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Pakistan: Letter of Intent, Supplementary Memorandum on Economic and Financial Policies, and Addendum to the Technical Memorandum of Understanding

March 16, 2009

PAKISTAN: LETTER OF INTENT

March 16, 2009

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

Dear Mr. Strauss-Kahn:

The Pakistani authorities held discussions with Fund staff for the first review under the Stand-By Arrangement (SBA) and the 2009 Article IV consultation. Based on these discussions, we have updated our economic program for the remainder of 2008/09 and 2009/10, as reflected in the attached Supplementary Memorandum of Economic and Financial Policies (SMEFP). In support of this program, our authorities request the Executive Board of the Fund completes the first review and approve the second purchase under the SBA of SDR 568.54 million.

Although our economic stabilization program is off to a good start, we are fully aware of the challenges ahead. The sharply deteriorating global environment will affect Pakistan's domestic economy, trade, and external financing. The government believes that the policies set out in the attached SMEFP are adequate to achieve the objectives of the program. However, it stands ready to take additional measures appropriate for this purpose, and will consult with the Fund in accordance with the policies of the Fund on such consultations. The Government of Pakistan will provide the Fund with information it may request to monitor progress in implementing its economic and financial policies.

We have recently modified cash margin requirements on letters of credit for certain imports, which resulted in nonobservance of the continuous performance criterion against imposing or intensifying exchange restrictions. We will issue a regulation to eliminate this restriction by end-June, 2009 and, on this basis, we request a waiver of nonobservance for the missed performance criterion.

We also consent to the publication of this letter, the attached SMEFP, the addendum to the Technical Memorandum of Understanding, and the related staff report.

Sincerely yours,

/s/	/s/
Shaukat Tarin	Syed Salim Raza
Advisor to the Prime Minister on Finance,	Governor
Revenue, Economic Affairs and Statistics	State Bank of Pakistan

Attachments:
Supplementary Memorandum of Economic and Financial Policies
Addendum to the Technical Memorandum of Understanding

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

March 16, 2009

I. INTRODUCTION

1. **This memorandum supplements our Memorandum on Economic and Financial Policies (MEFP) for 2008/09–09/10 of November 20, 2008**. It describes policy implementation to date and lays out additional policies agreed in the context of the first review under the Stand-By Arrangement (SBA).

II. RECENT ECONOMIC DEVELOPMENTS

2. **Our stabilization program is off to a positive start**. Headline inflation has decreased from 25 to 20½ percent, the exchange rate has been broadly stable, the international reserves position has strengthened and, following the November discount rate increase, demand for Treasury bills has rebounded. All quantitative performance criteria through end-December 2008 (Table 1) were met and the implementation of the structural reform agenda is broadly on track (Table 2).

3. **The deteriorating global economy is posing additional challenges for Pakistan**. The world economy has slowed more quickly than envisaged, reducing demand for exports and carrying a risk of declining capital flows. Further, domestic economic activity has weakened. As a result both internal and external factors have made the environment for our economic stabilization program less favorable.

4. **There are pressures on the budget**. As a result of the slowdown in imports and domestic demand, budget revenues have been lower than projected in the first half of 2008/09 and this trend is expected to continue, however, this was largely offset by revenues from Petroleum Development Levy (PDL). Disbursement of multilateral program financing has been slow and projected privatization receipts for the 2008/09 budget are unlikely to materialize.

5. **The State Bank of Pakistan (SBP) has tightened the monetary stance to reduce inflation and strengthen the external position**. Increased confidence and improved terms of trade have helped stabilize the rupee at around Rs. 80 per U.S. dollar since mid-October 2008 and enabled the SBP to rebuild its gross international reserves to $6.9 billion at end-January, well above target.

III. POLICIES FOR THE REMAINDER OF 2008/09 AND FOR 2009/10

6. **The government and the SBP remain committed to address Pakistan's economic problems despite the challenges posed by the global economic and financial crisis**. Consolidating macroeconomic stabilization is essential for the economy, and financing constraints leave little room for countercyclical fiscal policy to counter slowing economic activity given the inherited economic imbalances. Hence, although growth is expected to be

lower, and inflation is trending downwards, policies will continue to be geared to reducing the fiscal deficit, lowering inflation, and strengthening the external position. Nevertheless, improving and expanding the social safety net will continue to be central to the program. These policies will set the stage for higher investment and growth over the medium term and ensure vulnerable groups are protected. The success of our program also hinges on timely and generous support from the international community.

7. The program is built around the following revised economic parameters:

- Real GDP growth of 2½ percent in 2008/09 and 4 percent in the following year;
- Annual average consumer price inflation of 20 percent in 2008/09 and 6 percent in 2009/10; and
- A current account deficit of 6 percent of GDP in 2008/09 and 4½ percent in 2009/10.

A. Fiscal Policy

8. **We plan to maintain the path of fiscal adjustment in 2008/09–09/10**. Our budget deficit target for 2008/09 remains unchanged. The shortfall in tax revenue will be compensated by additional revenue and expenditure measures to achieve an unchanged deficit target of Rs. 562 billion (4.3 percent of revised GDP). Fiscal consolidation will continue in 2009/10; the budget deficit is to be reduced by 0.9 percentage points to 3.4 percent of GDP. This consolidation is facilitated by the elimination of the fuel and electricity subsidies in 2008/09. Further, tax policy measures and the ambitious tax administration reform will increase the revenue and assure achievement of the 2009/10 deficit target, while creating fiscal space for strengthening our social safety net.

9. **Revenue effort will play a key role in achieving the deficit target**. The Federal Board of Revenue is targeting collection of Rs. 1,300 billion (10.0 percent of revised GDP) in 2008/09 including an additional yield of Rs. 65 billion on account of stepped-up auditing and enforcement. The authorities are also considering the levy of a carbon tax. Any shortfall in tax revenues will be compensated by revenues from the PDL, tax administration measures, and expenditure control measures.

10. **The government will use non-SBP domestic sources to meet its financing needs**. This approach is based on careful advance planning of quarterly budgetary borrowing requirements. Moreover, the Ministry of Finance (MoF) has taken several measures, in coordination with the SBP, to expand and enhance available financing options for the budget. To this end the MoF also successfully issued three Ijara Sukuks, 3 to 30 year tenor Pakistan Investment Bond, and interest rates on National Savings Scheme instruments have been increased, which have resulted in significant extra demand. In addition, T-bill auctions have been successful with significant reductions in the cut-off yields.

11. **Treasury-bill auction management has improved**. To increase transparency and planning, Treasury-bill auction calendars were issued in November and December, and will

continue to be issued on a quarterly basis. As a step toward separation of public debt management from monetary policy operations, a volume-based auction approach has been adopted. Pre-announced auction volume targets will be observed and the accepted amount will generally be in line with the target to provide market participants with confidence to plan their investment. This approach complements the government's planning of its budgetary borrowing requirement and facilitates liquidity management by the SBP.

12. **Strengthening the social safety net is a key program objective**. To this end, a poverty scorecard has been adopted to improve targeting of the Benazir Income Support Program (BISP).

- The roll-out of the scorecard system for the selection of beneficiary families has started, and is expected to be completed in 16 districts as a pilot program by end-May 2009. The roll-out of the scorecard to all 130 districts is planned to be completed between December 2009 and June 2010. As the roll-out of BISP turned out to be more complicated than originally envisaged, BISP disbursements did not take place in the first half of the fiscal year. However, we have now approved 1.5 million beneficiary families using the pre-scorecard targeting system and expect to disburse the budgeted amount of Rs. 34 billion. In addition, we are continuing the implementation of Bait-ul-Mal with a budget of Rs. 6.7 billion and the province of Punjab has commenced its own cash transfer program with an envelope of Rs. 17 billion in FY 2008/09. The Small Public Works Programs of Rs. 28 billion also provide a social safety net for the rural and urban poor through small-scale employment opportunities.
- Looking forward, the number of families benefiting from BISP cash transfers will be increased to 5 million in 2009/10 using the new scorecard system, implying budgetary expenditure of Rs. 65 billion. For 2010/11, an increase in the number of beneficiary households to 7 million is envisaged. In addition, the province of Punjab is expected to continue its own program in FY 2009/10. The government is also considering reforming other components of the social safety net system, including the merger of the cash transfer component of Bait-ul-Mal with the BISP.

13. **An action plan to strengthen tax administration was adopted in January and steps to improve revenue collection have already been taken**. Most notably, the sales tax and income tax administrations were integrated on functional lines at the HQ level to enhance the effectiveness of tax administration. The full integration at the field level will be completed by end-December 2009. A detailed integration plan is being prepared as stipulated in the Action Plan. Other measures include the introduction of a unique tax payer identification number, strengthening of the Large Taxpayer Unit, and improved tax audits. The World Bank is providing technical assistance to implement further tax administration reforms, including strengthening of the refunds system for the General Sales Tax (GST).

14. **The government is pursuing a major tax reform agenda**. A key step will be the replacement, starting in 2010/11, of the GST with a broad-based VAT. At the same time, the government is exploring options to increase revenue in 2009/10. In particular, sales, excise,

and income tax laws will be reviewed to minimize exemptions and zero-rating. The timing of these reforms hinges on the capacity of the tax administration to process refunds. To support tax policy reforms, the government has requested Fund and World Bank technical assistance.

15. **The MoF has taken measures to strengthen payment control while work on a Single Treasury Account is progressing**. A key improvement is the introduction of a system preventing accumulation of unspent balances in accounts outside the Federal Consolidated Fund (FCF). All new budget releases are made through assignment accounts that are part of the FCF. To avoid destabilizing outflow of deposits from the banking system, remaining unspent balances (outside the FCF) will be allowed to be gradually reduced and eliminated. This process will take longer than earlier expected and will not be completed by June 30, 2009.

16. **The MoF is working to establish a Medium-Term Budget Framework (MTBF).** A calendar for the preparation of the MTBF has been established and the initiating document for medium-term budget preparation has been submitted to line Ministries. The MTBF will be submitted to the Cabinet in March/April 2009 together with the draft strategy paper. The document will provide a framework for the budget process, inform its strategic directions, establish resource envelopes, and identify policy reforms needed to fulfill the medium term fiscal consolidation objectives.

17. **In collaboration with the World Bank, the government has finalized a schedule for electricity tariff adjustments to eliminate tariff differential subsidies by end-June, 2009**. As a first step under this plan, tariffs were increased by 1 percent effective February 1, 2009. Tariffs will be raised further to result in a cumulative increase of 4 percent by end-June. Changes in the fuel cost component of electricity tariffs (the fuel adjustment surcharge) will continue to be reviewed on a monthly basis and adjusted as needed. The Asian Development Bank is also supporting power sector reforms jointly with the World Bank.

18. **We plan to resolve inter-corporate debt in the energy sector (circular debt)**. As a first step, we have prepared an issue of government-guaranteed Term Financing Certificates by Pakistan Electric Power Company (PEPCO) to settle amounts it owed to banks and suppliers. Further, we are preparing a plan to address ongoing losses on account of operational and collection losses of distribution companies, PEPCO and an independent power producer.

B. Monetary and Exchange Rate Policy

19. Monetary policy will aim at lowering inflation. The SBP will calibrate monetary policy to balance concerns about the slowdown in economic activity, subject to the overall objective of lowering inflation. Provided that the expected decline in inflation materializes and market confidence remains positive, there could be scope for a more accommodative monetary policy stance. However, the SBP stands ready to adjust policies if inflation resurges or if international reserves come under pressure. We will continue to avoid SBP financing of the budget.

20. The SBP will further improve its monetary policy framework. Market conditions permitting, the SBP remains committed to introduce in July 2009 an explicit corridor for overnight money market rate to enhance market signaling, strengthen the effectiveness of liquidity management, and reduce volatility in short-term market interest rates (see ¶19 in the MEFP). Use of an explicit interest rate corridor in support of the operational target will improve the transmission of a change in the policy rate (SBP discount rate) to the economy and so help achieve the objective of price stability.

21. The SBP will continue to pursue a flexible exchange rate policy. The exchange rate will continue to reflect market conditions and facilitate adjustments to achieve a sustainable external balance and macroeconomic stability. Interventions will be largely aimed at achieving the program's net foreign asset targets. The flexible exchange rate policy will be facilitated by phasing out SBP provision of foreign exchange for oil imports, according to the schedule in the program. As a first step, the SBP has ceased providing foreign exchange for the import of furnace oil as of February 1, 2009.

C. Financial Sector and Safeguards Issues

22. **Stress tests by the Financial Sector Assessment Program Update mission, using June 2008 data, and updated by the SBP using September data, indicated that banking system in general was resilient**. Most banks, including all large banks, would remain solvent, but some non-systemic banks would face insolvency under a severe crisis scenario. The capital injection needed to restore the capital adequacy ratio of the twelve largest banks to the minimum regulatory capital adequacy ratio of 8 percent was 2.3 percent of GDP in the worst case scenario. This relatively low level reflects the low credit-to-GDP ratio and the relatively high capital buffers. The main sources of risk for the vulnerable banks were a major deterioration in credit quality, mainly in the textile industry and exposure to the equity market. Default of the largest exposures put significant strains on solvency given the large concentration of exposures in some banks. The SBP has obtained similar results on the basis of end-September data. A few banks representing less than 10 percent of system assets face financial pressures, which are being addressed by the SBP and their owners through mergers or fresh injection of equity. Progress by these banks in resolving their problems is being monitored closely by the SBP.

23. **The financial sector has so far weathered the storm well, but the outlook calls for careful monitoring**. Provisional figures for December 2008 show gross non-performing loans (NPLs) have increased from 7.7 percent of total loans in June 2008 to 9.1 percent in December 2008, while net NPLs to net loans increased from 1.3 to 2.5 percent in the same period. However, the capital position of the banking system has improved, with the capital adequacy increasing from 12.1 to 12.2 percent of risk-weighted assets.

24. **Measures to improve banking resolution and banking supervision are being implemented**. In December 2008, the SBP adopted a problem bank management and contingency plan for dealing with problem banks. The document includes criteria for liquidity support, assessment of bank problems, criteria for use of scarce resources,

assessment of existing legal powers and intervention procedures. The effectiveness of the SBP's powers to enforce its banking supervision policies will also be strengthened and amendments to the banking legislation to this end have been drafted and will be submitted to Parliament before end-June 2009.

25. **A draft revision of the SBP law has been prepared and it will form the basis for strengthening the operational independence of the central bank**. The recently established inter-agency committee, which includes the MoF, is expected to propose measures to strengthen the operational independence of the SBP, based on the draft SBP law, by end-April 2009. A new central bank law will be submitted to Parliament by December 2009.

26. **A new bankruptcy law is under preparation**. It will help rehabilitation of viable companies and expeditious resolution of other highly indebted companies thus paving way for banks to clear their long outstanding loans. A review committee is finalizing the draft law which it will submit to the MoF by end-July 2009.

27. **The SBP has adjusted the rules on collateral and valuation of securities**. Regarding recognition of Forced Sale Value (FSV) of certain collateral, in 2007, SBP withdrew the benefit of the FSV for determining provisioning requirements in order to create a cushion in the balance sheet of banks. Recognition of FSV of collateral is permissible in most countries. In 2009, SBP has allowed partially the FSV benefit (up to 30 percent) of pledged stock as well as residential and commercial properties. Regarding valuation of securities, the imposition of a floor on the stock prices at stock exchanges last August, impeded price discovery for 3½ months in 2008. Accordingly, the Securities and Exchange Commission of Pakistan (SECP) allowed companies to delay recognition of any losses on securities (available for sale) in their income statements until end-December 2009. Losses need to be recognized immediately in capital positions, without routing them through their income statements. Any gains or delays in loss recognition from this treatment cannot be used to pay cash or stock dividends. Further, companies are also required to gradually realize losses in their income statement on quarterly basis and ensure full realization of the impairment by end-2009. SBP has allowed the banks the option to follow instructions issued by SECP regarding recognition of impairment on their capital position, but encouraged early recognition in income statements.

28. **The National Investment Trust's State Enterprise Fund (NITSEF), created to take advantage of market conditions to invest in eight government-owned/controlled companies, has begun its operations**. It has an initial capital of Rs. 20 billion. The participating institutions comprise banks, the State Life Insurance Company and the Employees Old Age Benefits Institution, which lent funds to NITSEF against a government guarantee. As of mid-February, the NITSEF had invested Rs. 7 billion. The NITSEF makes its purchases through the Stock Exchange at best available price. It will disclose its financial statements, investment strategy, and purchases on a quarterly basis on a dedicated website.

29. **The safeguards assessments of the SBP's financial control systems pointed to the need to improve SBP's internal controls further**. It recommended changes in the voting structure of the Audit Committee, improving internal controls, and establishing a Board committee to centralize risk management across all bank activities. The SBP intends to implement changes in these areas to change the voting structure of its Audit Committee in April 2009, to improve its internal controls by end-June 2009, and establish a Board Committee to centralize risk management by end-December 2009.

IV. Program Risks and Monitoring

30. The program remains subject to considerable risks. The economic situation in trading partner countries could deteriorate further and result in lower demand for exports, workers' remittances, and private capital flows. The recovery of domestic and external demand could take longer than anticipated, which would further undermine the revenue targets. As economic activity weakens, the risks to the domestic financial sector increase.

31. The program will remain subject to quarterly program reviews and quarterly performance criteria as specified in Table 1 for the remainder of 2008/09. The attached addendum to the Technical Memorandum of Understanding adds a definition of external payments arrears and provides for reporting of information on new liabilities incurred or guaranteed by the government in settling the circular debt, The adjustors, defined in the TMU, dated November 20, 2008, remain applicable.

V. Program Financing

32. The program requires additional financing to reduce its risks and enhance growth prospects. As noted, while the program is financed for 2008/09, financing constraints leave little room for countercyclical policy and there is a need for additional financing to finance social safety expenditure, development spending and enhanced security needs. The upcoming donor meeting in late March/April is pivotal for mobilizing additional financing, supporting our adjustment efforts, and reducing risks to the program.

Table1. Pakistan: Quantitative Targets, December 2008–June 2010

	Outst. Stock end-Sept. 2008	end-Dec. 2008 2/	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
Adjusted target	...	882		
Actual	...	2,355		
Ceiling on net domestic assets of the SBP* (stock, in billions of Pakistani rupees)	1,250	1,346	1,412	1,314
Adjusted target	...	1,356		
Actual	...	1,270		
Ceiling on net government borrowing from SBP* (stock, in billions of Pakistani rupees)	1,227	1,274	1,274	1,181
Adjusted target	...	1,274		
Actual	...	1,222		
Ceiling on overall budget deficit* (cumulative flow, in billions of Pakistani rupees)	142	261	405	562
Adjusted target	...	262		
Actual	...	253		
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
Actual	...	813		
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
Actual	...	1,000		
Accumulation of external payments arrears (continuous performance criterion during the program period)* (in millions of U.S. dollars)	0	0	0	0
Actual	...	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
Actual	...	1,850		
Memorandum items:				
Net external program financing (cumulative, in millions of U.S. dollars)	-166	-120	406	779
External project grants (in millions of U.S. dollars)	24	47	113	192
Foreign Exchange cash reserve requirement (CRR, incl. special CRR) deposits in SBP (in millions of U.S. dollars)	832	727	850	850
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: Structural Performance Criteria and Benchmarks

I. Structural Performance Criteria	Deadline	Status
Amendments to the banking legislation will be submitted to Parliament to enhance the effectiveness of SBP enforcement powers in the area of banking supervision.	end-June 2009	
The government will submit 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.	end-June 2009	
II. Structural Benchmarks		
A contingency plan for handling problem private banks will be finalized.	end-Dec. 2008	Met
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.	end-Dec. 2008	Met 1/
In close collaboration with the World Bank, the government will finalize the schedule for further electricity tariff adjustments during 2008/09,	end-Dec. 2008	Met
with a view to eliminating tariff differential subsidies.	end-June 2009	
The SBP's provision of foreign exchange for furnace oil will be eliminated.	Feb. 1, 2009	Met
In close collaboration with the World Bank, the government will develop a strategy and a time-bound action plan for the adoption of specific measures to strengthen the social safety net and improve targeting to the poor.	end-March 2009	Underway
The government will prepare a plan for eliminating the inter-corporate circular debt.	end-March 2009	Underway
The transition to a single treasury account will be completed.	end-June 2009	

1/ The action plan was adopted in January 2009.

ATTACHMENT II. PAKISTAN: ADDENDUM TO THE TECHNICAL MEMORANDUM OF UNDERSTANDING

March 16, 2009

1. The Technical Memorandum of Understanding (TMU) of November 20, 2008 will remain in effect except for the changes described below.

2. The following definition is added to Section I:

- External payment arrears are defined as unpaid debt service by the government beyond the due date under the contract and any grace period.

3. The following program reporting requirement is added to Section III:

- Information on new liabilities incurred or guaranteed by the government in settling the circular-debt, including government guarantees of Term Financing Certificates (TFCs) issued by Pakistan Electric Power Company (PEPCO). The information will include the size of the government exposure, the duration of the guarantee or claim, and any other provisions relevant for the government's exposure.

4. The attached table replaces Table 2 in the TMU.

Table 1. Pakistan: External Program Financing For Budget for 2008/09

(In millions of U.S. dollars)

	Jul.-Sep. Act.	Oct.-Dec. Act.	Jan.-Mar. Proj.	Apr.-Jun. Proj.	Total Proj.
Program Loans	494	811	1,390	900	3,595
World Bank	0	0	500	300	800
ADB	494	100	240	500	1,334
IDB	0	561	100	100	761
Bilateral support	0	0	500	0	500
Short-term commercial	0	150	50	0	200
Budgetary Grants	40	30	0	21	91
Privatization	0	0	0	0	0
GDRs	0	0	0	0	0
Amortization	700	795	864	548	2,907
Medium and Long-term	538	253	814	398	2,003
Euro bonds	22	0	500	0	522
IDB>1 year	200	0	0	0	200
Other	316	253	314	398	1,281
Short-term	162	542	50	150	904
IDB	162	426	0	150	738
Commercial	0	116	50	0	166
Net program financing (Budget)	-166	46	526	373	779
Amortization of government guaranteed debt	10	19	10	17	56
Net program financing (BoP)	-176	27	516	356	723

Sources: Pakistani authorities; and Fund staff projections.