		500
IDB>1 year	200	0	0	0	200
Other	250	257	264	371	1,142
Short-term	162	556	0	100	818
IDB	162	440	0	100	702
Commercial		116			116
Net program financing (Budget)	-53	190	781	1,585	2,503
Amortization of government guaranteed debt	13	24	12	21	70
Net program financing (BoP)	-66	166	769	1,564	2,433

Sources: Pakistani authorities; and Fund staff projections.

Table 3. Pakistan: Domestic Debt Outstanding, Jun. 2007–Sept. 2008

	Jun. 2007	Sep. 2007	Jun. 2008	Sep. 2008
A. Permanent Debt	553.0	553.7	608.4	618.3
Market Loans	3.0	3.0	3.0	3.0
Federal Government Bonds	9.3	9.3	9.3	9.3
Income Tax Bonds	0.0	0.0	0.0	0.0
Government Bonds (L.R.-1977)	0.1	0.1	0.1	0.1
Special Government Bonds For SLIC (Capitalization)	0.6	0.6	0.6	0.6
GOP Ijara Sukuk 3 years	0.0	0.0	0.0	6.5
Government Bonds (issued to HBL for settlement of CBR Refund)	9.8	0.0	0.0	0.0
Bearer National Fund Bonds(BNFB)	0.0	0.0	0.0	0.0
BNFB Roll Over-II	0.0	0.0	0.0	0.0
Special National Fund Bonds	0.0	0.0	0.0	0.0
Federal Investment Bonds(Auction)	3.1	2.4	1.0	1.0
Federal Investment Bonds (TAP)	0.0	0.0	0.0	0.0
Pakistan Investment Bonds (PIBs)	352.5	360.8	411.6	415.3
Prize Bonds	174.5	177.5	182.8	182.6
B. Floating Debt	1,107.7	1,184.6	1,637.4	1,809.7
Treasury Bills(3 Months)	0.0	0.0	0.0	0.0
Market Treasury Bills(auction)	656.1	784.3	537.0	451.8
MTBs for Replenishment 1/	451.5	400.2	1,100.4	1,357.9
C. Unfunded Debt	940.0	961.7	1,017.6	1,037.8
Defense Savings Certificates	289.0	293.6	284.6	283.5
National Deposit Certificates	0.0	0.0	0.0	0.0
Khas Deposit Certificates	0.3	0.3	0.3	0.3
Special Savings Certificates (Reg)	146.5	151.8	160.3	165.0
Special Savings Certificates (Bearer)	0.3	0.3	0.3	0.3
Regular Income Certificates	51.3	50.1	51.0	53.6
Premium Saving Certificates	0.0	0.0	0.0	0.0
Bahbood Savings Certificates	190.2	203.7	229.0	244.4
Khas Deposit Accounts	0.3	0.3	0.3	0.3
National Deposit Accounts	0.0	0.0	0.0	0.0
Savings Accounts	18.7	14.0	24.9	19.0
Special Savings Accounts	61.5	63.0	67.0	67.9
Mahana Amdani Accounts	2.5	2.5	2.5	2.4
Pensioners' Benefit Accounts	69.0	72.4	87.7	92.0
Postal Life Insurance	67.1	67.1	67.1	67.1
GP Fund	43.3	42.6	42.5	41.9
D. Total(A+B+C)	2,600.7	2,700.0	3,263.4	3,465.8

Source: State Bank of Pakistan.

1/ Inclusive of outright sale of MTBs to commercial banks.