August 19, 2013

Ms. Christine Lagarde
Managing Director
International Monetary Fund
Washington, D.C. 20431

Dear Ms. Lagarde:

Over the past several years, Pakistan has faced considerable challenges that have adversely affected the economy's performance: a difficult external environment, high international oil prices, two major floods, and continued security problems. These problems have been exacerbated by poor macroeconomic management during the previous government and by long-standing structural problems which have not been addressed. Falling capital inflows have been insufficient to finance even a modest current account deficit, leading to a large reduction in international reserves.

As a result of the recent elections providing the first democratic transition in Pakistan's history, the new government has a majority in parliament and a strong mandate to implement ambitious economic reforms to stabilize the economy and put our country on the path to growth and prosperity. For this, we have developed an economic program covering 2013/14–2015/16, as described in the attached Memorandum of Economic and Financial Policies (MEFP). The program focuses on strengthening macroeconomic and structural policies to shore up confidence, reduce economic imbalances, and foster sustained inclusive growth and employment generation.

In support of our economic program, we request a 36-month extended arrangement under the Extended Fund Facility (EFF) from the International Monetary Fund in the amount equivalent to SDR 4,393 million (equivalent to 425 percent of Pakistan's quota, about US$6.6 billion at current exchange rates). The extended arrangement under the EFF will provide needed external financing and signal our determination to implement sound policies, thereby bolstering market confidence and catalyzing additional financial support from other development partners and private sources.

Progress in the implementation of our program will be assessed through quarterly reviews, quantitative performance criteria, indicative targets, and agreed structural benchmarks, as described in the attached Tables 1-2 and the Technical Memorandum of Understanding (TMU). We expect the first purchase in the amount equivalent to SDR 360 million (34.8 percent of quota, about US$540 million) to become available upon approval of the extended arrangement under the EFF by the IMF Executive Board.

The Government of Pakistan and the State Bank of Pakistan (SBP) 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 and SBP believe that the policies set out in the attached MEFP are adequate to achieve the objectives of the program, but will take any further measures that may become necessary 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.

Please let us also reassure you that the policies underlying this program have the firm support of Prime Minister Sharif, the cabinet and provincial government leaders as indicated by the recent decision to this effect by the Council of Common Interest.

Sincerely yours,

Senator Mohammad Ishaq Dar
Minister of Finance
Pakistan

Yaseen Anwar
Governor of the State Bank of Pakistan
Pakistan

Memorandum on Economic and Financial Policies for 2013/14–2015/16

1. The Government of Pakistan has adopted a comprehensive program to address vulnerabilities and boost inclusive growth through macroeconomic stabilization and structural reforms. This memorandum sets out Pakistan's economic and financial policies for August 2013–July 2016, to be supported by the International Monetary Fund (IMF) under a 36-month extended arrangement under the Extended Fund Facility (EFF).

Economic Context

2. Pakistan's economy faces significant challenges. Growth has slipped to an estimated 3.6 percent in 2012/13. Productivity growth has fallen sharply and private investment has fallen by half in the past six years, undermining future growth prospects. Lack of reliable electricity supply and a difficult security situation in large parts of the country have been important factors behind this poor performance. Nevertheless, Pakistan remains a country with abundant potential, given its rich natural and human resources and its important geographical location.

3. Macroeconomic imbalances and vulnerabilities have built-up. The fiscal deficit has widened from 5 percent of GDP in 2008/09 to about 8.8 per cent of GDP in 2012/13, driven by weak tax collections, energy sector subsidies, and increased provincial government spending. Deficit financing has crowded out private sector borrowing and has contributed to inflation. Headline inflation has recently declined sharply, but it is expected to rebound. While the current account balance has improved significantly since 2008/09—due in part to rising remittances and transfer payments—capital inflows have collapsed at the same time as debt service obligations are increasing significantly, producing a steep fall in foreign exchange reserves. The State Bank of Pakistan (SBP) has also intervened in support of the currency, causing a further drop in reserves. Over the last 12 months, the SBP's reserves have fallen around 40 percent to US$6.0 billion in end-June 2013.

4. Longstanding structural impediments to growth have prevented a full realization of Pakistan's potential. Structural problems, particularly in the energy sector, security concerns, and a difficult investment climate have combined with adverse shocks to undermine economic performance. GDP growth has only averaged 3 percent over the past few years, well below that is needed to provide jobs for the rising labor force and reduce poverty. Technical and financial problems in the energy sector have led to large-scale power outages which have depressed output and have imposed hardship on the public at large. A difficult business climate has contributed to a sharp fall in private investment. Weak performance in large public enterprises in key industries constitutes a further drag on the public finances and on growth.

Medium-Term Macroeconomic Scenario

5. **The government's economic program aims to improve the medium-term growth outlook and move toward sustainable fiscal and external positions**. The program envisages consolidation to reach a sustainable fiscal deficit with a declining debt-to-GDP ratio, prudent monetary and exchange rate polices, strengthened financial stability, and structural reforms to reduce macroeconomic risks and boost inclusive growth over time. In the short run, fiscal adjustment would temper economic growth. However, the adverse impacts will be mitigated by: (i) sharply increasing public investment and improving private sector access to credit to boost private investment; (ii) alleviating acute energy supply bottlenecks to increase productive capacity and (iii) increasing targeted transfers to the most vulnerable population. Improved macroeconomic stability—together with the serious structural reforms contemplated under the program—would improve growth significantly over the medium term.

6. **Macroeconomic stability will be secured and economic performance will improve over time**. Growth will initially remain modest (about 2½-3 percent) in 2013/14 due to the necessary fiscal consolidation, but will then strengthen to around 4½-5 percent in the outer years as structural reforms are implemented and the investment climate improves. Inflation will initially increase, due in part to some weakening of the rupee as reserves are rebuilt. However, monetary policy will likely be tightened in later years to help bring inflation down to the 6-7 percent range by the end of the program period. Fiscal consolidation will bring the fiscal deficit from the baseline of 8.8 percent of GDP (excluding grants) in FY2012/13 to around 3½ percent in FY2016/17. In the early stage of the program, the current account deficit will narrow reflecting fiscal consolidation and exchange rate depreciation. Subsequently, with growth strengthening and private investment rising because of structural reforms, the current account deficit is projected to widen to around 2 percent of GDP, which will be fully financed by capital inflows. Over the course of the program, the SBP's foreign exchange reserves will improve to US$ 18 billion equivalent to over 3 months of imports of goods and services.

Economic Program

A. Fiscal Policy

7. **Fiscal consolidation is needed to put debt on a declining path and foster sustainable growth**. Fiscal consolidation of around 4-4½ percent of GDP over the three year program will lower the fiscal balance to around 3½ percent of GDP and place the debt-to-GDP ratio on a firmly declining path. Moreover, a more efficient and equitable tax system would foster competition, while providing the needed resources to finance infrastructure and support the poor through targeted programs. An upfront adjustment of near 2 percent of GDP aims at restoring policy credibility (prior action). The negative impact on economic activity will be ameliorated by structural reforms to boost growth and a somewhat more accommodative monetary policy stance early in the program than would normally be required given the inflation outlook.

8. **The initial consolidation effort relied mainly on the revenue side given the chronically low tax revenue-to-GDP ratio**. The government is taking a series of measures aimed at strengthening tax revenues by over 1 percent of GDP on an annualized basis. The tax measures contained in the 2013 Finance Bill seek to increase revenues by 0.75 percent of GDP, and included: (i) an increase in the GST rate; (ii) an increase in the corporate minimum tax rate; (iii) higher personal income tax rates for the top income brackets; (iv) higher excises on cigarettes; (v) increases in several withholding rates; (vi) introduction of several withholding rates; and (vii) imposition of new levy on movable assets. Moreover, by end-December 2013 we will implement a new gas levy that will increase tax revenue by 0.4 percent of GDP on an annualized basis. This package is a first step towards a more efficient and equitable tax system.

9. **On the expenditure side, the government has initiated a plan to phase out electricity subsidies over the life of the program**. The federal government has approved at the highest level, with support of the provinces, an energy policy entailing periodic increases in the average tariff, aiming at eliminating the tariff differential subsidy for all consumers except the very lowest over the next three years. The first adjustments to commercial, industrial, bulk, and large consumers (¶27) reduced subsidies by 0.75 percent of GDP on an annualized basis (prior action). However, for the first year we will maintain tariffs for consumers between 0-200 kWh consumption. For the second and third years, we will further reduce subsidies by roughly 0.4 percent of GDP per year to reach a maximum of 0.3 percent of GDP thereafter. As part of our initial adjustment package, we have also undertaken significant cuts in ministries' nonwage current expenditures an across the board reduction of 30 percent from the budget allocations—amounting about 0.15 percent of GDP—by ministerial decision), have scaled back the budgeted increase in capital spending, and will delay some of the remaining capital spending until new revenues from the gas levy materialize.

10. **Tax administration reforms will gradually deliver further improvements in revenue collections**. An initiative to incorporate three hundred thousand new taxpayers into the income tax net was launched in July. The 2013 Finance Bill granted the FBR access to bank information enhancing the scope and quality of information in its databases. The first step has been taken with the issuance of ten thousand notices based on large potential fiscal liabilities by end-July (prior action), and will be followed by a provisional assessment, collection procedures, and penal and prosecution proceedings. The income tax initiative will be complemented with initiatives to enhance revenue administration for sales, excises and customs, to be developed and launched by end-December 2013 (structural benchmark). These efforts will be further assisted by increasing the number of risk-based tax audits to 4.2 percent of declarations (from 2.2 percent). We will also continue to seek technical assistance on tax administration from our international partners.

11. **To ameliorate risks to the program, several contingent measures have been identified and will be implemented in case the expected fiscal adjustment falls short of objectives**. These measures include reduced expenditure allocations in the first 9 months of the year compared to the budget to create a reserve against any shortfall and use of reserves built into the capital expenditure budget if needed. These could yield savings amounting to 0.5 percent of GDP. In addition, we stand ready to take any other measures needed to assure compliance with our fiscal target.

12. **Beyond the current fiscal year, further revenue and expenditure measures will be implemented to achieve a sustainable deficit of around 3½ percent of GDP by 2016/17**. This will require further fiscal consolidation of about 1¼ percent of GDP per year in the coming 2 fiscal years. Roughly half of the adjustment could come from the revenue side, mainly through further widening of the tax base with some contribution from improved tax administration. Among the initiatives to widen the tax base we will finalize a comprehensive plan to separate existing statutory regulatory orders (SROs) either by eliminating those granting exemptions or concessions through SROs by end-December 2013. We will introduce the remaining to FY14/15 finance bill by end-June 2014. The government has already stopped issuing any new tax concessions or exemptions (including customs tariffs) through SROs except by an act of Parliament, and will also approve by end-December 2015 legislation to permanently prohibit the practice. We will also quantify the remaining tax expenditures and publish a detailed list in the budget in future years. These steps will facilitate gradually moving the GST to a full-fledged integrated modern indirect tax system with few exemptions and to an integrated income tax by 2016/17. On the expenditure side, further reductions in untargeted subsidies will be undertaken in 2014/15 and 2015/16, along with steps to streamline wage and salary costs via civil service reforms.

13. **The program envisages enhanced and better-targeted assistance for the poorest households**. The poor and most vulnerable segments of the society must be protected from the direct and indirect impacts of fiscal consolidation and tariff adjustments. The Benazir Income Support Program (BISP) is the largest targeted social assistance mechanism directly reaching 4.8 million families (16 percent of the population) within the two poorest quintiles. For FY2013/14, we have approved an increase in the budget allocated to BISP to PRs. 75 billion. This translates into an increase in the level of benefits from PRs.1000 to PRs. 1200 per family per month reaching 5.7 million families and will provide conditional cash transfers (CCTs) to primary education, supporting 560,000 families in 20 districts with a benefit of Rs. 200 per child per month attending school. As savings from tariff adjustments and fiscal space are realized, we will further expand the coverage of the program and increase the benefit amount to protect the real purchasing power of the beneficiaries. In FY2014/15, we envisage expanding coverage of basic cash payments to 6.3 million families, and by FY 2015/16 to 6.6 million families (24 percent of the population) and expansion of CCTs in at least 80 districts. In the meantime, we will phase-out the non-targeted subsidies and strengthen the technology based platform linked with National ID database for effective delivery of cash benefits. We are committed to exploring evidence based income generation schemes that enables graduation of the most vulnerable including microfinance and youth training, skills developments and asset transfer schemes.

14. **Provincial governments will play an important role in the fiscal reform process**. Under successive constitutional amendments (most recently the 18th), Pakistan has moved decisively to a more decentralized federal system of government. The most recent National Finance Commission (NFC) award grants 57.5 percent of most revenues to the provinces, along with a substantial devolution of spending responsibilities and taxation authority in agriculture, property and services which left the federal government with a severe imbalance between its remaining expenditure responsibilities and its revenue. Since under the NFC award, the bulk of the additional revenue

generated by the program will be distributed to the provinces, an agreement has been reached at the level of the Council of Common Interest to assure that it is used for deficit reduction or saved. In addition, the government has tightened the balanced-budget requirement on provinces, and provided incentives for them to maintain surpluses (prior action). Before the end of FY 2013/14, negotiations will begin on a new NFC award and the new agreement will adjust the terms of fiscal decentralization to be consistent with the imperatives of macroeconomic stability.

15. Public debt management will be strengthened over the program period. The large fiscal deficit and a weak institutional setting have hindered public debt management. Treasury bills amount to over half of domestic debt and National Savings Schemes account for almost a quarter, while outstanding bonds amount to only 20 percent of domestic debt. Out of the total domestic debt (including SBP Market Related Treasury Bills), around 60 percent of debt has a maturity of less than a year. Pakistan Investment Bonds, the prime longer-term debt instrument, have an average duration of around 3½ years. Moreover, debt management operations are fragmented across several agencies and the Debt Policy Coordination Office has only an advisory role. The fiscal consolidation envisaged will reduce government domestic financing and will facilitate developing a strategy to increase duration, lowering interest rates and rollover risks, and broadening the investor base. In this context, during the program we plan to revamp the Debt Policy Coordination Office into a debt management unit with enhanced authority to independently administer the government's financial obligations and cash flows. The unit will ensure the government's financing at the lowest possible cost given risk exposure parameters, and will seek to improve the benchmarking of issues to develop a deeper financial market. We will seek technical assistance (TA) from the IMF and the World Bank to develop a Medium Term Debt Strategy (MTDS).

B. Monetary and Exchange Rate Policies

16. The SBP has pursued an accommodative monetary policy to stimulate the economy, in view of sustained weak private investment and declining headline inflation. Over the past two years, the SBP has reduced the policy rate by a cumulative 500 basis points to 9 percent. In addition, in FY2012/13, the SBP continued direct financing for the large fiscal deficit (about 20 percent of the reserve money) and open market operations and foreign currency swaps have also pumped additional liquidity into the market. As a result, despite falling net foreign assets (NFA), monetary aggregates have expanded relatively quickly; however, private credit has shrunk in real terms.

17. To address declining reserves and a projected rebound in inflation, the SBP will adjust monetary and exchange rate policies. Monetary and exchange rate policies will focus on rebuilding foreign exchange reserves and maintaining price stability. As a first step, to signal a shift in policy, the SBP began net purchases of foreign exchange in the interbank market, which since July 1 have totaled US$125 million (prior action). The SBP will refrain from further net direct lending to the government, and limit open market liquidity injections to the economy to those consistent with the program. Inflation reduction will not be a primary focus of the first year of the program so as to mitigate the impact of the envisaged fiscal contraction.

18. Beginning in 2014/15, monetary policy will aim to reduce inflation while continuing to rebuild foreign exchange reserves. To ease some of fiscal adjustment effects, the program initially envisages a moderate monetary policy, with policy tightening in years two and three, as exchange rate pressure eases, to bring inflation down to the 6-7 percent range. To reduce inflation, monetary accommodation of fiscal deficits will be scaled back considerably and policy rates will be set prudently to ensure positive real interest rates. To protect the external position, the SBP will allow greater exchange rate flexibility, limiting intervention in the exchange market to that needed to build reserves, cushion major shocks, and strengthen competitiveness over time. Reserve losses exceeding $500 million in any 30-day period during the program will trigger consultation with IMF staff. The program envisages no further direct financing of the budget by the SBP including purchases of government papers on the primary market (continuous PC) and limits on Net Domestic Assets of the SBP. The SBP's short swap/forward foreign exchange position will be gradually scaled back to US$1.25 billion by the end of the program.

19. Enhanced central bank independence will improve monetary policymaking. Amendments to the SBP law will be enacted to strengthen the autonomy of the SBP, including full operational independence in its pursuit of price stability as its primary objective, complemented with enhanced governance structure including strong internal controls, by end-March 2014 (structural benchmark). Among other things, the amendments will establish an independent, decision-making monetary policy committee to design and implement monetary policy. The amendments will also prohibit any form of new direct lending from the SBP.

C. Financial Sector

20. The banking system is generally well-capitalized, profitable, and liquid. While NPLs remain high, they have come down since September 2011, as successive policy rate cuts have reduced the interest burden on borrowers. Despite this improvement, growth in banks' lending to private sector continues to be weak while banks' holdings of government securities continue to expand. On the funding side, bank deposits continue to grow strongly, supported in part by recent initiatives including branchless (i.e., mobile phone and internet) banking and a floor on deposit rates. As of end-March 2013, there are four small banks (one state-owned and three private) comprising 6.7 percent of banking system assets that fall below the minimum capital adequacy requirement (CAR) of 10 percent of risk-weighted assets. To comply with this requirement, the immediate capital needs of these institutions are Rs. 12.6 billion (less than 0.1 percent of GDP), but could rise if conditions were to deteriorate significantly.

21. The SBP will prepare a more detailed plan by end December 2013 to achieve compliance of all banks that fall below minimum capital adequacy (structural benchmark). The plan will include contingency measures in case of slippages and will indicate clearer alternatives in case banks are unable to raise expected capital.

- ***State-Owned Banks***: the SBP will require completion of the recapitalization of the state-owned bank that is slightly below the CAR by end-December 2014 after having received substantial capital injections over the past two years. The bank has returned to profitability and is gaining deposits, but more capital is needed for full compliance.

- ***Private Banks***: Of the three private banks that fall below the CAR, the SBP has indicated capital subscription from a private foreign investor for one to fill part of the shortfall, capital raising plans via issuance of non-cumulative perpetual preferred stock for another, and is exploring merger or acquisition by a foreign investor for the third bank. All three banks are asked to provide an approved capital plan with specific timelines, where banks are expected to complete required capital formation by end-December 2014.

22. In revamping the recovery mechanisms, consultations on the new bankruptcy law (Corporate Rehabilitation Act) are ongoing with key stakeholders. The new law will facilitate the legal framework for rehabilitating viable corporate and financial entities speeding up the process of liquidation of unviable entities. The MoF, along with the SBP and SECP, will approach the key stakeholders to address the concerns regarding creditor and debtor protection. The draft law is expected to be finalized by end-September 2014 and enacted by end-December, 2015.

23. To strengthen the long-term stability of the banking system, Ministry of Finance in consultation with the SBP plans to introduce a deposit insurance scheme. The proposed initial coverage limit is Rs. 100,000 per depositor per bank, covering 72 percent of depositors and 40 percent of total insurable deposits. The deposit insurance scheme will be managed by a Deposit Protection Fund, established as a subsidiary of SBP, with its own governance structure and funded by flat premium payments from banks. The draft act for the Fund is being finalized and is expected to be enacted by end-September 2014 (structural benchmark) and the scheme would begin operations by end-December 2015.

24. Revising the regulatory and supervisory frameworks is critical for financial stability. The Securities and Exchange Ordinance, 1969 "SEO 69" lacks a proper structure and suffers from numerous inconsistencies and gaps due to several amendments made over years. Several initiative will address these difficulties:

- The draft Securities Bill will enhance the supervisory and enforcement power of the regulator. It will be submitted to Parliament by end-March 2014, and will be enacted by end-December 2014 (structural benchmark).

- In terms of enhancing the regulatory power of the SECP, the Securities and Exchange Commission of Pakistan Act "SECP Act,"1997, did not enable the Commission to act as an integrated regulator and to act promptly, despite several amendments. In order to remove this redundancy, the Securities and Exchange Commission of Pakistan (Regulation and Enforcement) Bill has been drafted which will be sent to parliament by March 2014.

- Future markets are currently being regulated by certain amendments to SEO 69. In order to have a comprehensive framework for the futures markets, a Futures Trading Bill has been drafted and will be placed before the Parliament for expected approval by end-December 2014.

- Finally, as banks broaden their business into non-banking financial activities, it presents a challenge to the SBP and SECP to effectively regulate and supervise these entities. Therefore, the SBP and SECP have agreed on a Memorandum of Understanding (MoU) for sharing information and regulatory assistance, and will seek technical assistance from the IMF and World Bank to develop a legal framework for consolidated supervision, to be prepared by end-December 2015.

D. Structural Reforms

25. Pakistan's growth potential has deteriorated significantly over the past decade. Average growth has fallen from around 5 percent from 1995-2005 to around 3 percent since 2008. This is due in part to the difficult regional security situation which has discouraged investment. However, the secular growth decline is also driven by periodic bouts of macroeconomic instability and long-standing structural impediments to growth. We are committed to boosting long-term growth by comprehensively tackling the problems of the energy sector, which we estimate has lowered output by up to 2 percentage points per year. We will also undertake growth-promoting initiatives to improve the investment climate, liberalize and simplify the international trade regime, and reform and/or privatize public sector enterprises in key economic areas.

Energy Sector Reforms

26. We will implement a comprehensive energy policy covering all elements of the energy supply chain, demand management, and pricing policies for better functioning of the sector. The energy sector is saddled with considerable problems, including price distortions, insufficient collections, costly and poorly targeted subsidies, governance and regulatory deficiencies, low efficiency in energy supply and distribution, inadequate attention to planning as a tool for optimal decision making (particularly with regard to location, fuel choices, etc.), and insufficient investment in new energy production. We finalized an energy policy identifying priority steps for the short-term stabilization and the medium- and long-term viability of the sector to anchor the reform agenda at end-July 2013. The policy was approved by the federal government at the highest level and supported by the provincial governments to signal their buy-in to reform in the sector. We have established an energy committee chaired by the Prime Minister with participation of relevant federal ministries, provincial representatives, and key stake holders, which will meet regularly and take all key decisions on a timely basis to implement the energy policy.

27. ***Price Adjustments***. Energy sector reform should initially concentrate on "quick wins" and short-term measures that contribute to alleviation of energy bottlenecks and fiscal adjustment. In this respect, we have developed a three-year plan for phasing out the Tariff Differential Subsidies (TDS) and bringing tariffs to cost recovery level, along with cost-cutting and efficiency measures to reach full cost recovery in the electricity sector. Tariff adjustments will improve resource allocation and efficiency, and will encourage conservation. The plan will be approved by the Government of Pakistan and will begin with: (i) the notification of NEPRA determined tariffs for FY2012/13; (ii) phasing-out immediately the subsidy on industrial consumers and moving to minimum determined tariff on, commercial, bulk and AJ&K consumers' electricity consumption through increasing the weighted average notified tariffs by 50 percent; and (iii) announce the elimination and reduction of the subsidy on second group of consumers (as defined in the TMU) through increasing the weighted average notified tariffs by 30 percent that will be in effect from October 1st, 2013. The plan, together with implementation of the first step should be undertaken by August 1, 2013 to kick start the reform (prior action). In addition, the costs of servicing the syndicated term credit finance facility which was issued to cover some past losses will be incorporated into the notified base tariff by end-December 2013. In the years two and three of the program, we will generate around 0.4 percent of GDP of savings per year through reduction in subsidies to 0.3-0.4 percent of GDP at the end of the program. Tariffs for consumption between 0-200 kWh will be retained for now, and income support programs will cushion the impact of future tariff increases on the most vulnerable segments of the population. In years 2 and 3 of the program, subsidies will be phased out for users above 200 kWh and reduced for all but the lowest consumers in the 0–200 kWh range.

28. ***Arrears***. Beyond adjusting tariffs and reducing costs to reach full cost recovery, we are implementing a plan to resolve the difficult legacy of circular debt arrears. The plan is aimed at making the sector viable and removing barriers to new investment. In this respect, out of the Rs. 503 billion of payment arrears identified as of end-May 2013, we paid off Rs. 342 billion at end-June 2013 and will be resolving the residual by end-August 2013. Such arrears reduction will alleviate cash constrained power producers and allow them to bring additional electricity supply to the system and reduce load shedding by around three hours. We will also hire a professional audit firm to conduct a technical and financial audit of the system to identify the stock and flow of payables at all levels of the energy sector (including Power Sector Holding Company Limited) by end-November 2013 (structural benchmark), and based on the findings of the report we will design a roadmap to prevent the accumulation and recurrence of payables arrears.

29. **Monitoring and Enforcement**. A key shortcoming of the current electricity sector has been the limited ability to collect for energy supplied, due in part to a lack of specific real-time data on energy flows, and which also results in inadequate compliance with usage restrictions. To address this, we are going to sign strengthened performance contracts with all power sector companies to tackle losses, raise payment compliance, and improve energy efficiency and service delivery. In cases of failure to comply with the performance contracts, we will invoke remedial measures for management and the Boards as specified in the Companies' Ordinance. The government will enact the pending amendments to the Penal Code 1860 and the Code of Criminal Procedures 1898 to strengthen the legal framework in cases of electricity theft by enhancing investigation, prosecution, and penalties by end-December 2013 (structural benchmark). In parallel, we are drafting a new Electricity Act to modernize governance of the sector. The act will establish investigation systems and a fast track judicial mechanism to improve enforcement. We are also empowering the distribution companies (DISCOs) to take commercial decisions on power allocations and allowing them to impose differential outages on neighborhoods with low payment rates (as is already done in Karachi). This new legislation, along with the installation of smart or pre-paid metering trees, will allow better load management in the national grid and will reduce losses. Such legislation will also decrease the unscheduled load-shedding, which is particularly damaging to economic productivity. In the short-run, we will move to a web-based reporting portal to monitor electricity draws to reduce overdraws and improve information flows. The metering at the incoming and outgoing 11kv feeders will be completed by end-August 2013. To minimize losses in fuel delivery to generation companies (GENCOs), we will lease the fuel storage and delivery facilities to Pakistan State Oil (PSO) by end-December 2013.

30. ***Demand Side Management***. Conservation and energy efficiency are the cheapest and the fastest ways to alleviate the electricity shortage. Pricing (¶27) and other market based instruments to encourage energy conservation will significantly improve resource allocation and energy efficiency. In addition, we will place the Pakistan Energy Efficiency and Conservation Act before the Parliament for expected approval by end-September 2013. Equipment performance standards will be enforced through strengthened mechanisms, and would cover key electrical and gas equipment and appliances, which are not yet covered.

31. ***Supply Side Management***. Current energy generation is tilted towards the use of costly fuel oil. Changes in the energy mix are required to decrease the production costs. We are now prioritizing the use of gas and coal rather than fuel oil. In the short-run, increasing the allocation of natural gas to the power sector will deliver savings in production costs. However, quantity-based allocations distort market conditions. We are committed to making allocations through pricing mechanisms in the medium term. We will encourage the conversion of fuel oil-based GENCOs and Independent Power Producers (IPPs) to coal-based plants, which could substantially reduce the fuel component of electricity production costs. To further improve supply, we will continue to rehabilitate generation plants, while continuing to upgrade electricity transmission and distribution facilities to reduce technical losses. We are initiating regular efficiency testing of GENCOs by end-September 2013 to facilitate savings. The current round of three rehabilitations should be completed by end-December 2013 with 500 MW capacity recovery and a 1–2 percent increase in efficiency. Moreover, to enhance energy supply, we will continue with the development of hydropower projects—the cheapest source of supply. Policies should also promote private investment for power generation through both the entry of new players as well as expanding existing capacity of those IPPs systematically adhering to energy mix targets and least cost generation plans. The expansions are expected to generate additional 2000 MW by 2016.

32. ***Governance, Regulatory, and Transparency Improvements***. We have placed high priority on improving energy sector governance and transparency. To enhance governance, we will augment the independence, accountability, and administrative capacity of the regulatory body, the National Electric Power Regulatory Authority (NEPRA). To reduce circular debt accumulation, the period for NEPRA's determination of the base tariff will be reduced from 8–10 months to 90 days by the next determination cycle. Specifically, for FY2013/14 DISCOs will submit the tariff petitions by end-July 2013, and NEPRA will issue the determined tariff by end-October 2013. The government will notify new determined tariffs within 15 days, and over time determination and notification of tariffs will be consolidated with NEPRA. There is also currently a lag of 7 months for the application of fuel price adjustments (FPAs) dictated by NEPRA because of court injunctions. We intend to address these injunctions through the legal system to ensure timely adjustments and to revise the monthly application of FPAs to reflect next quarter's prices to minimize price distortions and improve predictability by end-November 2013. To enhance transparency, a web-based reporting of dispatching, merit order of all power plants, and payment records to stakeholders will be introduced by end-July 2013. Second, the Central Power Purchasing Agency (CPPA) should be made operational by separating it from the National Transmission and Dispatch Company (NTDC), hiring key staff, issuing CPPA rules and guidelines, and taking over the payment and settlement system by end-December 2013 (structural benchmark). Dissolution of PEPCO should also be finalized by end-December 2013 and its remaining functions should be devolved.

33. ***Energy public sector enterprise (PSE) reform***. The institutional capacity of all energy sector PSEs needs to be strengthened to allow them to eventually operate independently from the Government as efficient commercial entities. We will transfer governance of DISCOs and the NTDC to new boards of directors and management by end-2013. We are committed to building the institutional capacity of the Water and Power Development Authorities (WAPDA) through continued corporatization and commercialization, and we will strengthen WAPDA's financial capacity by allowing the tariff to incorporate capital investment plans and ensure timely payments by NTDC/CPPA for all power purchased from WAPDA. In the medium term, we are committed to introduce competitive pricing and direct contracting between power producers and wholesale customers in the power sector. We will endeavor to incorporate this transition into future phases of solicitation for new IPPs.

34. ***Oil and Gas Sector***. The current level of gas supply is barely one half of unconstrained demand due to low prices and insufficient investment. To help tackle the gas shortages, we will facilitate the import of Liquefied Natural Gas (LNG) and through pipelines and limit further expansion of the gas distribution networks for domestic consumption. We will also accelerate new investment in existing fields, which is projected to increase supply by some 7 percent by end-December 2013. We will retain the priority ranking of the power sector to second (after households) and we have diverted an additional 16 percent of gas to the most efficient power plants. Last year we announced the new Petroleum Exploration and Production Policy 2012 to offer higher gas prices for enhanced production from existing and new fields. As new production comes on line, the cost of this gas will be fully reflected in the base tariff on a semiannual basis. We will gradually rationalize gas prices to continue encouraging new investment, promote efficiency in gas use, and assure that there will continue to be no fiscal cost from the gas sector. We will announce a rationalization plan and introduce the new gas levy by end-December 2013 (structural benchmark). The current level of unaccounted for gas losses (UFG) is on average 11 percent due to commercial and technical losses. We have already directed companies to reduce losses benchmarking international standards through investment measures, managerial and administrative improvements, and through building the capacity of the gas distribution companies. We are committed to enhancing the capacity of Oil and Gas Regulatory Authority (OGRA) and Ministry of Petroleum and Natural Resources.

Improving the business climate, liberalizing trade, and reforming state-owned firms

35. Sustainably boosting economic growth in Pakistan will require a sharp increase in foreign and domestic private investment. Achieving macroeconomic stability and addressing the energy sector bottlenecks will do much to encourage renewed investment, but improvements in the business climate, the trade regime, and PSEs will also be essential, as Pakistan currently falls short of its peer countries in these areas.

36. *Business Climate*. Impediments in the legal framework for creditors' rights and contract enforcement, barriers to new business start-ups, complicated legal and taxation requirements, and impaired access to finance hamper the business climate and investment.

- *Contract enforcement*. We will consult with key stakeholders to finalize a new draft bankruptcy law (Corporate Rehabilitation Act) which we will submit for public consultation by end-September 2013 (¶22) and will send to parliament by end-September 2014. While the draft is prepared, we will undertake a diagnostic of needs to speed up rehabilitation of weak but viable corporate entities, and will expedite the liquidation of the insolvent entities. In addition, we will provide the Alternative Dispute Resolution (ADR) Mechanism, which is already functional in Karachi.

- *Start-ups*. We will establish a "one stop shop" (OSS) for registering limited liability companies (LLC), including the human resource and funding needs by end-December 2013. We continue to engage with the World Bank on this through technical assistance and capacity building. The OSS will enable firms to complete all legal formalities at a centralized location grouping Federal Board of Revenue (FBR), Securities and Exchange Commission of Pakistan (SECP), and other Government departments such as Employees Old Age Benefits Institute. In parallel, we will build capacity to set up the OSS and strengthen the Board of Investment (BOI) in facilitating implementation of investment friendly regulations. By end-September 2013, the BOI, in coordination with SECP, FBR, provincial governments and other concerned agencies, will develop a plan to further simplify procedures and costs for setting-up businesses in Pakistan.

- *Access to credit*. Accessing credit for small and medium enterprises (SME) remains very limited. We will build on the State Bank of Pakistan's Financial Inclusion Program to enhance access of micro and small enterprises to financial services. This will encompass building on regulatory reforms, product innovation, and improved delivery mechanisms, financial literacy and consumer protection.

37. *Trade Policy*. Trade policy reforms would increase consumer welfare and stimulate growth via increased competition. Simplifying tariff rates, eliminating the statutory regulatory orders (SROs) that establish special rates and/or nontariff trade barriers in some 4,000 product areas, and normalizing trade relations should deliver the much needed competitive environment.

- *Tariff simplification*. We will begin working on simplifying the tariff structure to return to the 2003 framework, with 4 slabs and 0 to 25 percent rates. Design of the new system would be completed by end-December 2013, with application of the revised tariff rates and begin the phase-out of trade SROs by June 2014 (see also ¶12 on SROs). Implementation of the new trade framework would be completed by end-June 2016.

- *Normalizing trade relations*. We are moving forward with eliminating the negative list on trade with India and extending India most favored nation status, and shifting to "sensitive list" under SAFTA regime to facilitate increased regional trade. We will also develop a strategy to take full advantage of trade preferences available from the EU where we have autonomous trade preferences in 75 items. In addition, the EU is currently considering our request for receiving GSP plus benefits (zero percent duty) from January 1, 2014 on exports.

38. ***Public Sector Enterprises***. We will step up efforts to reform public sector enterprises, focusing on limiting poor performance and improving public sector resource allocation. We are working on a time bound strategy for 65 PSEs approved for privatization by the Council of Common Interest (CCI) to facilitate decisions to either privatize firms, restructure those with prospects of profitability but which the government wishes to retain in the public sector, or close nonviable firms. The strategy will include information on the financial statements of these firms with detailed information on government liabilities.

- ***Privatization***. The strategy for 30 firms will be announced by end-September 2013 (structural benchmark), with plans for the remainder will be completed by end-December, 2013.

- ***Restructuring***. We have already begun the process of hiring professional chief executives and board members for those enterprises with a corporate structure in line with the corporate governance rules. We are developing medium-term action plans to restructure Pakistan International Airlines (PIA), Pakistan Steel Mill and Pakistan Railways. The action plans include partial privatization of companies through initial or secondary public offerings. Specifically:

- *Pakistan International Airlines*. Aging equipment, outstanding loans, and incomplete pass-through of fuel costs weigh on the profitability of the firm. Our restructuring plan includes stripping the nonviable components of PIA under a separate public sector enterprise—PIA2—by end-December 2013. We will service the guaranteed past loans of PIA2, apply a voluntary "handshake" plan for the excess work force and liquidate by end-June 2014. The PIA will retain some liabilities that it can service, streamline workforce and will receive capital injection from the government. We plan to privatize 26 percent of PIA's shares to strategic investors by end-June 2014 (structural benchmark). In the meantime, PIA will continue contracting leases on more efficient airplanes and rationalizing routes. Shifting non-flight activities to a new subsidiary company could be among the options in order to focus on core activities.

- *Pakistan Steel Mill*. To restore operations, hit hard by the collapse in steel prices during the global recession, we have appointed a professional board and secured a commercial credit line mostly from private banks to pay for loans, wages, and raw materials. The privatization commission and Cabinet Committee on Restructuring will fast track the decision-making process to approve a new comprehensive restructuring plan by end-September 2013, with implementation to begin immediately thereafter.

- *Pakistan Railways*. Aging and shortage of equipment, overstaffing, and large debts continue to weigh on railway operations. By end-March 2014 we will develop a comprehensive restructuring plan for Pakistan railways, and the railways company will be converted from a government department to a state-owned limited liability company.
- *Other companies*. We have identified a number of other companies that can quickly be privatized in the financial and energy sectors. The strategy will include plans for block sales, secondary public offerings for institutional and general public, or international listings. We will hire transaction advisors by end-December 2013 to sell residual shares in 2 major companies with already in private hands. The sequence will be calibrated to match market conditions. Minority stakes of two blue chip companies will be sold after gauging investors' appetite and global market conditions. In this regard, we will hire transaction advisors by end-December 2013 to undertake the operation. In the medium-term energy companies can also be included among the companies to be privatized.

Financing

39. In addition to our request for a financial arrangement with the IMF, we have commitments for grants and loans from other bilateral and multilateral partners to fully close the anticipated financing shortfall. We have firm commitments that financing will be in place for the first 12 months of the arrangement. Current projections suggest a financing gap of US$15 billion through June 2016, almost half of which will be filled by the extended arrangement under the EFF. Roughly US$3.5 billion will be met by the estimated improvement in the balance of payments due to the adjustment measures under the program. In addition, we expect additional external financing assurances over the program period from the World Bank ($1.5 billion), Asian Development Bank ($1.6 billion), the United Kingdom ($0.5 billion), the United States ($0.4 billion), and others ($1.5 billion).

Program Issues

40. There are important risks to the program. Pakistan is highly vulnerable to increases in oil prices, and our high reliance on textile exports means that volatility in international cotton prices is a key source of risk. In addition, a further economic slowdown in trading partner countries—including in Europe—would adversely affect Pakistan's exports while a scaling back of workers' remittances would undermine the external position further. We have consulted with the provincial governments and are collectively committed to the key points of the adjustment program outlined in this memorandum.

41. **Program monitoring**. The program will be subject to quarterly reviews, quarterly performance criteria and continuous performance criteria as set out in the TMU. Completion of the first two reviews scheduled for December 2, 2013 and March 2, 2014 will require observance of the quantitative performance criteria for end-September 2013 and end-December 2013, respectively, and continuous performance criterion as specified in Table 1. To facilitate program monitoring, we are committed to providing detailed statistical information as specified in the TMU. We will also continue to improve our economic statistics, including by beginning to produce quarterly national accounts data and by improving the coverage and organization of fiscal data.

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

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

Table 1. Pakistan: Quantitative Performance Criteria and Indicative Targets for FY2013/14 1/
(In billions of rupees, at program exchange rates, unless otherwise specified)

	FY2012/13	FY2013/14			
	end-June	end-September	end-December	end-March	en
	Act.		Program		
Performance Criteria					
Floor on net international reserves of the SBP (millions of US dollars)	-2,437	-2,499	-2,090	-141	
Ceiling on net domestic assets of the SBP (stock, billions of Pakistani rupees)	2,402	2,377	2,532	2,354	
Ceiling on overall budget deficit (cumulative, excluding grants, billions of Pakistani rupees) 2/	2,012	419	882	1,209	
Ceiling on SBP's stock of net foreign currency swaps/forward position (millions of US dollars)	2,255	2,255	2,005	2,005	
Ceiling on net government borrowing from the SBP (including provincial governments, stock, billions of Pakistani rupees) 3/	2,168	2,690	2,560	2,390	
Continuous Performance Criterion					
Accumulation of external public payment arrears by the general government (continuous)	0	0	0	0	
Indicative Targets					
Cumulative floor on Targeted Cash Transfers Spending (BISP) (billions of Pakistani rupees)	54	19	38	56	

Sources: Pakistani authorities; and Fund staff estimates.

1/ All items as defined in the TMU. Fiscal year runs from July 1 to June 30.
2/ Excluding grants, FY2012/13 overall budget deficit is a stock.
3/ FY 2012/13, total stock of government debt as of June 30, 2013.

Table 2. Pakistan: Prior Actions and Structural Benchmarks Under Extended Fund Facility

Item	Measure	Time Frame (by End of Period)
Prior Actions (implemented before Board consideration of the program)		
1	Net purchase of $125 million by the SBP in the foreign exchange sopt market between July 1 to Aug 15.	5 days prior to the Board mee
2	Develop and approve a three-year plan by the Government for phasing out Tariff Differential Subsidies (TDS), and implement the first step by: (i) the notification of new tariffs for FY2012/13; (ii) increasing the weighted average tariffs by 50 percent on industrial, commercial, bulk, and AJ&K consumers' electricity consumption; and (iii) announcing a reduction of the subsidy on second group of consumers (as defined in the TMU) through increasing the weighted average notified tariffs by 30 percent that will be in effect from October 1st, 2013.	5 days prior to the Board mee
3	Implement a series of fiscal adjustment measures (including those in the 2013/14 budget) totaling 2 percent of GDP on an annualized basis.	5 days prior to the Board mee
4	Impose a balanced budget requirement on provinces and agree with provinces to save additional revenues generated by the program.	5 days prior to the Board mee
5	Issue 10 thousand notices based on large potential fiscal liabilities.	5 days prior to the Board mee
Structural Benchmarks		
Fiscal sector		
1	Develop and launch initiatives to enhance revenue administration for sales tax, excises, and customs similar to that prepared for income tax.	end-December 2013
2	Announce a rationalization plan for gas prices which will involve a levy to generate 0.4 percent of GDP fiscal savings by end-December 2013.	end-December 2013
Monetary sector		
3	Enact the amendments to the SBP law to give SBP autonomy in its pursuit of price stability as its primary objective, while strengthening its governance and internal control framework, in line with Fund staff advice.	end-March 2014
Financial sector		
4	Prepare detailed plans to achieve compliance of all banks that fall below minimum capital adequacy, including specific actions, end dates, and contingency arrangements. Also detail a plan for recapitalization, consolidation or liquidation of 9 banks that fall below the minimum capital requirement but not CAR.	end-December 2013
5	Enact the Deposit Protection Fund Act, in line with Fund staff advice	end-September 2014
6	Enact the Securities Bill, in line with Fund staff advice.	end-December 2014
Structural Policies		
7	Develop and approve PSE reform strategy for thirty firms among the 65 PSEs approved for privatization by the Council of Common Interest (CCI).	end-September 2013
8	Hire a professional audit firm to conduct a technical and financial audit of the system to identify the stock and flow of payables at all levels of the energy sector (including Power Sector Holding Company Limited).	end-November 2013
9	Make Central Power Purchasing Agency (CPPA) operational by separating it from the National Transmission and Despatch Company (NTDC), hire key staff, issue CPPA rules and guidelines, and initiate the payment and settlement system.	end-December 2013
10	Enact the amendments to the Pakistan Penal Code 1860 and the Code of Criminal Procedures 1898.	end-December 2013
11	Privatize 26 percent of PIA's shares to strategic investors.	end-June 2014