FIRST PAKISTAN FISCALLY SUSTAINABLE AND INCLUSIVE GROWTH DEVELOPMENT POLICY CREDIT

Description and Development Objectives: This is the first in a proposed series of two development policy credits (DPCs) supporting Pakistan's goal of achieving fiscally sustainable and inclusive growth. The main development objectives of the proposed credit are: (i) Increased private and financial sector development through measures fostering privatization, improving the business environment, facilitating trade and promoting financial inclusion; and (ii) Expanded social protection and revenue mobilization through measures seeking to protect priority social expenditure and create fiscal space.

Strategic Context: Pakistan faces a serious economic situation. Unprecedented floods in 2010 and 2011, coupled with continuing security issues, stalling economic reform, falling investment and external financial inflows, increased devolution of responsibilities to the provinces, and fiscal disarray preceding elections in May 2013 posed critical challenges that have severely affected two major macroeconomic imbalances: by the end of the 2012/13 international reserves were below 1.5 months of imports, and the fiscal deficit (excluding grants) reached 8 percent of gross domestic product (GDP), a very high level for the third year in row. As a result of weak fundamentals, the economy also featured borderline stagflation: modest growth coupled with, until recently, double-digit inflation.

As soon as it took office in mid-June 2013, the new Government articulated an ambitious emergency response so as to prevent a balance-of-payments crisis, correct fiscal imbalances and put the economy on the road to stabilization and rapid recovery. Immediately thereafter, the new government entered into successful negotiations of an Extended Fund Facility (EFF) with the International Monetary Fund (IMF). Approved on September 4^{th}, 2013, the Government's program goes beyond merely rebuilding the reserve position and fiscal consolidation. It also contains a growth-oriented agenda in the areas identified as the major constraints to growth — energy reform, as well as growth, investment, and competitiveness.

Recovering fast, sustained and inclusive economic growth is critical for Pakistan. It is the world's sixth most populous country and growth is critical for job creation and associated progress in poverty reduction and shared prosperity. The economic outlook for the country is improving, with predictions of steadily increasing growth, lowering inflation, improved economic fundamentals and reduced country risk.

Implementation and Sustainability: Whereas measures to ensure sustainability of reforms have been integrated into the DPC, there are five main areas that will require constant diligence. First, there are political economy risks, like opposition by those affected by any reduction in tax benefits or the phasing out of tax exemptions. Second, there are economic risks related to the unavoidable recessionary bias and social unrest related to adjustment measures needed to prevent (or correct) macroeconomic imbalances. Third, the reform program supported by the DPC may get affected by staff turnover, counterpart capacity constraints, and weak policy coordination. Fourth, there are substantial fiduciary risks due to some weaknesses in the public financial management system. Finally, there are social risks as the expected positive benefits on social livelihoods might materialize slower than anticipated.