Statement by Mr. Hosseini and Mr. Ahmed

On behalf of our Pakistani authorities, we thank the mission team, led by Mr. Porter, for extensive and thorough consultations during the EFF 7th and 8th review discussions. The authorities appreciate staff's policy advice and are keen to strengthen Pakistan's macroeconomic resilience and accelerate inclusive and sustainable growth. The authorities also express their gratitude to the Management and Executive Board for their continued support during these challenging times. They are also thankful to the country's bilateral and multilateral development partners for their support in facilitating the implementation of broad-based structural reforms.

I. Introduction

Pakistan's economy has been remarkably resilient in the face of the outbreak of the COVID pandemic. The authorities' comprehensive and well-targeted response has helped the economy rebound from the pandemic-induced slump. Indeed, Pakistan's cumulative growth through the Covid shock (FY20-22) has been among the strongest in the world. However, the war in Ukraine has created uncertainty by exacerbating international commodity price increases and adverse external financing conditions. This has already resulted in high inflation, elevated spreads, and a wider current account deficit, which created a challenging economic and political environment in Pakistan. At the same time, the political government in Pakistan changed, and Mian Muhammad Shehbaz Sharif became the Prime Minister of a coalition government on April 11, 2022.

To cushion the economy and people of Pakistan from these external shocks, the previous government granted a 4-months relief package on February 28, 2022, including broad-based energy subsidies, fuel tax cuts, new tax exemptions, and a tax amnesty. The authorities recognize that these actions were not conducive to maintaining a sustainable macroeconomic environment and the relief package was against some of Pakistan's previous commitments under the EFF program. Accordingly, over the last few months, the authorities have been striving hard to restore macroeconomic and external sustainability and, as such—beyond the policies outlined in the MEFP—**they have taken four concrete measures as prior actions (PA) for completion of the reviews** that included:(i) Parliamentary approval of the FY23 budget, including a personal income tax (PIT) reform which was signed into law on June 30, 2022; (ii) signing of MOUs by provinces on provincial fiscal targets consistent with the FY23 budget;(iii) reversal of the February relief package by eliminating fuel and power subsidies, restoration of fuel taxes along with fuel-cost adjustment; and (iv) increase in electricity base tariffs.

II. Recent Economic Developments and the Outlook

Economic growth accelerated in FY22 by more than was projected at the sixth program review. After contracting by 0.9 percent in FY20, the economy rebounded to grow by 5.7 percent in FY21 and by 6 percent in FY22. The authorities expect real GDP growth to moderate to 3-4 percent in FY23 due to the tightening of fiscal and monetary policies and the necessary external adjustment. Going forward, growth is expected to rise to above 5 percent over the medium-term on account of stronger investment and improved market confidence supported by an appropriate macroeconomic policy mix.

Nonetheless, there are emerging vulnerabilities with elevated inflation and the widening of the current account deficit. Notably, driven mainly by higher international commodity prices, exchange rate depreciation, elimination of fuel and electricity subsidies, and the restoration of fuel taxes, inflationary pressures have intensified recently. July 2022 headline CPI inflation rose to a 14-year high of 24.9 percent as compared with 8.4 percent in July 2021 and core inflation to 12 percent (y/y) in urban and 14.6 percent (y/y) in rural areas. With complete pass-on of global oil prices to domestic prices, gradual increase in Petroleum Development Levy (PDL) rates and increase in electricity base tariffs and fuel cost adjustment, energy inflation increased sharply by 70.1 and 61.2 percent (y/y) in July 2022 in urban and rural areas, respectively. In addition, inflation expectations of households remain elevated although those of businesses have declined recently. Looking ahead, inflation is expected to remain in the range of 18-20 percent in FY23 before falling to the medium-term target range of 5-7 percent by end-FY24 supported by fiscal consolidation, monetary tightening, moderating growth, normalization of global commodity prices, and beneficial base effects.

At the same time, adverse terms of trade shock and tightening global financial conditions have significantly increased the external sector vulnerabilities for Pakistan. The current account deficit has widened to 4.6 percent of GDP in FY22 due to a sharp rise in import prices coupled with strong domestic demand. With this sharp increase and inadequate financing, SBP's FX reserves declined sharply to $9.8 billion at end-June 2022 from $17.3 billion at end-June 2021 and stood at $7.9 billion as of August 12, 2022. Looking ahead, the current account deficit is expected to decline to around 3 percent of GDP in FY23 and settle at about 2.5 percent of GDP in the medium-term as the terms of trade shock facing imports dissipates and the trade deficit moderates. Nevertheless, reserve cover is expected to remain at about two and a half months of imports. External financing will continue to rely mostly on official and multilateral creditors, but also on issuance of Eurobonds and Sukuks as market conditions allow.

In this context, macroeconomic policies have been appropriately tightened to reduce demand-led pressures and rein in the current account deficit. The authorities have taken strong corrective measures, including aggressive monetary tightening and fiscal adjustment, to address the emerging challenges, reduce vulnerabilities, and lay the foundation for more sustainable growth going forward.

III. EFF Program Performance

Against this difficult backdrop, the EFF program performance has suffered; however, the government has already demonstrated its strong commitment to agreed policies and program targets by implementing unpopular economic decisions which have cost it enormous political capital. Despite the challenges, six of the eight end-June quantitative performance criteria (QPCs) were met. The two end-June QPCs were missed—floor on net international reserves (NIR) as the country lost reserves in a difficult external environment; and ceiling on the primary budget deficit due to the costly relief package introduced by the previous

government and spending pressures (mainly from the energy sector). These two QPCs were already missed at end-March 2022 for the same reasons.

More recently, the authorities have taken several actions to bring the EFF back on-track, including passing an ambitious budget for a primary surplus, significantly increasing the policy rate by 800 bps to 15 percent, eliminating post-tax fuel subsidies, and increasing fuel taxation and electricity tariffs.

The implementation of structural measures under the program is also proceeding, albeit with delay. To reinforce the structural reform agenda: (1) the Parliament adopted amendments to the Oil and Gas Regulatory Authority (OGRA) Act for the gas sector in time; (2) regulations to require the collection for publication of beneficial ownership information from companies with large procurement contracts by the Public Procurement Regulatory Authority (PPRA) were issued in mid-May 2022; and (3) measures were taken to strengthen the effectiveness of the AML/CFT framework. To further advance transparency, accountability, and integrity in the public sector, the authorities will issue regulations to establish a comprehensive electronic asset declaration system **(end-March 2022 SB, reset to end-September 2022)**.

The authorities believe that the Fund-supported program is crucial to entrench macroeconomic stability and build resilience. Therefore, to facilitate the implementation of the reform program, meet the higher financing needs in FY23, and catalyze additional financing, the authorities additionally request: (1) an extension of the EFF until end-June 2023 (with new quarterly PCs that reflect macroeconomic developments and a reset as well as new structural benchmarks); and (2) an augmentation of access by SDR 720 million (around 36 percent of quota), bringing total access to 245.6 percent of quota.

IV. Fiscal Policy and Debt Sustainability

Fiscal policy has been recalibrated to reinforce fiscal discipline by reversing the unsustainable energy subsidy package and the passing of FY23 budget centered on strong fiscal consolidation. The authorities were able to achieve significant fiscal consolidation of 1.8 percent of GDP during FY20 owing to strong revenue collections and a further improvement of 0.4 percent of GDP in FY21. As a result, Pakistan was one of the few countries that reduced the public debt-to-GDP ratio through the Covid shock, of around 2.5 percent of GDP between FY19 and FY21. However, high commodity prices and extended fiscal stimulus amid high inflation resulted in the underlying primary deficit of 2.3 percent of GDP in FY22 against the programmed zero balance.

The FY23 budget aims for an underlying general government primary surplus of 0.4 percent of GDP, a consolidation of over 2.5 percent of GDP. In addition to new taxation measures, the budget strategy seeks to control spending to strengthen debt sustainability and make space for more social and infrastructure expenditure. While the planned fiscal consolidation in FY23 relies on both revenue mobilization and sharp spending cuts, the government has protected social spending on the most vulnerable including through the elevation of the related IT target to a QPC.

Notably, the authorities have laid before the National Assembly a list of all public guarantees expected to be issued in FY23, thus setting a ceiling on guarantees on a modest downward trajectory, which, along with the budget bill, was approved on June 29, 2022.

Despite the challenging environment, the authorities continue to advance important fiscal reforms. The work on the harmonization of the services sales tax across provincial jurisdictions is ongoing with support from the World Bank. To enhance public financial management, the authorities plan to fully operationalize the treasury single account by end-December 2022.In this regard, the Ministry of Finance has created Treasury and Cash management Unit and a Cash Forecasting Unit in the Federal Treasury Office in Islamabad. Monthly and quarterly cash forecasts have been developed since January 2022, with technical assistance from the ADB. To improve debt management, amendments to the Fiscal responsibility and Debt Limitations Act, supported by World bank and IMF TA, have been passed by the National Assembly and signed into law in June 2022, which will institutionalize the establishment of a central Debt Management Office to implement the agreed Medium-term Debt Management Strategy.

Supported by the planned fiscal adjustment, reforms, and robust growth, public debt is projected to fall by 7 percentage points to 72.1 percent of GDP by end-FY23. Public debt is projected to follow a downward trajectory towards 60 percent of GDP by FY27, with external debt declining to 25 percent of GDP.

V. Monetary, Exchange Rate, and Financial Sector Policies

The authorities' efforts remain centered on safeguarding monetary and financial stability by lowering inflation towards target, maintaining a market-determined exchange rate, and building foreign exchange reserves. Increased demand for FX associated with the wider current account deficit and weak sentiment exerted pressure on the exchange rate, which depreciated by 16 percent between end-December and end-June 2022, notwithstanding FX sales to prevent disorderly market conditions. At the same time, rising inflation has been a major challenge in Pakistan.

To ensure that inflation expectations remained well-anchored, the SBP raised its key policy rate by 800 basis points since September 2021 to 15 percent through July 7, 2022, (including 525 bps increases since April). The cumulative increase in the policy rate over this period is among the largest in the world, and the SBP has been more proactive and aggressive in raising rates in response to higher inflation than most emerging market and developing economies. Monetary policy will remain data-driven, and the authorities consider that the recalibration of the fiscal-monetary policy mix will help ease inflationary and external pressures.

The SBP supports exchange rate flexibility and adequate foreign reserves as key shock absorbers, with FX interventions continuing to be limited to containing disorderly market conditions. To support the balance of payments position and reduce foreign currency outflows, the SBP has imposed cash margin requirements on the import of non-essential items since late-September 2021.The authorities are aware that this constitutes an intensification of exchange

restrictions, an MCP and import restrictions for balance of payment measures, and intend to eliminate them when feasible. Therefore, they request Board approval for all existing measures subject to Article VIII. In addition, the SBP imposed a requirement for prior approval of initiating payments for imports of certain goods in late-May 2022. The authorities recognize that this constitutes an exchange restriction and intend to eliminate it as soon as market conditions allow, in consultation with the IMF.

The banking system remains adequately capitalized and profitable. Non-performing loans (NPLs) are contained at 7.8 percent with non-provisioned NPLs remaining low at 0.7 percent as of end-March 2022. The SBP continues to selectively tighten prudential regulations for consumer financing and closely monitor the health of the banking sector to safeguard its resilience.

VI. Energy Sector Policies

Following the amendments to the National Electric Power Regulatory Authority (NEPRA) Act, adopted by the Parliament in June 2021, NEPRA has determined and automatically notified the overdue quarterly tariff adjustments. The government has also notified other adjustments in several stages in July 2022. The authorities concur with staff that subsidy reform needs to continue to effectively protect the vulnerable, introduce more fairness, and reduce fiscal costs. In this regard, the authorities are committing, *inter alia,* to entering the third stage of their multi-year subsidy reform plan, supported by the World Bank.

Efforts are being made with the help of WB and ADB to reduce commercial and technical losses (including by introducing smart metering and cutting off delinquent consumers). The reform plan includes expanding cheaper and cleaner energy generation as per the Alternative and Renewable Energy Policy. Moreover, the authorities have geared up efforts to turn around the gas sector. Amendments to the OGRA Act, adopted by Parliament in March 2022 (**end-June 2022 SB**) will improve efficiency of the gas sector.

VII. Social Protection and Poverty Reduction

The authorities remain committed to boosting social protection and reducing poverty. This is indeed crucial to protect the poor and vulnerable from the economic hardships, to accelerate the progress on SDGs, and garner buy-in for the current policies. Accordingly, the authorities raised the FY23 budget allocation for regular BISP spending to PRs 316 billion, marking an almost 40 percent increase over its FY22 execution level. This will allow to further expand the unconditional cash transfers Kafalat program to 9 million families by end-FY23 (**new end-June 2023 SB**), using the National Socio-Economic Registry (NSER) finalized in October 2021 and since kept live.

VIII. AML/CFT Developments

The authorities have demonstrated a high level of commitment to working closely with the Financial Action Task Force and the Asia Pacific Group on Money Laundering. To this end,

Pakistan has successfully completed all action items in its 2018 Action Plan, including the last item on terrorist financing investigations and prosecutions of senior leaders of UN-designated terrorist groups (Immediate Outcome 9) in June 2022 paving the way for the country's exit from the FATF list of jurisdictions with serious deficiencies (**end-March 2022 SB**). In parallel, the authorities have also completed all the 7 action items in its 2021 AML/CFT Action Plan, ahead of the committed deadlines. They will continue to ensure the sustainability and effectiveness of AML/CFT efforts in addressing the ML/TF risks in the country.

IX. State-Owned Enterprises (SOEs)

While the planned privatization of SOEs could not take place due to heightened uncertainty, the authorities continued to improve governance, transparency, and efficiency while limiting their fiscal risks. The process of strengthening the legal and regulatory frameworks of SOEs is at an advanced stage. Benefitting from Fund TA, the authorities submitted a new SOE law to the Parliament, which has been adopted by the National Assembly in July 2022 and is now awaiting Senate approval (**end-June 2022 SB, reset to end-September 2022**). Once enacted, the new SOE law will define the rationale for state ownership; ensure that SOE operations are grounded on commercial footing; and regulate oversight and ownership arrangements. In parallel, the authorities are working with ADB support to finalize further regulatory reforms by end-December 2022. Furthermore, to strengthen the monitoring of SOEs, the authorities are in the process of establishing a Central Monitoring Unit within the MoF to improve SOE performance and provide better analysis at the aggregate SOE level. They aim to operationalize the CMU by January 2023 **(new end-January 2023 SB)**.

X. Concluding Remarks

During a uniquely challenging time for the global economy, our authorities believe that the EFF program provides a robust policy anchor for safeguarding macroeconomic stability, supporting a smooth economic recovery, and facilitating inclusive growth over the medium term, while protecting the poor. Based on the authorities' strong actions that they have already taken, and their firm commitments to program targets and policies for the period ahead, they seek Executive Directors' support to complete the combined seventh and eighth review under the EFF with associated waivers and for extension, augmentation and rephasing of the access. This will help ensure that the pressing balance of payments and fiscal financing needs are fully met. The authorities view Fund support as an important catalyst in mobilizing donor support.