INTERNATIONAL MONETARY FUND

Staff Country Reports

Pakistan: Request for a Three-Year Arrangement Under the Poverty Reduction Growth Facility (PRGF)—Staff Report; Staff Statement; Press Release on the Executive Board Discussion; and Statement by the Executive Director

In the context of the request for a three-year arrangement under the PRGF, the following documents have been released and are included in this package:

- the staff report for the request for a three-year arrangement under the PRGF, prepared by a staff team of the IMF, following discussions that ended on **October 26, 2001** with the officials of Pakistan on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on November 26, 2001.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- a staff statement of **December 6, 2001** updating information on recent economic developments.
- a press release summarizing the **views of the Executive Board as expressed during its December 7, 2001, discussion** of the staff report that completed the review.
- a statement by the Executive Director for Pakistan.

The documents listed below have been separately released.

Letter of Intent by the authorities of the member country*
Memorandum of Economic and Financial Policies by the authorities of the member country*
Technical Memorandum of Understanding*

*May also be included in Staff Report.

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INTERNATIONAL MONETARY FUND

PAKISTAN

**Request for a Three-Year Arrangement Under the
Poverty Reduction Growth Facility**

Prepared by the Middle Eastern Department and the
Policy Development and Review Department

(In consultation with other departments)

Approved by P. Chabrier and M.T. Hadjimichael

November 26, 2001

- Discussions for a new program that could be supported by a three-year arrangement under the Poverty Reduction and Growth Facility (PRGF) were initiated in Islamabad in August 2001 and continued in Washington D.C. and in Paris from October 9–26, 2001.
- The staff team consisted of Mr. Enders (Head), Ms. Fichera, and Mr. Le Dem (all MED); Mr. Taube (FAD); Mr. Ronci (PDR); and Mr. Ghesquiere (Senior Resident Representative). Ms. Vishwanath and Mr. Panzer (both World Bank) participated in the discussions.
- The Pakistani delegation led by Finance Minister Shaukat Aziz, included the Governor of the State Bank of Pakistan (SBP), the Secretary General Finance and Secretary Finance, and other officials from the Ministry of Finance and the State Bank of Pakistan.
- On September 26, the Executive Board concurred that performance under the program supported by a SDR 465 million Stand-By Arrangement established a good track record of macroeconomic policy and structural reform implementation, thus laying the ground for a successor arrangement under the PRGF. Directors emphasized that the key priorities for a PRGF-supported program should include: (a) an ambitious and credible action plan to reform tax administration and improve tax collection; (b) quantitative and qualitative improvements in public poverty-related spending and in the delivery and monitoring of basic social services; (c) continued efforts to improve governance and fiscal transparency; (d) a clear and public strategy for any transition to a financial system consistent with Islamic principles; (e) deepening of the foreign exchange interbank market to allow phasing out of the SBP's korb market purchases; (f) reform and privatization of major commercial banks and public enterprises; and (g) mobilization of concessional resources to help Pakistan get out of the debt trap.
- The principal authors of this report are Jean Le Dem and Klaus Enders, with substantial inputs from Valeria Fichera, Günther Taube, and Marcio Ronci.

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List of Acronyms

AGPR	Accountant General Pakistan Revenue
AsDB	Asian Development Bank
BSRP	Banking Sector Restructuring and Privatization
CBR	Central Board of Revenue
EFS	Export Finance Scheme
FIBR	Floating interbank market exchange rate
FMC	Fiscal Monitoring Committee
FSAP	Financial Sector Assessment Program
GSP	Generalized System of Preferences
GST	General Sales Tax
HBL	Habib Bank Limited
IFIs	International Financial Institutions
I-PRSP	Interim Poverty Reduction Strategy Paper
KESC	Karachi Electricity Supply Corporation
KSE	Karachi Stock Exchange
LTU	Large Taxpayer Unit
MEFP	Memorandum on Economic and Financial Policies
MTBF	Medium-Term Budget Framework
NBP	National Bank of Pakistan
NDA	Net domestic assets
NDFC	National Developing Financial Corporation
NEPRA	National Electric Power Regulatory Authority
NFA	Net foreign assets
NSS	National Saving Schemes
NWFP	North Western Frontier Province
PIA	Pakistan International Airlines
PIFRA	Pakistan Improvement of Financial Reporting and Accounting
PPL	Pakistan Petroleum Limited
PRGF	Poverty Reduction and Growth Facility
PRSC	Poverty Reduction Support Credit
PRSP	Poverty Reduction Strategy Paper
PSDP	Public Sector Development Program
PSIA	Poverty and Social Impact Analysis
PSO	Pakistan State Oil
PTCL	Pakistan Telecommunications Company Limited
ROSC	Review of Standard and Codes
SBP	State Bank of Pakistan
SRO	Statutory Regulatory Order
TRIMs	Trade Related Investment Measures
UBL	United Bank Limited
WAPDA	Water and Power Development Authority

Executive Summary

Performance under the recently expired Stand-By Arrangement has established a good track record of macroeconomic policy and structural reform implementation. However, Pakistan has yet to build a viable modern tax system and tackle widespread poverty, and weaknesses in basic social services.

The reform agenda under the proposed PRGF arrangement and the I-PRSP is aimed at raising growth closer to Pakistan's potential of at least 6 percent within a few years, while ensuring that the benefits are widely shared by the poor. The authorities' strategy centers on the continued pursuit of sound macroeconomic policies, in particular sustained fiscal adjustment, while increasing the share of poverty-reduction related public spending; strengthening governance, with specific focus on efficiency, transparency and accountability in public resource management; tax policy and administration reform; public enterprise restructuring and privatization; and financial sector and foreign exchange market reforms.

The envisaged fiscal consolidation over the medium term, combined with external support through grants and debt relief, will allow a substantial reduction in the public debt-to-GDP ratio. While the deficit excluding grants in 2001/02 of 5.3 percent of GDP is slightly less ambitious than the original budget objective, reflecting the impact of the September 11 shock, it will have a positive impact on public debt dynamics while allowing for additional social spending. Achieving the fiscal targets will depend critically on measures to widen further the tax base, and a fundamental reform of the tax administration.

The central bank will maintain a prudent monetary policy under the floating exchange rate regime to keep its 5 percent inflation target and build up international reserves to at least three months of imports at the end of the program period. The program envisages further exchange rate liberalization and integration of the interbank and kerb markets.

The main risks to the program would arise from a prolongation of the regional conflict, which could adversely affect growth, trade and investment and intensify budgetary pressures. Other risks include resistance from interest groups affected by the planned reforms, and limited administrative capacity to implement certain aspects of the program. However, recognizing such uncertainties, the program includes a number of contingency measures to protect fiscal and external balances.

The success of the economic reform program depends, to a considerable extent, on measures to address the large external debt burden. The staff is encouraged that the government will seek a debt rescheduling with bilateral creditors at the Paris Club with a view to reduce the debt burden towards sustainable levels. Financial support by creditors and donors will remain crucial over the medium term.

The authorities have requested financial support from the Fund under an arrangement supported by the PRGF. Access under the new arrangement, as proposed in this paper, would be SDR 1033.7 million or 100 percent of quota, disbursed in equal quarterly installments over three years.

I. INTRODUCTION AND BACKGROUND

1. Over the previous decade, Pakistan has repeatedly failed to complete a number of adjustment and reform programs supported by Fund arrangements—prior to the Stand-By Arrangement that expired at end-September 2001. Attempts by successive governments to carry through sustained reform generally ended up in policy reversals that prevented any lasting improvements in the fiscal and external positions, and, in several instances, brought the country to the verge of a foreign exchange crisis. Average annual growth hovered at about 4 percent because of relatively low investment in manufacturing, low productivity in the large agriculture sector, and several episodes of two-digit inflation. A low tax ratio, resulting from a narrow tax base and poor tax administration and enforcement, limited the government's ability to provide critical social services and infrastructure. For years, the fiscal deficit remained well above 6 percent of GDP, causing a continuous increase in public sector indebtedness and rising interest payments. Despite successful efforts at gradually reducing the ratio of defense expenditure over GDP, the composition of noninterest public expenditure remained skewed towards unproductive spending. Limited budgetary space for development expenditure, insufficient focus on the provision of basic social services and inefficiency (when not outright corruption) in expenditure management, resulted in poor social indicators and rising poverty. On the external front, a noncompetitive exchange rate and a strongly regulated foreign exchange regime discouraged export diversification and resulted in unsustainable current account deficits. Low private investment inflows and the recourse to short-term debt and foreign currency deposits only delayed an external debt crisis, which was eventually triggered by economic sanctions following Pakistan's nuclear test in 1998.

2. The military government that took office in October 1999 has candidly taken stock of the economic weaknesses besetting Pakistan, including poor governance and weak social indicators. It has also made a strong start in addressing many of the long-standing structural problems facing the economy, and bringing the country back on the path of higher growth, sustainable development and reduced poverty. Pakistan's achievements, under the more recent 12-month Stand-By Arrangement that expired end-September 2001, are encouraging (as detailed in EBS/01/161). In 2000/01, despite a severe drought, total GDP grew by 2.7 percent, supported by a rise in manufacturing output of about 8 percent, while CPI inflation declined to 4.4 percent, notwithstanding large increases in fuel and electricity prices and a significant depreciation of the rupee. Although the program's tax collection targets were not fully achieved, the revenue collected by the Central Board Revenue (CBR) increased by 0.4 percentage points of GDP. Cuts in nonpriority development expenditures contained the budget deficit to 5.2 percent of GDP (0.1 percent below the target), compared with 6.5 percent the previous year. Official reserves reached US\$1.7 billion at end-September 2001 compared with US\$0.6 billion a year earlier (Table 1 and Figures 1–5). Low inflation and successful reserves accumulation reflected responsive monetary management, supported by the introduction of a floating exchange rate regime and measures to deepen the interbank foreign exchange market.

3. The government also made significant progress on its ambitious reform agenda, with far broader coverage than under a typical Stand-By Arrangement, and strong emphasis on tackling a broad range of governance issues. Efforts were particularly focused at improving tax policy and widening the tax net by eliminating the General Sales Tax (GST) and some income tax exemptions, modernizing income taxation, and enhancing fiscal management and transparency by strengthening basic institutions and procedures to monitor budget execution. A restructuring of the banking sector was initiated and several credit and savings instruments were based on market-determined interest rates; IMF Safeguard Assessment recommendations were fully implemented. However, notwithstanding the progress achieved on the economic front, widespread poverty continues to affect close to one-third of the population and Pakistan compares poorly with other developing countries on several social indicators (Table 2).

4. In view of the post-September 11 regional tensions, and a weaker international environment, Pakistan's economic outlook has become subject to unusually high uncertainty. On one hand, perceptions about security risks related to the ongoing military operations in neighboring Afghanistan, together with the global slowdown, have taken a substantial toll on economic activity, as well as on prospects for exports and FDI inflows in 2001/02 (Box 1). Major challenges to the implementation of the program could arise from protracted economic stagnation and social instability. On the other hand, the good performance under the Stand-By Arrangement, together with the lifting of sanctions by various industrial countries, has created a unique opportunity for Pakistan to benefit from substantial international financial support for the implementation of strong macroeconomic adjustment and structural reforms.

5. Despite the uncertainty and the existing risks, the government intends to proceed forcefully in the implementation of its medium-term poverty reduction strategy. In the attached letter dated November 21, 2001, the government of Pakistan requests a three-year arrangement under the PRGF in support of its economic reform program for the period October 1, 2001–September 30, 2004 (Attachment I). The government's program is described in the Interim Poverty Reduction Strategy Paper (I-PRSP, EBD/01/107) and in the attached Memorandum of Economic and Financial Policies (MEFP). In a Joint Staff Assessment (JSA, EBD/01/106), the staffs of the Fund and the World Bank consider that the I-PRSP provides a sound basis for the development of a fully participatory Poverty Reduction Strategy Paper (PRSP) and for Fund and Bank concessional assistance, and recommend its endorsement by their respective Boards.

6. The requested access under the PRGF arrangement is SDR 1,033.7 million (100 percent of quota), to be disbursed in 12 equal quarterly installments. As of end-October 2001, total Fund credit and loans outstanding to Pakistan amounted to SDR 1,383 million (133.8 percent of quota) (Appendix I). Full and timely disbursements under the schedule set-out in Table 3 would raise Pakistan's outstanding use of Fund resources to 165.5 percent of quota at end September 2004.

Box 1. External Financing Gaps After September 11 ^{1/}

(In millions of U.S. dollars)

	2001/02	2002/03	2003/04
Financing gap (before September 11 shock) 2/	1,421	1,776	1,549
(In percent of GDP)	2.4	2.9	2.4
Current account changes	-283	-306	-193
(In percent of GDP)	-0.5	-0.5	-0.3
Export fall	-805	-853	-1,039
Import fall	675	808	1,038
Services (net)	-77	-111	-36
Private transfers	-76	-151	-156
Changes in private capital flows	-1,060	-544	-517
(In percent of GDP)	-1.8	-0.9	-0.8
Foreign direct investment decline	-400	-344	-317
Privatization receipts loss	-500	-200	-200
Commercial borrowing loss	-160	-	-
Financing gap (after September 11 shock)	2,763	2,627	2,258
(In percent of GDP)	4.7	4.3	3.6
Bilateral grant pledges 3/	818	680	651
Afghan refugees' grants spent in Pakistan	100	...	...
Additional export receipts from lifting textile quotas ahead of WTO agreement	100	200	200
Other (net) 4/	389	99	-285
Financing gap (after additional identified assistance)	1,356	1,648	1,692
(In percent of GDP)	2.3	2.7	2.7
IMF-PRGF (100 percent of quota)	329	441	442
Paris Club and bilateral creditors 5/ 6/	1,027	1,021	997
Residual financing gap 7/	0.0	187	253
(In percent of GDP)	0.0	0.3	0.4

Source: Fund staff estimates.

1/ Including impact of revisions to the World Economic Outlook, change in reserve accumulation path, and minor data revisions.

2/ As in the Staff Report of September 12, 2001 (EBS/01/161) less rollover of domestic special U.S. dollar bonds (80 percent) to make it comparable to the new presentation of the balance of payment.

3/ Mainly from United States, Saudi Arabia, and Japan. Includes commodity assistance for 2002/03 and 2003/04.

4/ In 2001/02, additional IFIs support, and short-term private inflows, including US\$90 million from OPIC

5/ Assuming enhanced terms as compared with the Paris Club agreement of 2001.

6/ Maturities from October 2001 to June 2004.

7/ For 2002/03 and 2003/04, the residual gap could be covered by additional bilateral support, including debt relief, and PSI.

II. RECENT DEVELOPMENTS

7. **Pakistan's prompt decision to fully cooperate in the fight against terrorism in the aftermath of the September 11 attack has been initially supported** by the political parties. Protests against the decision have been led mainly by fundamentalist Islamic groups. The president has reiterated his pledge to hold parliamentary elections as scheduled in October 2002.

8. **Available data for the period July–September 2001 point to a deterioration of the real economy.** Sluggish export growth (1.8 percent in U.S. dollar terms with respect to the same period of the previous year) reflects a slowdown in world demand, as well as a drastic rise in freight and insurance costs, exacerbated by reductions in air cargo services. Since mid-September, a reported widespread cancellation of export orders, especially from the United States, has affected export prospects and is already slowing investment and production. Imports dropped by 8 percent (in U.S. dollar terms) compared with the same period of the previous year, with a dramatic fall in the second half of September exacerbating an already downward trend, evenly accounted for by volume and unit value effects. Favorable preliminary data on sugar cane and cotton crops indicate that the recovery of agriculture from the drought could be somewhat stronger than envisaged, thus partially offsetting lower-than-projected manufacturing growth. However, recently discovered signs of pest contamination in the cotton crop may result in a substantial reduction in its value added, and together with declining international cotton prices (which have now fallen to a level 37 percent below the average of the last five years) could reduce income of farmers and textile exporters and affect domestic demand. Price developments in September have remained benign and the twelve-month CPI inflation rate has declined to 2.9 percent.

9. **Tax collection has been severely affected by the large decline in imports and higher-than-expected tax refunds to exporters.** Lower custom and import-related sales tax revenue explains part of the cumulative shortfall during July–September 2001, compared with the target discussed during the last review under the Stand-By Arrangement. In addition, a faster-than-expected reduction in the stock of sales tax refunds, which had been allowed to accumulate at the end of last fiscal year, also contributed to the shortfall. Despite these unfavorable revenue developments, effective control over the release of budgetary allocations allowed the authorities to meet their budget deficit target for the quarter.

10. **International reserves reached US\$2 billion in early November 2001.** The SBP's end-September indicative target on international reserves was narrowly missed, despite substantial purchases, mainly from the kerb market, because expected capital flows were delayed. However, facing increasing demand for rupees, in October the SBP stepped up its intervention on the interbank market, buying more than US\$300 million, and in early November reserves crossed the US\$2 billion level for the first time in years. In part, this appears to reflect a large repatriation of holdings abroad by Pakistan residents through the official banking channel since end-September, triggered by the tightening of anti-money laundering legislation in Gulf countries. Combined with the market's perception that large

external flows of assistance to Pakistan will stabilize the rupee, these capital inflows have at least temporarily increased the supply of dollars on both interbank and kerb markets and reversed the dollarization of bank deposits. These inflows may also have been a factor behind a recovery in the Karachi Stock Exchange (KSE) index, which at end-October stood about 13 percent above its pre-September 11 level. Similarly, between September 11 and November 1, the rupee has appreciated by 3.4 percent on the interbank market and by 8.3 percent on the kerb market, reducing the spread to virtually zero.

11. **During July–September 2001, the SBP managed to keep broad money growth (including foreign currency deposits) and reserve money growth at 9.2 percent and 9.7 percent (on an annual basis), respectively.** The rupee cash-to-deposit ratio at end-September remained close to its end-June level despite an increasingly volatile economic and political situation. On the asset side, the government's borrowing temporarily crowded out credit to the private sector, reflecting external budget financing shortfalls, notably a delay in complying with reform measures needed to allow expected World Bank disbursements. In October, in an effort to jumpstart activity, the SBP reduced the discount rate by 2 percentage points to 10 percent, and set the auction yield for six-month treasury bills at 8.5 percent.

III. PAKISTAN'S ADJUSTMENT AND REFORM STRATEGY

A. The Medium-Term Strategy and Post-September 11 Scenario

12. The solid performance under the Stand-By Arrangement and the government's continued pursuit of macroeconomic stabilization since has strengthened the basis for higher and sustainable growth. However, Pakistan has yet to tackle in a forceful way widespread poverty and weaknesses in basic social services that preclude large parts of the population to share in, and benefit from, higher growth. In clear recognition of this challenge, Pakistan's emerging poverty reduction strategy is being elaborated in a broad participatory process. An interim draft of the I-PRSP was posted on the Web to facilitate public comment and debate. As detailed in the I-PRSP, this process will intensify in the months ahead in preparing the full-fledged PRSP, to be finalized by the government emerging from the parliamentary elections in October 2002. The broad strategy builds on the comprehensive structural reform process initiated under the Stand-By Arrangement, but puts additional emphasis on basic social service delivery, growth, and sustainable development. As a poor and heavily indebted country, Pakistan is seeking financial support for such a program under the Fund's PRGF, and from other international financial institutions (IFIs) and bilateral creditors and donors.

13. **Pakistan's emerging poverty reduction strategy as laid out in the I-PRSP has three main objectives: increasing growth potential, improving social outcomes, and reducing vulnerability to shocks.** It recognizes that higher growth and a more diversified economy cannot be achieved without a dynamic private sector. Building private investors' confidence requires continued macroeconomic stability, improved governance, and a rapid exit from Pakistan's debt trap. Accordingly, the medium-term macroeconomic framework features continued fiscal adjustment, based on a broadening of the tax base and a major tax

administration reform, as well as spending restraint. The authorities also seek external support for a sizable reduction in the net present value (NPV) of external debt, without which recovery of business and investor confidence and mobilization of public resources for social services and infrastructure will remain severely constrained (see below). To improve governance, the authorities will rely on a four pillar strategy: (a) devolution to the local authorities of the responsibility for delivery of public services; (b) civil service reforms; (c) judicial reforms and fight against corruption; and (d) greater fiscal and financial transparency. The strategy also aims to support the poor directly through a reorientation of public expenditure toward education, health and social services, public support for rural development and small and medium enterprises, as well as job creation and social safety net programs. Macroeconomic vulnerability to shocks will be contained through a flexible exchange rate and lower debt, while various social programs aim to reduce the vulnerability of the poor.

14. **Discussions with the staff on the poverty reduction strategy focused on the consistency between social goals and the budgetary allocations, the monitoring of progress in achieving these goals, and the tracking of social sector expenditures.** On the social goals, in particular for health and education, the authorities recognized that the I-PRSP targets for the next three years were highly ambitious when assessed against Pakistan's achievements over the last ten years. The authorities stressed at the same time that the targets reflected a broad-based consensus on the urgency of forcefully tackling dismal social indicators. They recognized that future budgetary allocations for education and health would likely have to be raised substantially if the social targets of the I-PRSP were to be met, once a preliminary costing of the I-PRSP social programs is prepared in the context of the preparation of the next budget. The staff pointed out that within the proposed fiscal framework, given the limited prospects of achieving revenue gains higher than currently envisaged, this would require a more forceful reorientation of expenditure, including in the PSDP and away from defense. Such allocation was pressing given the current low levels of public spending on health and education. However, in the authorities' view, performance will not be determined by budget allocations only, but also by the fundamental reforms undertaken in the delivery of social services. In particular, in strong agreement with, and support from, the World Bank and the Asian Development Bank (AsDB), they expect major efficiency gains from the ongoing fiscal devolution, which will allow districts and provinces to set their own targets and to monitor progress, while strictly limiting districts' ability to borrow and to hire. The authorities concurred with staff on the need to monitor social progress through close tracking of social expenditure and key intermediate targets. To this end, they are in the process of establishing a preliminary set of such indicators for this current fiscal year (MEFP, paragraph 14) while working on a more comprehensive and reliable system to be established with the full PRSP. The full PRSP, scheduled for next fiscal year, will be based on the elaboration of poverty reduction strategies for each province.

15. **If the strategy is fully implemented in a timely manner, and assuming a return to normal security conditions in early 2002, the staff views the authorities' medium-term macroeconomic objectives as attainable.** The program projects a gradual increase in real

GDP growth to 5.2 percent in 2003/04, while annual inflation would be kept at about 5 percent (Table 1). Growth would be driven by productivity gains and modest increases in investment (mainly by nongovernment). Nongovernment savings are cautiously assumed to remain broadly unchanged as a share of GDP, as the impact of higher per capita GDP may be offset by financial liberalization, the gains in government saving, and the financial difficulties of public enterprises. Further fiscal consolidation would bring the deficit excluding grants to 3.2 percent of GDP in the third program year. The maintenance of the present free float exchange rate regime will protect the competitiveness of the economy, while facilitating the buildup of foreign exchange reserves to about three months of imports of goods and services by June 2004.

B. Macroeconomic Policies for 2001/02

16. The revised macroeconomic framework for 2001/02 is based on a preliminary assessment of the fallout of the September 11 attacks, and is highly dependent on the assumption that the impact of current military operations on the economy would be limited, and that normal economic conditions are restored from early 2002 onward. Compared with pre-September 11 projections, the framework for 2001/02 includes a downward revision in export growth (from 7.6 percent to -0.3 percent in U.S. dollar terms), and real GDP growth from 4 percent to 3.7 percent. The latter reflects a weaker manufacturing sector, while agriculture output projections, including in the cotton sector, have been revised upward. The inflation target (5 percent) has not been revised.

17. **The proposed fiscal program involves some revision of both revenue and fiscal deficit targets for 2001/02, and the measures necessary to achieve the new targets.** The revised macroeconomic assumptions imply a projected shortfall in CBR revenue of about PRs 14 billion (0.3 percent of GDP) from the targets specified under the last Stand-By review, of which PRs 12 billion stem from the fallout of the September 11 attacks, that is, lower imports and activity up to December 2001. While staff would have preferred offsetting part of this shortfall by additional tax measures, the authorities did not consider such steps feasible in the present delicate political context, and before careful analysis of the social impact. They noted furthermore that the budgetary grants already pledged by the United States and other bilateral donors would more than cover this exceptional revenue shortfall. However, they decided to protect the tax revenue objective against any further shortfall by taking commensurate tax measures if needed, as specified in the MEFP.

18. **The authorities have set the revised target for the fiscal deficit excluding grants for 2001/02 at 5.3 percent of GDP in 2001/02, with the possibility to increase it up to 5.7 percent of GDP to make room for additional social spending financed by grants.** Including grants, the deficit is projected at 2.6 percent of GDP against 3.6 percent in the initial budget, entailing therefore a positive impact on the public debt dynamics (Table 4). Any additional budgetary spending would emphasize job creation and specific social programs detailed in the MEFP, in particular in the provinces bordering Afghanistan. Last year's strict budgetary expenditure management mechanism will continue to be implemented.

Only social sector allocations are being released in full at the start of each fiscal exercise, to protect core social and poverty related expenditure. To contain the expenditure to targeted levels, in particular in case of prolonged security problems, the authorities would cut nonpriority spending as needed.

19. **The SBP intends to maintain a prudent monetary policy under the current floating exchange regime, in support of its inflation and international reserve targets.** While the SBP will look into the merits and disadvantages of moving toward an inflation-targeting framework, and once uncertainties regarding financial sector reforms are resolved (see below), monetary policy for 2001/02 will continue to focus on the targeting of monetary aggregates. Broad money and reserve money targets for 2001/02 have been set broadly in line with nominal GDP growth, and assuming that the rupee cash-to-deposits ratio continues to revert to historical trends over the current fiscal year. The projected reduction in net bank lending to the public sector should ensure adequate space for private sector credit expansion (Tables 5 and 6).

20. **Uncertainties will continue to surround the monetary projections in general, and the money multiplier in particular.** A protracted economic slowdown could prompt a return to stronger cash preference. The SBP, therefore, is fully committed to keep monetary conditions under close review, and adapt promptly the monetary stance, if needed, to meet its reserves and inflation targets. The SBP has been stepping up its intervention in the foreign exchange interbank market so as to limit the appreciation of the rupee against the U.S. dollar triggered by (likely temporary) capital inflows, and maintain the competitiveness of exports.

C. Fiscal Reform

21. **To achieve the targeted medium-term fiscal consolidation, tax policy measures to widen further the tax base and a fundamental reform of the CBR will be critical.** The authorities aim for tax revenue to increase by 1.5 percentage points of GDP over three years, to 14.3 percent in 2003/04. Tax policy discussions centered on the scope and timetable for the further elimination of GST and income tax exemptions and other measures to rationalize the tax system (Box 2). Reforming the CBR will be one of the cornerstones of the structural reform agenda under the PRGF-supported program, and several key measures will be implemented during this fiscal year. These include the organizational restructuring of the CBR headquarters and the establishment of a large taxpayer unit (MEFP, paragraphs 20–21).

22. The authorities intend to ensure that the establishment of the new tax administration structure will not affect the ongoing improvements of tax collection. Sales tax audit and enforcement activities will continue to be strengthened, on the basis of a detailed monthly plan elaborated by CBR. Altogether, tax and tax administration reforms are expected to increase revenue by 0.3 percent of GDP in 2001/02.

Box 2. Tax Reforms Under the PRGF-Supported Program

The government is committed to further rationalize the tax system through tax policy and administration reforms, with particular focus on the major federal taxes (sales and income tax). The authorities will not introduce any new exemptions or special privileges under the sales tax, income tax, and customs tariff regime, and will allow all time-bound exemptions to lapse without extension. Additional tax policy measures include the following:

- The base of the **general sales tax (GST)** has been broadened significantly in recent years, but several non-standard exemptions remain (including edible oil, vegetable ghee, pharmaceuticals, GST subsidy on electricity). While the current situation calls for a cautious approach to avoid price increases for important consumer goods, the authorities intend to adopt by end-March 2002 a firm timetable for the phasing out of these and other exemptions, starting with the 2002/03 budget. Experiences with the special GST rate (20 percent; the standard rate is 15 percent), which was introduced for certain inputs with the last budget, will be reviewed by March 2002, with a view to return to the single-rate regime with the next budget if the measure is found to have brought little additional revenue or compliance.
- On the **income tax**, the authorities will take further steps to broaden the base and simplify taxation on the basis of the recently promulgated Income Tax Ordinance. The following measures are envisaged for the 2002/03 budget: (a) elimination of at least 55 exemptions (about one-third of the total); (b) lowering of the threshold on National Savings Schemes (NSS) instruments subject to withholding tax on interest income; (c) further steps toward unifying the corporate tax rates; and (d) elimination of two minor withholding taxes. The latter two steps imply revenue losses in the short-run, and more ambitious steps in these directions will have to be phased in cautiously later.
- **Tariff** reforms include a further reduction in the maximum tariff (to 25 percent) in mid-2002, cutting the number of exemptions provided through Statutory Regulatory Orders from 13 to 6 by June 2003, and eliminating the remaining nonstandard exemptions by June 2004. In the area of **petroleum taxation**, the authorities intend to reduce the bias in favor of diesel consumption by raising the levy on diesel fuel to bring it more in line with that of gasoline, which will also be environmentally beneficial. The structure of **excise taxes** will be rationalized further through a number of specific reforms with the 2002/03 budget (MEFP, paragraph 19).
- Tax policy measures will be accompanied by a major reform of the federal government's **tax administration**, the Central Board of Revenue (CBR), which has already started with Fund and World Bank technical assistance. On the basis of a medium-term strategy and action plan, prepared as a prior action for the program, the reform focuses on reorganization, large taxpayers, self-assessment, human resource management, and enhancing the use of IT and improving accommodation (for details, see Box 1 in EBS/01/161). Critical milestones during the first program year are the completion of the new organizational setup for CBR headquarters by end-February 2002 and the establishment of a large taxpayer unit by end-June 2002 (both are structural performance criteria).

23. **The authorities are planning a substantial reorientation of public expenditure towards development and social spending over the medium term.** While current expenditure as a share of GDP is projected to decrease over the medium term, due mainly to declining interest payments and defense spending, development expenditures under the PSDP are projected to increase from 2.7 to 3.9 percent of GDP over three years, and social and poverty-related expenditure to increase from 3.4 to 4 percent of GDP during the same period.¹ Consistent with the devolution program, this implies that provincial spending (both current and capital) will increase from 5.1 percent of GDP last fiscal year to 5.7 percent at the end of the program period. Given the need for the provinces to increase their tax collection efforts, and in particular enforce the potentially buoyant agricultural income tax, the National Financial Awards Commission will review the future resource allocation and revenue sharing formula between the federal government and the provinces this year. With help from the World Bank, the authorities are envisaging to conduct a public expenditure review, including the PSDP, before the next budget.

24. **The government will continue its efforts to reform the civil service and the pension system.** A major pay and pension reform package is currently being implemented, with technical support from the World Bank, with a view to rationalizing and streamlining pay structures while removing various distortions in the pension system to contain future pension liabilities (EBS/01/101, Box 2). Even after these reforms, preliminary studies suggest that the present pension system may not be sustainable over the long term. Without further measures, pension payments could reach, in ten years, amounts comparable to the public wage bill. The authorities are therefore ready to prepare further steps to put the pension system on an actuarially sound footing, in conjunction with another pay package for the 2003/04 budget. As a first step, a new contributory regime for new entrants will be introduced in July 2002.

D. Exchange System and Financial Sector Reform

25. **The program includes several measures to further deepen and unify the foreign exchange market.** Effective November 25, the restriction that transactions in the interbank market should be backed by commercial transactions will be eliminated. The measure was introduced to limit the commercial banks' ability to take speculative positions in 1998, at a time when the exchange rate regime was still a heavily managed float. After the 1999 shift to a cleaner float, and with the recent increased confidence in the rupee, the SBP considers that prevailing tight foreign exchange exposure limits are sufficient to protect the banking system against the risks of taking excessive intra-day open positions, and that the measures will not put undue pressure on the exchange rate.

¹ The authorities decided to use a broad definition of the social and poverty-related expenditures, which they intend to monitor over the course of the program. For instance, all spending on health and education has been included. The definition and data for 1999/2000–2001/02 are laid out in the I-PRSP and in the TMU.

26. **The SBP's plans to better integrate the kerb and interbank markets will be facilitated by the elimination of the spread in recent weeks.** The authorities are ready to use this opportunity to speed up the integration between the two markets, by favoring the channeling of workers' remittances into Pakistan through the banking system and by encouraging the conversion of informal money changers into foreign exchange companies (MEFP, paragraph 27). The SBP will also clarify its regulations to ensure that no restrictions on payments or transfers for current transactions remain, including on travel, and more generally streamline foreign exchange regulations to reduce the "hassle" associated with buying foreign exchange for current transactions through the banking system.

27. **Financial sector reforms in 2001/02 include continued pursuit of the privatization of nationalized banks and the elimination of a remaining credit allocation system for agricultural credit** (MEFP, paragraph 26). A comprehensive long-term strategy to develop the financial sector is currently being discussed with the main domestic actors and the multilateral creditors. The envisaged Financial Sector Assessment Program (FSAP) mission is now expected to visit Pakistan in early 2002 and its findings will be reported to the Board in the context of the next Article IV consultation. Its recommendations, notably in the area of prudential and anti-money laundering regulations, will be discussed with the authorities during the first program review and, as appropriate, be incorporated into the program.

28. **Implementation of several measures will complete the government's long-lasting efforts to restructure and privatize the state-owned entities in the financial sector.** With support from the World Bank through a Banking Sector Restructuring and Privatization (BSRP) project, the authorities will complete last year's measures to close excess branches of United Bank Limited (UBL), Habib Bank Limited (HBL), and the National Bank of Pakistan (NBP). As of end-October 2001, 650 branches have been closed, and the remaining closures (out of a total estimate of 1,800 unprofitable branches) should be completed by March 2003. The BSRP project finances about 70 percent of the severance payments granted to 25,000 employees of the closed branches, for an estimated total of US\$340 million. Part of the operation will be financed through a bridge loan from the SBP to the nationalized banks, but such quasi-fiscal operations will cease with the next budget. The authorities aim to privatize all the nationalized banks over the program period, starting with bringing UBL to the point of sale by end-May 2002. Through merger and acquisition, the authorities are also liquidating several nonviable nonbank financial institutions, including the recent merger of the National Developing Financial Corporation (NDFC) (whose negative net worth was estimated at US\$370 million) with the NBP. The Government will finance part of the restructuring costs through the public selling on the stock exchange of remaining shares in Allied Bank and Muslim Commercial Bank, as well as 5 percent of the NBP's capital. The SBP will also eliminate a mandatory credit scheme in the agricultural sector.

29. **The authorities consider that Islamic banking should be viewed as an opportunity to diversify the supply of financial products and deepen financial intermediation.** The government will develop and seek Supreme Court approval for a dual

approach where traditional and Islamic finance institutions would coexist, ahead of the July 1, 2002 deadline set by the Court for implementation of a financial system in conformity with Islamic principles. It does not plan to restrict traditional financial practices and instruments. The SBP also intends to rely on other countries' experiences of such a dual approach to develop its capacity to regulate and monitor Islamic finance products and operators.

E. Governance Reforms and Private Sector Development

30. **Improved governance and promotion of private sector development will constitute the core of the structural reform agenda.** As detailed in the MEFP (paragraphs 11–16 and 23), the agenda involves: (a) the pursuit of the reforms to improve fiscal and financial transparency; (b) the restructuring of public enterprises and the privatization program in the banking, energy, and telecommunication sector; (c) the elimination of red tape through the streamlining of current administrative regulations and procedures that affect the private sector and provide incentives for corruption; (d) the launching of judicial reforms to strengthen the rule of law and foster a better access to justice for all; (e) further liberalization of the agricultural sector; and (f) further trade liberalization.

31. **Building on progress made under the Stand-By Arrangement, the authorities are committed to improve fiscal transparency and data quality further, with particular focus on the monitoring and publication of pro-poor public expenditure data and trends in social indicators.** With the beginning of this fiscal year, disaggregated pro-poor public expenditure data will be tracked and made available to the public on a quarterly basis. At first, these data will be provisional and unreconciled, but the authorities are committed to improve their quality over time. Also, the authorities intend to combine the tracking of pro-poor spending with the monitoring of intermediate and outcome indicators, for which work has recently been stepped up as part of the preparation of the I-PRSP. More broadly, fiscal data accounting and reporting will be improved at the federal level and, especially, in the provinces where progress in data reconciliation and fiscal transparency has lagged behind. In collaboration with the World Bank, the authorities want to press ahead with the modernization of government accounting in the context of a follow-up project to Pakistan *Improvement of Financial Reporting and Accounting (PIFRA)*.

32. **The authorities concurred that the financial situation of Karachi Electricity Supply Corporation (KESC) and, to a lesser extent, of other public enterprises present important risks for macroeconomic balances.** To improve accountability of public enterprise managers, the authorities will adopt clear performance targets and enforce regular and transparent reporting on progress in achieving these targets. Regarding Water and Power Development Authority (WAPDA), in close collaboration with the World Bank, the corporatization of energy production and distribution is being pursued. KESC has been put

on a fast track towards privatization, within an AsDB-supported project.² The staff emphasized the need to accelerate the move towards a market-based and private sector driven energy sector. It stressed in this regard the urgency to elaborate, in the context of a planned World Bank operation, a framework for private investments that avoids granting special fiscal privileges or guaranteed profits, reduces regulatory uncertainties by clarifying rules for tariff-setting, and phases-out below-market gas pricing and the related fertilizer subsidization.

33. The government will further enhance the efficiency of commodity markets, with support from the AsDB. In this perspective, the government will gradually remove remaining restrictions on marketing and distribution of basic commodities such as wheat and sugar and agricultural inputs and phase-out remaining commodity price supports and subsidies, including for the marketing of cotton. In particular, the government will limit its role to ensure the procurement and management of a wheat strategic reserve for the purpose of food security. Sales prices will reflect the procurement price (based on international reference prices), storage, distribution, and management costs.

F. Social Impact and Safety Net Programs

34. The social impact of the program should be strongly positive as a whole. Higher investment and growth should boost job creation in the private sector. In the I-PRSP, the authorities outline several complementary sectoral initiatives aimed at developing labor-intensive activities in the rural areas and for small and medium enterprises (Box 3). To ensure a long-lasting reduction in unemployment, this strategy may have to be complemented by a phasing out of labor market rigidities.³ Income-generating activities and direct cash support will be boosted by several social safety net initiatives targeting the poor (Box 3). At the same time, as detailed in the I-PRSP, the authorities will further reinforce programs aimed at eradicating child labor. The authorities agreed with the staff on the need to enhance the poverty and social impact analysis (PSIA) of reform measures. They welcomed that the World Bank and the Fund will conduct a joint pilot study on the social impact of past economic stabilization programs, notably increases of public utility prices and petroleum taxation. This study is expected to help guide, and create capacity for, the PSIA of key policy measures under the program, and improve the design of social safety net measures in the outer years of the program.

35. Already in fiscal year 2001/02, increased budgetary allocations target the poor and vulnerable segments of the population, along with higher spending on health and education. In addition, the establishment of local implementation and monitoring structures

² In preparing the next budget, the authorities plan to work out the budgetary costs of the privatization of KESC.

³ The government has recently increased the minimum monthly wage by 16 percent to PRs 2,500. This measure should have a limited impact, as only a negligible amount of wage earners receive the minimum wage.

Box 3. Social Safety Net Initiatives ^{1/}

Pakistan's multi-pronged poverty reduction strategy seeks to reinvigorate growth through macroeconomic stabilization and strong structural reforms, and improve public service delivery, especially in the social sectors, through better governance and increases in pro-poor expenditure. In addition, the strategy relies on a number of key initiatives and programs targeted at the poor and vulnerable, including the Kushal Program, the Food Support Program, and Zakat grants.

The Kushal Program

The Kushal program is a poverty alleviation initiative of the federal government that finances community-level public works programs, including the construction or rehabilitation of farm-to-market roads, water supply schemes, water and drainage canals, schools, and health facilities. The program directly helps the poor through the creation of employment and income, and it reduces poverty indirectly by generating, or rehabilitating, economic and infrastructure assets from which the poor benefit disproportionately. The initiative fits well into the new decentralized administrative set-up, and it fosters ownership of the beneficiaries at the community level. The federal government only pays for the development and rehabilitation costs, while recurrent costs and maintenance requirements are expected to be taken over by the communities or local governments.

Under this program, so far, more than 2,000 rural roads and 1,000 water supply schemes have been constructed, and close to 3,000 schools have been rehabilitated, creating employment opportunities for about 350,000 persons. In the North Western Frontier Province (NWFP), more than 2,000 schemes have been initiated under the Kushal program, with funding allocated to districts and communities on the basis of need as determined by social indicators (including literacy and infant mortality rates) and infrastructure requirements. The Kushal program started in 1999/2000 and expanded last fiscal year during which PRs 5.2 billion (0.2 percent of GDP) were spent. This fiscal year, the budget has allocated PRs 7 billion (0.2 percent of GDP) for the Kushal program, but under the PRGF-supported program, the government is committed to use additional external grants to increase spending under the Kushal program and other poverty and social sector programs by as much as PRs 15 billion.

Food Support Program

The objective of this program is to mitigate the impact of food price increases on the poorest segments of the population. Those with monthly incomes below PRs 2,000 (equivalent to about US\$1 per day) are eligible to receive cash support (PRs 2,000, paid out in biannual installments) from district governments on the basis of means testing. Last fiscal year, about 1.2 million persons benefited from this safety net program, with budgetary costs of about PRs 2.5 billion (0.1 percent of GDP). This fiscal year, a budget allocation of PRs 2.9 billion is available to finance this program, which could be expanded further (for example, to cover the urban poor) as more external grants become available.

Zakat Grants

In addition to budgetary safety nets, the Zakat charity program provides help to the poor and vulnerable through income transfers (PRs 500 per month and person in 2000/01), stipends for students at primary and other schools, free medical service at local government health facilities, and emergency relief. The Zakat program has recently been strengthened and reorganized, providing now also one-time rehabilitation grants (PRs 10,000–50,000) to Zakat beneficiaries as start-up capital for small income-generating business ventures. During 2000/01, 2 million persons benefited from Zakat grants, and funds are available to support an additional 1.5 million people. The program is financed through a 2.5 percent levy on the value of declared financial assets above certain limits; it is collected each year at the beginning of Ramadan.

^{1/} Sources: I-PRSP; World Bank; and Pakistani authorities.

should improve social service delivery. Starting by end-December 2001, the authorities will publish an annual report on the progress achieved in this area, based on a list of intermediate outcome indicators. The staff expressed concern at the apparent weaknesses in the institutional mechanism for monitoring such indicators; and stressed that there was a strong need to strengthen these mechanisms to allow timely identification of any problems or shortcomings.

G. The External Sector and Balance of Payments Outlook

36. **The September 11 attacks have lead to a substantial revision of the balance of payments projection for 2001/02, increasing the need for exceptional financing in 2001/02** (Table 7 and Box 1). Compared with the projections elaborated for the third review under the Stand By Arrangement, the current account deficit excluding grants has been revised upward by about US\$300 million. Exports are expected to remain broadly flat in U.S. dollar terms, against an 8 percent growth target before the September 11 attacks, reflecting cancellation of export orders, temporary difficulties in freight, and other disruptions in normal trade relations due to the war in Afghanistan, as well as lower prices for cotton and other textile products. Some recovery is expected during the second half of the year, in part boosted by the European Community's decision to increase quotas for textile and clothing products by 15 percent and to reduce duties by about 7 percent effective January 1, 2002 on all Pakistani exports except textiles and leather products.⁴ The impact of this measure has been conservatively estimated at US\$100 million for this fiscal year, and US\$200 million per year for the following two years. Imports of goods have also been revised downward, because of lower activity and commodity prices, while the services' balance is deteriorating due to higher insurance premia for cargo trade to and from Pakistan. The annual cost of the latter is estimated at about US\$160 million, although it is expected to be partly offset by lower travel expenditure abroad. Shortfalls are also projected in the capital account reflecting lower foreign direct investment and privatization proceeds. At the same time, the projections assume that the estimated short-term capital inflows that have already taken place in the immediate aftermath of the attack will not be reversed, although continuation of such inflows is not expected. All the projections depend critically upon the assumed return to normal economic and trade conditions by early 2002. Should the current conditions prevail for another two quarters, an additional deterioration of external balances in the order of US\$500-600 million would seem likely.

⁴ Tariff concessions to Pakistan have been granted under the new Generalized System of Preferences (GSP) special incentives for combating drug production and trafficking. As a result, tariff on all exports to the E.U. except textiles, leather and leather products have been eliminated. In return, Pakistan has confirmed its intention to reduce duties on imports of certain textiles from July 1, 2002 to three rates: 5 percent, 15 percent, and 25 percent, and to bind these rates in the WTO. Improved access to the U.S. market is also being considered by the U.S. Administration and Congress, but has not been factored into the projections.

37. With the dissipation of the impact of the present crisis and the impact of structural reform, the external position should improve in the outer years of the program. Over the medium term, the external current account deficit (excluding official transfers) is projected to narrow to 2.6 percent of GDP by 2003/04, and subsequently stabilize around 2.0 percent of GDP. Export volume growth is expected to be sustained at about 6.0 percent a year on average as a result of structural reforms, the recent exchange rate adjustment, and expected further gains in competitiveness. Over the longer term, import volumes are projected to grow at about 5.5 percent a year, consistent with the long-run growth and investment rates. The capital account should improve as private investment inflows respond to greater confidence and the country's improved repayment capacity.

38. Accordingly, substantial exceptional financing for the program period is required. Expected contributions include program lending by the World Bank (US\$1.5 billion) and the AsDB (US\$1.4 billion)—all highly tentative for the outer years and based on the assumption of continued support at broadly the 2001/02 levels—as well as cash grants and commodity support. The residual gap is expected to be filled by Fund support under the PRGF, and a debt rescheduling by the Paris Club and other bilateral creditors during the period of the Fund arrangement, with exceptional coverage of debt service obligations falling due at least during part of this period. For FY 2001/02, the financing gap is expected to be fully closed on this basis.

39. **A clear and credible path towards a sustainable external debt position is a key condition to reach the program's growth and investment objectives and achieve a sustainable balance of payments.** For a poor country, Pakistan's NPV of external public and publicly guaranteed debt of 260 percent of exports (and even higher if private debt is included) is unsustainable, deterring investment and severely constraining the resources available for social development and poverty reduction (Appendix IV). As envisaged under their debt reduction strategy, the authorities therefore plan to reduce nonconcessional external borrowing to the minimum required to meet balance of payments needs. They also intend to request from the Paris Club and other bilateral donors a reprofiling of the bilateral debt stock to achieve a sizable reduction in the NPV of debt as a share of exports.

40. Risks to the medium-term viability of the balance of payments include failure to achieve a significant reduction in the debt burden, but also weaker export growth should the global economy deteriorate further, or should the current conflict be prolonged. Another risk would arise if a return of drought conditions would necessitate additional food imports. In addition, external balances remain vulnerable to higher oil prices—an increase in the world crude price by US\$1 entails, all other things equal, a deterioration of the current account by about US\$90 million (0.2 percent of GDP).

41. **Pakistan has always maintained a sound record in meeting debt service obligations to the Fund, and, based on the above scenario, Pakistan should not encounter difficulties to repay the Fund.** Assuming that all disbursements under the PRGF are made, Pakistan's liabilities to the Fund would peak at a maximum of 5.5 percent of total

public and publicly-guaranteed debt and 16 percent of projected exports of goods and services in 2002/03. Debt service obligations would peak at 3.6 percent of exports in 2002/03 and decline to 1–1.5 percent in the medium term, and would not exceed 12 percent of gross official reserves after 2002/03 (Table 11). The proposed level of access and phasing is based upon the size of Pakistan's balance of payments requirements, including the need to reconstitute reserves to more comfortable levels; the satisfactory track record of macroeconomic performance and policy actions over the last two years, including the recently expired Stand-By Arrangement; and the strength of the proposed program.

IV. PROGRAM MONITORING AND IMPLEMENTATION CAPACITY

42. Structural conditionality is limited, focused on areas of Fund expertise, and designed to protect crucial areas of the reform program (Box 4). Quarterly quantitative targets are set forth in Table 1 of the MEFP, and focus on a similar set of aggregates as the recent Stand-By Arrangement. The majority of performance criteria and benchmarks aim at ensuring that the medium-term fiscal objectives can be attained, focusing on fundamental reform of the CBR and crucial steps to broaden the tax base, critical steps to contain public enterprises' financial imbalances, and better monitoring of expenditure and, in particular, priority social and poverty-related outlays. Measures to deepen and unify the foreign exchange market are also covered by conditionality, strengthening the ability of exchange rate adjustments to help absorb additional shocks.

43. In view of the large uncertainties surrounding the macroeconomic framework, the program will be monitored through quarterly reviews. Quantitative and structural performance criteria and benchmarks have been proposed through March 2002, as detailed in the MEFP. A major risk to the program arises from possible delays in the expected return to normal activity after December 2001. The authorities have laid out various contingency measures for such a case, which would also trigger accelerated consultation with Fund staff (MEFP, paragraph 39), including revenue measures, cuts in nonpriority spending, some limited use of reserves, but most of all maintenance of a fully flexible exchange rate. The first review will include a reassessment of the macroeconomic framework in light of the status of the regional conflict, and given the external financing constraint.

44. Additional risks to program implementation derive from the highly vocal vested interests in Pakistan, and the need for the authorities to mobilize sufficient domestic support for the reform program and the international war against terrorism. These issues could slow progress under the tax policy and tax administration reforms, and prevent the authorities from taking adequate offsetting tax measures if another shortfall in tax collection were to emerge. Finally, the elections envisaged for October 2002 will bring a new government, the commitment of which to the reform program is obviously unknown.

Box 4. Structural Conditionality

1. Coverage of structural conditionality in the PRGF program

Structural conditionality is detailed in Table 2 of the MEFP, and reflects some streamlining from the recently expired Stand-By Arrangement. The focus is on tax policy and tax administration reforms, public expenditure management reforms and fiscal transparency, all considered essential to the success of the government's growth and poverty reduction strategy. A few measures to deepen the foreign exchange market and streamline foreign exchange regulations are also included and will build on progress made in this area under the Stand-By Arrangement. In addition, the program includes measures concerning public sector enterprise restructuring and privatization, which are not in the core area of Fund responsibility, but are critical to the success of the program. In particular, the privatization of KESC, which is being pursued in the context of an energy sector reform program supported by the AsDB, is a structural performance criterion; while the privatization of UBL, envisaged in the context of a World Bank-supported banking sector restructuring project, is a structural benchmark. Failure to privatize KESC would entail continuous and substantial draining of budgetary resources and undermine medium-term fiscal consolidation. Delays in the privatization of the nationalized banks would be a setback to the efforts to create a sound and efficient financial sector that contributes to growth, and is less vulnerable to government interference.

2. Status of structural conditionality from earlier programs

Virtually all structural measures included in the Stand-By Arrangement, which expired at the end of September, have been implemented. A benchmark on the establishment of best practice anti-money laundering rules has been missed because of a postponement in the scheduled FSAP mission, that was expected to provide technical advice. The benchmark on the reconciliation of provincial expenditure has only been partially met because of limited institutional capacity in managing both the devolution initiative and revising accounting procedures to include the newly created district administrations. The I-PRSP and the structural reform program in the PRGF include a series of steps to improve expenditure reconciliation over the program period.

3. Structural areas covered by World Bank and other donors' lending and conditionality

World Bank program lending for 2000/01 was delivered under a one-tranche Structural Adjustment Credit. Disbursement was conditional on: (a) reforms in governance, transparency, and efficient use of resources (separation of audit and accounts, establishment of Public Accounts Committees, new public accounting system); (b) civil service reform (strengthening of recruitment, evaluation, and promotion processes); (c) pricing and policy reforms for the deregulation of the power, oil and gas sectors; and (d) policies to improve delivery of social services (enactment and implementation of education sector reforms, measures to reduce teacher and health staff absenteeism, and measures to improve the social sector investment program). Conditionality related to the restructuring of three nationalized banks is part of a banking sector project loan approved at the end of October. A Poverty Reduction Support Credit (PRSC) is expected to be discussed later this year with conditionality to be focused on governance, private sector development through enhanced deregulation and privatization, and social service delivery.

The AsDB is supporting Pakistan's adjustment effort through an Energy Sector Restructuring Program loan (including conditionality leading to the privatization of KESC and two of the corporatized WAPDA entities); in addition to a Small and Medium Enterprise Trade Enhancement Finance loan, and a Trade, Export Promotion and Industry program. The AsDB is currently finalizing an agricultural policy reform loan, aimed at reducing the government's intervention in agriculture and raising agricultural productivity, and a medium-term loan to enhance access to justice, raise accountability of justice and law enforcement agents, and strengthen the rule of law.

V. STATISTICAL ISSUES

45. **The program incorporates substantial steps to improve the availability, quality, and timeliness of Pakistan's statistical data.** In the past, data weaknesses have complicated the analysis of economic developments and might have hampered timely policy responses. Under the impetus of technical assistance, including from the Fund, the authorities are making steady progress in addressing these weaknesses. To strengthen these efforts, the program incorporates steps to improve the availability, quality, and timeliness of Pakistan's economic and financial data. In line with recommendations from the Fund Statistics department in the context of the ongoing action plan to improve national accounts, the program includes specific steps that will lead to the production of a new quarterly GDP series with a 1999/2000 base year, starting in fiscal year 2002/03 (MEFP, Section VI). Progress in developing an array of Producer Price Indices will eventually result in the production of a methodologically correct and more reliable GDP deflator.

46. **The large unexplained flows of foreign exchange that entered Pakistan in the aftermath of September 11 make the need to establish credible estimates of these flows and their nature more urgent.** So far, the SBP has not developed a reliable system for collecting data on the nature of the foreign exchange flows intermediated by money changers in the kerb market. The SBP presumes that its purchases through money changers in the Gulf ultimately reflect remittances from Pakistani workers, but these may be only part of the flows that go through the kerb market. Without any wider assessment of kerb market flows, total workers remittances and private capital inflows could be largely underestimated, providing an incomplete picture of both capital and current accounts. The planned setting up of regular and structured surveys of the money changers' operations should shed more light on these operations.

47. **The authorities' interest in a direct move towards subscription to the SDDS over the course of the program is a very ambitious goal** given the large existing statistical deficiencies and the fact that Pakistan does not currently participate in, or comply with, the guidance on good statistical practice under the GDDS. The feasibility of such a move and the related need for reforms and technical assistance will be assessed in the context of the forthcoming STA mission to prepare the data module of the Review of Standard and Codes (ROSC).⁵

VI. STAFF APPRAISAL

48. Economic performance and the implementation of an impressive structural reform agenda under the recent Stand-By Arrangement have established a solid basis for a further deepening of the reform process in Pakistan. This performance has also left Pakistan's

⁵ The mission had been originally scheduled for October and November 2001, but in light of the September 11 events has been postponed.

economy in a better position to weather the pressures arising from a weakening world economy and the fallout from the September 11 events. At the same time, the experience of the last 18 months has highlighted important weaknesses that must be addressed if Pakistan's economy is to move toward a path of high and sustainable growth, and if living conditions and prospects for a third of the population, currently trapped in poverty, is to improve.

49. Such weaknesses include, first of all, the inadequacy of public resources available for basic social services, social safety nets, and critical infrastructure investments. Therefore, the authorities' reform strategy rightly puts strong emphasis on tax policy and tax administration reform, to raise the revenue-to-GDP ratio in a manner that also reduces distortions and inequities, along with the scope for corruption. The staff considers the forceful and timely implementation of the fundamental CBR reform, and the early and comprehensive reduction of the income tax and GST exemptions, as perhaps the most critical element of the reform strategy. Such measures will require strong political will to overcome powerful interest groups benefiting from exemptions and, within CBR, from opaque and complex rules that allow room for discretion and rent-seeking. To underpin the revenue targets, staff encourages the authorities to increase the diesel levy early on if oil prices decline, regardless of immediate need.

50. Higher revenue mobilization needs to be complemented by better prioritization of public expenditure allocations: defense expenditure, pay and pensions for a bloated civil service, and explicit and implicit subsidies for an inefficient and insufficiently accountable public enterprise sector need to be reduced over time. This will make room for spending that contributes to overall growth and development, and helps and protects the most vulnerable segments of the population.

51. Yet a better reallocation of resources is not enough. The government's I-PSRP and MEFP rightly identifies better governance and transparency in public finances as another indispensable ingredient for achieving the reform targets. This includes the production and publication of more timely and reliable fiscal data, to allow policy makers to identify the performance of ongoing expenditure programs and allow public scrutiny and monitoring. The ongoing accounting and auditing reform must be pursued with vigor, with clearly defined responsibilities and accountability of the departments concerned. The continued large amounts of expenditure that remain unreconciled and unclassified for long periods of time, along with the difficulties of establishing even a rudimentary system for monitoring the impact of social expenditures, remains of concern. The staff shares the hopes of the authorities that the empowerment of the local governments through devolution, which is strongly supported by the World Bank and AsDB, will strengthen the formulation of development programs and the monitoring of their implementation. However, the staff foresees a strong need to strengthen training for, and enforce strict accountability on, local governments to avoid a loss of fiscal discipline and the hijacking of local budgets by local elites.

52. Improved governance in public finances also includes a better budgeting process that more clearly recognizes the many contingent liabilities arising from public enterprises, as well as the long-term implications of ongoing spending programs. The staff is encouraged that the recent pay and pension reform has started to recognize and address the unsustainability of current policies. However, deeper civil service and pension reforms will need to be formulated and eventually incorporated into the program, and should extend to the provinces and the military, since current pension rules remain unsustainable over the long-run. A move to medium-term budgeting will be critical to highlight more clearly the implications of current choices. This should include a better formulation and costing of the medium-term health and educational reform programs that are key to deliver the targeted social outcomes.

53. Great strides have been made in liberalizing markets and making room for private sector activity, including in sensitive areas such as petroleum product, and wheat pricing and marketing. Yet these reforms need to be strengthened, so as to further reduce the federal and provincial government's role in production and distribution. The staff strongly encourages the authorities to implement a planned AsDB-supported program aimed at further reducing provincial governments' role in agricultural marketing, moving rapidly to market-based pricing for natural gas, and to refrain from granting fiscal and other privileges to new investors, including in the energy sector. Existing regulatory bodies such as National Electric Power Regulatory Authority (NEPRA) and the prospective regulator in the oil and gas sector need to be bound by more clearly specified rules; without greater regulatory certainty, the privatization of KESC, for example, will likely prove difficult. The staff recognizes that, under current circumstances, the planned privatization program will have to be delayed. However, the staff encourages the authorities to take whatever steps are feasible as early as possible, and to implement the few planned major privatizations on time in spring 2002, as an important signal to the investor community that reforms are irreversible.

54. The staff welcomes the financial sector reform strategy elaborated by the SBP. Many specifics will have to be worked out in the context of the planned FSAP mission, which unfortunately had to be delayed following the September 11 events. However, the thrust of current initiatives needs to be pursued. In particular, in the staff's view, to obtain the full return from the huge outlays necessary for restructuring the nationalized banks, rapid privatization is required. The staff also welcomes that the government has formulated a clear strategy regarding Islamic Finance, based on an evolutionary approach that should not disrupt financial systems, and which will be submitted to the Supreme Court.

55. The macroeconomic framework and policy mix for fiscal 2001/02 should help consolidate recent stabilization gains despite the setbacks arising from the current regional security problems. Given the great uncertainties surrounding short-term prospects, the authorities need to be extremely vigilant and stand ready to reinforce macroeconomic policies as needed to preserve inflation and reserves targets. Clearly, the main risk is a prolongation of regional conflict that could stall the growth recovery and weaken the potential for any poverty reduction. In such a case, it will be critical to enact forcefully and early the envisaged tax and

expenditure contingencies. Risks will arise not only from exogenous uncertainties, but also from domestic pressures exerted by interest groups most affected by the planned reforms, and from siren calls that the prospective greater international support for Pakistan justifies a relaxation of the adjustment process. A different risk relates to the possibility that administrative weakness and bureaucratic inertia will prevent the governance and fiscal management reforms that are needed to ensure effective implementation of the greater focus on social sectors and poverty reduction. The track record from past experience is rather mixed, and devolution has brought untested new players into the picture, the impact of which is difficult to foretell.

56. Still, the staff strongly considers that such risks are worth taking. The current government has now established a solid track record of commitment and implementation, both in preserving macroeconomic stability and carrying out difficult and unpopular reforms. To an impressive degree, government economic policies are transparently formulated and discussed and made publicly available, along with a wealth of statistics and other economic reports. The reform program is strongly owned by the government, and the I-PSRP from which the proposed PRGF program is derived has been formulated in an open and consultative process, fully driven by the authorities, and is remarkable for its frankness in recognizing existing weaknesses in policies, data, and diagnosis. While the direction and comprehensiveness of reforms is encouraging, Pakistan's growth prospect over the medium-term is constrained by an unsustainable level of external debt, an issue the authorities plan to take up with their creditors. The international community has been showing strong support for Pakistan's reform, and the assurances received for continuing and intensifying such support in appropriate forms in the future are welcome. This will help to relax the constraints to economic growth and reduction in poverty that have in the past adversely affected the economy. Accordingly, the staff recommends granting approval to the authorities' request for Fund support under the PRGF and wishes the authorities well in the implementation of their ambitious adjustment and reform program.

Figure 1. Pakistan: Output and Inflation, 1995/96– 2000/01

Source: Data provided by the Pakistan authorities.

1/ Last observation July, 2001

2/ Last observation September, 2001

Figure 2. Pakistan: External Sector Developments, 1994/95–2000/01

Source: Data provided by the Pakistan authorities.

1/ Customs basis. Last observation July, 2001.

2/ Including official transfers.

3/ Excluding short-term swap and forward commitments. Last observation October, 2001.

Figure 3. Pakistan: Exchange Rate and Stock Market Developments, 1995–2001

Source: Data provided by Pakistan authorities; and Fund staff estimates.

1/ Last observation October, 2001.

2/ Last observation August, 2001.

Figure 4. Pakistan: Fiscal Developments, 1993/94–2000/01

Source: Data provided by the Pakistan authorities.

1/ Gross public debt less government deposits with the banking system.

Figure 5. Pakistan: Monetary Developments, 1993–2001

Source: Data provided by the Pakistan authorities.

1/ Last observation August, 2001.

Table 1. Pakistan: Selected Economic and Financial Indicators, 1998/99–2003/04 (Continued)

	1998/99	1999/2000	Est. 2000/01	Prog.		
				2001/02	2002/03	2003/04
(Annual changes in percent)						
Output and prices						
Real GDP at factor costs	4.2	3.9	2.7	3.7	5.0	5.2
Real GDP at market prices	3.7	4.4	3.4	3.9	5.0	5.2
Partner country demand	2.7	4.0	3.2	2.0	2.9	3.8
Consumer prices (p.a.)	5.7	3.6	4.4	5.0	5.0	5.0
Consumer prices (e.o.p.)	3.7	5.1	2.5	5.9	...	...
Rupees per U.S. dollar (p.a.)	17.0	3.0	12.8	11.3	...	...
(In percent of GDP)						
Savings and investment						
Gross national savings	11.9	13.5	12.8	14.6	14.7	15.5
Government	-3.0	-3.6	-1.8	0.7	1.0	1.8
Nongovernment 1/	15.0	17.2	14.6	13.8	13.8	13.7
Gross capital formation	15.6	15.6	14.7	15.2	16.2	16.8
Government	3.7	3.2	2.7	3.4	3.6	3.9
Nongovernment 1/	11.9	12.4	12.0	11.8	12.6	12.9
(In percent of GDP)						
Public finances						
Budgetary revenue (excluding grants)	16.2	16.5	15.7	16.5	17.3	17.6
Budgetary expenditure	22.2	23.0	21.0	21.9	21.4	20.8
Budgetary balance (excluding grants)	-6.0	-6.5	-5.2	-5.3	-4.1	-3.2
Primary balance	1.3	1.1	1.5	1.5	2.3	2.7
Net public debt	91.6	89.4	95.4	92.4	87.9	84.6
Net domestic public debt	40.3	40.8	39.0	36.0	32.7	29.4
Implicit interest rate on public debt (percent) 2/	8.9	9.0	8.2	7.8	7.6	7.5
(Annual changes in percent of initial stock of broad money)						
Monetary sector						
Net foreign assets	1.6	2.0	5.2	2.6	...	...
Net domestic assets	4.5	7.4	3.7	6.5	...	...
Of which: credit to the private sector	8.5	1.4	3.4	7.7	...	...
Of which: net credit to government	-3.8	6.1	-3.4	-2.8	...	...
Broad money	6.2	9.4	9.0	9.1	...	...
Six-month treasury bill rate (in percent, p.a.)	13.1	8.6	10.4	...	...	...
(In percent of GDP)						
External sector						
Merchandise trade balance	-3.6	-2.3	-2.1	-2.2	-2.1	-1.7
Merchandise exports	12.8	13.3	15.0	15.2	15.8	16.2
Merchandise imports	16.4	15.6	17.1	17.4	17.8	18.0
Current account excluding official transfers	-4.6	-3.6	-3.3	-3.6	-3.1	-2.6
Current account including official transfers	-3.6	-2.1	-1.9	-0.6	-1.5	-1.3

Table 1. Pakistan: Selected Economic and Financial Indicators, 1998/99–2003/04 (Concluded)

	1998/99	1999/2000	Est. 2000/01	Prog.		
				2001/02	2002/03	2003/04
(In percent of exports of goods and services)						
External public and publicly guaranteed debt	331.6	310.7	319.8	324.0	317.2	304.5
Debt service 3/	41.2	38.4	32.1	32.0	28.1	25.8
Implicit interest rate (in percent) 4/	3.7	4.2	3.9	3.8	3.5	3.5
Gross reserves (in millions of U.S. dollars) 5/	1,672	908	1,681	2,385	3,029	3,895
In weeks of next years' imports of goods and services	7.7	3.9	7.2	9.7	11.6	14.3
In percent of short-term external debt 6/	35.2	19.2	63.8	75.1	96.2	130.2
Memorandum items:						
ICOR, three-year moving average	4.5	4.7	4.6	4.3	3.4	3.1
Real effective exchange rate (percentage change)	-9.1	-0.6	-2.6	-6.1	-3.2	-2.1
Terms of trade (in percentage change)	4.1	-9.2	-1.6	-1.0	2.5	4.2
Real per-capita GDP (in percentage change)	1.3	2.1	1.1	1.6	2.7	2.9
GDP at market prices (in billions of Pakistani rupees)	2,938	3,183	3,472	3,788	4,179	4,623

Source: Data provided by the Pakistani authorities; Fund staff, INS and World Economic Outlook.

1/ Includes public sector enterprises.

2/ The implicit interest rate on public debt is calculated as interest payments in percent of the end-of-period debt stock of the previous year.

3/ Including interests on short term debt.

4/ The implicit interest rate on external public debt is calculated as interest payments in percent of the average stock of debt of the current and previous fiscal year.

5/ Excluding gold, foreign assets relating to foreign currency deposits contracted after May 1998 (FE-25s), and short-term foreign exchange swaps and outright forward sales by the SBP.

6/ Data on short-term external debt includes public and private short-term at original maturity and amortization payments on public medium- and long-term debt of the following year.

Table 2. Pakistan: Social Indicators, 1970–1999

	Latest single year 1/			I-PRSP target	Latest single year 1/ (1990–1999)	
	1970–75	1980–85	1993–1999	2003/04	South Asia	Lower-income (world-wide)
Population						
Total population, mid-year (in millions)	71.0	94.8	134.8	...	1,329.3	2,417.1
Growth rate (percent annual average)	3.2	2.7	2.4	1.8	1.9	1.9
Urban population (percent of population)	26.4	29.8	36.5	...	28.0	31.4
Total fertility rate (births per woman)	7.0	6.5	4.8	4.1	3.4	3.7
Unemployment (as percentage of total labour force)	...	3.7	6.1	...	...	...
Income						
GNP per capita (1995 U.S. dollars)	275.7	366.5	511.3	569.5	445.9	449.1
Consumer price index (1995 = 100)	16.4	42.4	136.0	170.3	136.0	138.4
Food price index (1995 = 100)	...	39.3	134.5	164.8	122.7	140.8
Social indicators						
Public expenditure						
Health (percent of GDP)	...	...	0.5	0.5	0.9	1.2
Education (percent of GDP)	2.2	2.9	1.6	1.8	3.1	3.3
Education 2/						
Gross primary school enrollment rate (in percent of age group)						
Total	39.5	43.7	73.5	100.0	100.3	96.6
Male	52.7	55.7	100.6	119.0	109.6	102.5
Female	25.5	30.4	45.4	76.0	90.2	85.5
Gross secondary school enrollment rate (in percent of age group)						
	14.7	17.2	25.6	68.0	48.6	45.7
Illiteracy rate (as percentage of population aged 15 and above)	75.8	68.2	55.0	41.0	46.0	38.5
Access to safe water (in percent of population)						
Total	...	38.0	63.0	68.0	87.0	76.0
Urban	75.0	84.0	83.0	87.0	92.0	88.0
Rural	5.0	28.0	53.0	57.0	85.0	70.0
Immunization rate (percent under 12 months)						
Measles	...	23.0	81.0	...	62.7	64.0
DPT	...	30.0	80.0	...	75.2	70.4
Life Expectancy at birth (years)						
Total	52.3	57.4	62.5	64.4	62.6	59.1
Male	52.1	56.9	61.5	...	61.8	58.1
Female	52.5	58.0	63.6	...	63.4	60.2
Mortality						
Children under 5 years (per thousand live births)	183.0	161.0	126.0	65.0	98.6	116.3
Adult (15–59 years)						
Male (per 1,000 population)	339.5	282.5	186.0	...	223.2	288.3
Female (per 1,000 population)	381.1	290.9	153.0	...	212.2	257.7

Source: World Bank: World Development Indicators 2001; and Pakistani authorities.

1/ Latest available observation within the period indicated.

2/ Education targets in the I-PRSP are not comparable with historical data for the previous years. The outstanding methodological and source issues related to the selection of education baseline indicators and output targets will be addressed during the preparation of the full PRSP.

Table 3. Pakistan: Reviews and Phasing of Disbursements Under the PRGF
December 2001–December 2004

(In millions of SDRs)

Availability Date	Conditions to be Observed	Disbursement
Early December 2001	Board approval of PRGF arrangements	86.16
March 20, 2002	First PRGF review; end–December 2001 performance criteria	86.14
June 20, 2002	Second PRGF review; end–March 2002 performance criteria	86.14
September 20, 2002	Third PRGF review; end–June 2002 performance criteria	86.14
December 20, 2002	Fourth PRGF review and reaching understanding on the second year program; end–September 2002 performance criteria	86.14
March 20, 2003	Fifth PRGF review; end–December 2002 performance criteria	86.14
June 20, 2003	Sixth PRGF review, end–March 2003 performance criteria	86.14
September 20, 2003	Seventh PRGF review; end–June 2003 performance criteria	86.14
December 20, 2003	Eight PRGF review and reaching understanding on the third annual program; end–September 2003 performance criteria	86.14
March 20, 2004	Ninth PRGF review; end–December 2003 performance criteria	86.14
June 20, 2004	Tenth PRGF review; end–March 2004 performance criteria	86.14
September 20, 2004	Eleventh PRGF review; end–June 2004 performance criteria	86.14

Table 4. Pakistan: Consolidated Government Budget, 1999/2000–2003/04 (Continued)

	1999/2000	Est. 2000/2001	Prog.		
			2001/2002	2002/03	2003/04
(In billions of Pakistani rupees)					
Revenue and grants	529.4	591.1	729.9	781.8	862.2
Revenue	525.4	546.4	626.6	721.0	811.5
Tax revenue	406.8	444.8	497.1	584.0	659.9
Federal	388.4	425.4	475.6	559.4	631.6
CBR Revenue	348.1	393.9	429.9	508.3	575.8
Direct tax	109.8	127.4	142.4	157.1	161.8
Federal excise duty	56.9	49.2	49.4	58.4	67.8
Sales tax	117.6	152.8	176.8	221.8	271.6
Customs duties	63.8	64.5	61.3	71.0	74.6
Petroleum surcharge	25.4	17.9	29.0	33.5	37.2
Gas surcharge	13.5	12.6	15.0	15.8	16.6
Other	1.4	1.0	1.7	1.9	2.1
Provincial	18.4	19.4	21.5	24.7	28.3
Nontax revenue	118.6	101.6	129.6	137.0	151.6
Grants	4.0	44.7	103.2	60.8	50.7
Expenditure	733.6	728.5	828.8	893.8	960.6
Current expenditure	645.1	652.4	701.5	741.9	780.6
Federal	489.8	500.6	525.5	544.0	557.6
Interest payments	243.3	234.7	260.1	267.8	275.7
Domestic	198.4	183.5	197.9	201.3	205.3
Foreign	44.9	51.2	62.2	66.5	70.4
Defense 1/	150.8	157.3	162.6	172.7	181.3
Running of the civil government	47.9	50.6	57.6	65.7	71.0
Subsidies	20.4	14.7	13.7	8.2	8.2
Grants	11.8	24.0	22.8	16.8	18.6
Other	9.9	-0.4	8.8	12.8	2.8
Of which: bank restructuring	0.0	0.0	6.5	10.3	0.0
Unidentified	5.7	19.7	0.0	0.0	0.0
Provincial	155.3	151.8	176.0	198.0	223.0
Development expenditure and net lending	88.5	76.2	127.3	151.8	180.0
Public Sector Development Program 2/	100.7	92.5	127.0	151.7	179.9
Federal 2/	64.4	69.6	97.0	115.6	136.8
Provincial	36.3	22.9	30.0	36.1	43.1
Net lending	-12.2	-16.3	0.3	0.2	0.1
Budget balance (excluding grants)	-208.3	-182.1	-202.2	-172.7	-149.1
Budget balance (excluding grants and one-off expenditure) 3/	-208.3	-182.1	-182.7	-162.4	-149.1
Budget balance (including grants)	-204.3	-137.4	-98.9	-111.9	-98.4
Financing	204.3	137.4	98.9	111.9	98.4
External	70.2	80.5	36.9	30.1	14.4
Domestic	134.0	57.0	8.8	2.3	-7.5
Bank	40.0	-33.1	-7.0	-6.0	-14.0
Nonbank	94.1	90.0	15.8	8.3	6.5
Privatization proceeds	0.0	0.0	6.5	25.7	36.1
Financing gap (after identified assistance) 4/	0.0	0.0	46.7	53.8	55.4
Memorandum items:					
Primary balance	35.0	52.6	58.0	95.1	126.5
Social and poverty-related expenditure 5/	114.3	119.3	136.4	158.8	184.4

Table 4. Pakistan: Consolidated Government Budget, 1999/2000-2003/04 (Concluded)

	1999/2000	Est. 2000/2001	Prog. 2001/2002	2002/03	2003/04
	(In percent of GDP)				
Revenue and grants	16.6	17.0	19.3	18.7	18.7
Revenue	16.5	15.7	16.5	17.3	17.6
Tax revenue	12.8	12.8	13.1	14.0	14.3
Federal	12.2	12.3	12.6	13.4	13.7
CBR Revenue	10.9	11.3	11.4	12.2	12.5
Direct tax	3.4	3.7	3.8	3.8	3.5
Federal excise duty	1.8	1.4	1.3	1.4	1.5
Sales tax	3.7	4.4	4.7	5.3	5.9
Customs duties	2.0	1.9	1.6	1.7	1.6
Petroleum surcharge	0.8	0.5	0.8	0.8	0.8
Gas surcharge	0.4	0.4	0.4	0.4	0.4
Other	0.0	0.0	0.0	0.0	0.0
Provincial	0.6	0.6	0.6	0.6	0.6
Nontax revenue	3.7	2.9	3.4	3.3	3.3
Grants	0.1	1.3	2.7	1.5	1.1
Expenditure	23.0	21.0	21.9	21.4	20.8
Current expenditure	20.3	18.8	18.5	17.8	16.9
Federal	15.4	14.4	13.9	13.0	12.1
Interest payments	7.6	6.8	6.9	6.4	6.0
Domestic	6.2	5.3	5.2	4.8	4.4
Foreign	1.4	1.5	1.6	1.6	1.5
Defense 1/	4.7	4.5	4.3	4.1	3.9
Running of the civil government	1.5	1.5	1.5	1.6	1.5
Subsidies	0.6	0.4	0.4	0.2	0.2
Grants	0.4	0.7	0.6	0.4	0.4
Other	0.3	0.0	0.2	0.3	0.1
Unidentified	0.2	0.6	0.0	0.0	0.0
Provincial	4.9	4.4	4.6	4.7	4.8
Development expenditure and net lending	2.8	2.2	3.4	3.6	3.9
Public Sector Development Program 2/	3.2	2.7	3.4	3.6	3.9
Net lending	-0.4	-0.5	0.0	0.0	0.0
Budget balance (excluding grants)	-6.5	-5.2	-5.3	-4.1	-3.2
Budget balance (excluding grants and one-off expenditure) 3/	-6.5	-5.2	-4.8	-3.9	-3.2
Budget balance (including grants)	-6.4	-4.0	-2.6	-2.7	-2.1
Financing	6.4	4.0	2.6	2.7	2.1
External	2.2	2.3	1.0	0.7	0.3
Domestic	4.2	1.6	0.2	0.1	-0.2
Bank	1.3	-1.0	-0.2	-0.1	-0.3
Nonbank	3.0	2.6	0.4	0.2	0.1
Privatization proceeds	0.0	0.0	0.2	0.6	0.8
Financing gap (after identified assistance) 4/	0.0	0.0	1.2	1.3	1.2
Memorandum items:					
Primary balance	1.1	1.5	1.5	2.3	2.7
Social and poverty-related expenditure 5/	3.6	3.4	3.6	3.8	4.0
GDP (in billions of Pakistani rupees)	3,183	3,472	3,788	4,179	4,623

Sources: Ministry of Finance; and Fund staff estimates and projections.

1/ Military pensions are included in defense expenditure.

2/ In 2001/02, includes PRs 10 billion and PRs 3 billion of spending related to drought and fiscal devolution, respectively.

3/ In 2001/02, projections include one-off expenditure of PRs 10 billion for drought and PRs 6.5 billion for bank restructuring.

4/ Expected to be filled by bilateral debt rescheduling.

5/ As defined in the I-PRSP.

Table 5. Pakistan: Monetary Developments, 1997/98–2001/02

	1997/98	1998/99	1999/2000	2000/01	Prel. 1/ Sep. 2001/02	Prog. 1/ Dec. Mar. Jun. 2001/02 2001/02 2001/02		
(End-of-period stocks in billions of Pakistan rupees)								
Net foreign assets	-90.1	-70.7	-43.9	27.3	13.4	67.8	52.7	67.5
Net domestic assets	1,296.4	1,351.3	1,443.6	1,499.0	1,512.7	1,542.2	1,547.1	1,597.6
Net claims on government	597.5	551.4	629.6	582.3	605.5	548.7	542.3	540.3
Of which:								
Net bank borrowing	552.4	505.9	545.8	512.9	537.5	503.3	508.9	505.9
Commodity operations	63.7	67.3	107.4	94.9	94.0	70.9	58.9	58.9
Net claims on nongovernment	697.5	816.7	842.8	911.9	882.1	988.8	1,000.0	1,052.6
Private sector	632.0	734.7	753.2	801.4	774.2	872.7	875.5	919.5
Public sector	65.5	82.0	89.6	110.6	107.9	116.1	124.6	133.1
Privatization account	-2.9	-2.9	-2.9	-2.9	-2.9	-2.9	-2.9	-2.9
Other items, net	4.3	-13.9	-25.9	7.7	28.0	7.7	7.7	7.7
Total liquidity (broad money)	1,206.3	1,280.5	1,399.7	1,526.3	1,526.1	1,610.0	1,599.9	1,665.2
Of which:								
Rupee liquidity	927.8	1,131.9	1,288.2	1,371.9	1,371.8	1,455.9	1,445.1	1,508.4
(Changes in percent of stock of broad money at the beginning of the fiscal year)								
Net foreign assets	-2.7	1.6	2.0	5.2	-0.9	2.7	1.7	2.6
Net domestic assets	17.3	4.5	7.4	3.7	0.9	2.8	3.2	6.5
Of which:								
Net bank borrowing by govt.	4.5	-3.9	3.1	-2.4	1.5	-2.2	-2.6	-2.8
Net claims on private sector	8.1	8.5	1.4	3.4	-1.8	4.7	4.9	7.7
(Changes over 12 months; in percent)								
Broad money	14.5	6.2	9.4	9.0	9.2	9.0	9.1	9.1
Net claims on private sector	13.7	16.2	2.5	6.4	2.7	4.4	4.7	14.7
Memorandum item:								
Indicative Program exchange rate 2/	...	...	...	63.98	63.98	63.98	63.98	63.98

Sources: State Bank of Pakistan; and Fund staff estimates.

1/ At indicative program exchange rates.

2/ end-June 2001 actual exchange rate.

Table 6. Pakistan: Accounts of the State Bank of Pakistan, 1997/98–2001/02

	1997/98	1998/99	1999/2000	2000/01	Prel. 1/ Sep. 2001/02	Prog. 1/ Dec. Mar. Jun. 2001/02 2001/02 2001/02		
(End-of-period stocks in billions of Pakistan rupees)								
Net foreign assets	-48.6	-42.5	-55.1	-24.4	-35.2	5.1	-18.5	-4.5
Net domestic assets	418.1	440.4	552.9	557.6	549.2	568.6	586.2	586.9
Net claims on government	223.7	257.8	391.0	357.5	363.9	365.5	381.6	380.8
Of which:								
Budgetary support	242.2	279.6	414.6	383.1	389.8	391.0	407.1	405.3
Claims on nongovernment	40.8	56.1	51.2	40.1	29.3	40.1	40.1	40.1
Claims on scheduled banks	158.5	187.2	193.4	198.0	184.5	201.0	202.5	204.0
Other items, net	-2.0	-57.7	-79.8	-35.0	-25.5	-35.0	-35.0	-35.0
Reserve money 2/	369.5	398.0	497.8	533.2	533.8	573.7	567.7	582.4
Of which:								
Banks' reserves	71.4	85.2	114.7	128.6	120.3	130.5	131.0	138.1
Currency	291.7	306.6	375.1	394.6	399.3	432.0	425.4	433.0
(Changes in percent of stock of reserve money at the beginning of the fiscal year)								
Net foreign assets	-10.8	1.7	-3.3	7.1	-2.0	5.5	1.1	3.7
Net domestic assets	17.3	6.0	28.4	0.0	-1.6	2.1	5.3	5.5
Of which:								
Budgetary support	-1.3	10.1	33.9	-6.3	1.2	1.5	4.5	4.4
(Changes over 12 months, in percent)								
Reserve money 2/	6.5	7.7	25.1	...	...	...	...	9.2
Currency	11.3	5.1	22.4	5.2	12.3	0.3	5.1	9.7
Memorandum item:								
Indicative program exchange rate 3/	...	...	...	63.98	63.98	63.98	63.98	63.98

Source: State Bank of Pakistan; and Fund staff estimates.

1/ At indicative program exchange rates.

2/ Starting 2000/01, including reserves on foreign currency deposits.

3/ end-June 2001 exchange rate.

Table 7. Pakistan: Balance of Payments, 1999/2000–2003/04 (Continued)

	1999/2000	Est. 2000/01	Proj.		
			2001/02	2002/03	2003/04
(In millions of U.S. dollars)					
Current account (excluding official transfers)	-2,208	-1,946	-2,084	-1,877	-1,671
Current account balance (including official transfers)	-1,282	-1,128	-355	-887	-850
Trade balance	-1,411	-1,245	-1,288	-1,243	-1,114
Exports f.o.b.	8,191	8,926	8,900	9,576	10,323
Of which: lifting of textile quotas	...	...	100	200	200
Imports f.o.b.	-9,602	-10,171	-10,188	-10,820	-11,437
Services (net)	-2,795	-3,130	-3,222	-3,060	-3,055
Of which: interest payments	-1,676	-1,620	-1,574	-1,473	-1,464
Private transfers (net)	1,997	2,429	2,426	2,426	2,498
Official transfers (net) 1/	926	818	1,729	991	820
Capital account	-2,610	-604	-3,143	-1,743	-1,378
Public medium- and long-term capital	-1,452	-670	-1,122	-1,335	-913
Project and nonproject loans	-664	-342	-732	-649	-613
Disbursements	1,304	1,453	766	745	786
Amortization	-1,968	-1,795	-1,498	-1,394	-1,399
Commercial banks and IDB	-170	-76	-293	-182	-72
Other	-618	-252	-97	-504	-228
Public sector short-term (net)	-221	-5	-860	69	-319
Private medium- and long-term (net)	273	337	-268	114	401
Of which: FDI	471	322	200	400	500
Private short-term (including errors & omissions) 2/	-1,211	-266	-893	-590	-548
Overall balance (before debt relief)	-3,892	-1,732	-3,499	-2,630	-2,229
Financing	3,892	1,732	3,499	2,630	2,229
Reserve assets (increase -)	208	-1,091	-779	-790	-1,014
State Bank of Pakistan (including FE-25s)	379	-730	-723	-680	-903
Deposit money banks	-171	-361	-56	-110	-111
Use of Fund credit (net)	-280	85	-185	-324	-389
Net exceptional Financing	3,965	2,738	3,107	2,095	1,940
Arrears (increase +)	343	-525	0	0	0
Rescheduling 3/	1,750	1,587	327	0	0
Rollover of foreign deposits with banking system 4/	1,872	1,676	1,312	900	800
Assumed program financing from IFIs	0	0	1,468	895	840
World Bank	0	0	665	445	400
AsDB	0	0	535	450	440
Fund	0	0	268	0	0
Privatization receipts	0	0	0	300	300
Financing gap 5/	0	0	1,356	1,648	1,692

Table 7. Pakistan: Balance of Payments, 1999/2000–2003/04 (Concluded)

	1999/2000	Est. 2000/01	Proj.		
			2001/02	2002/03	2003/04
(In percent of GDP)					
Current account (excluding official transfers)	-3.6	-3.3	-3.6	-3.1	-2.6
Current account balance (including official transfers)	-2.1	-1.9	-0.6	-1.5	-1.3
Private medium and long term capital	0.4	0.6	-0.4	0.2	0.6
Trade balance	-2.3	-2.1	-2.2	-2.1	-1.8
Exports f.o.b.	13.3	15.0	15.2	15.8	16.2
Imports f.o.b.	-15.6	-17.1	-17.4	-17.8	-18.0
(Annual percentage change)					
Exports f.o.b.	8.8	9.0	-0.3	7.6	7.8
Imports f.o.b.	-0.1	5.9	0.2	6.2	5.7
Export unit value	-3.3	-2.5	-4.1	1.0	2.6
Import unit value	6.4	-1.0	-3.1	-1.4	-1.6
Export volume	12.5	11.8	3.9	6.5	5.1
Import volume	-6.2	7.0	3.4	7.7	7.4
Terms of trade	-9.2	-1.6	-1.0	2.5	4.2
(In millions of U.S. dollars)					
Memorandum item:					
End-period gross official reserves ^{6/}	908	1,681	2,385	3,029	3,895
(In weeks of imports of goods and nonfactor services)	3.9	7.2	9.7	11.6	14.3

Sources: State Bank of Pakistan; Ministry of Finance; and Fund staff estimates.

1/ Includes budgetary grants and commodity assistance.

2/ Includes repayment of foreign currency deposits held in NBFIs and banks (reschedulings shown as exceptional financing).

3/ Includes rescheduling of bilateral debt in 1999 and 2001, and rescheduling of commercial bank credit and Eurobonds in 1999.

4/ Includes rollover of FE-45 deposits with the banking system, of Kuwait's and UAE's deposits with the SBP, and Bank of China's deposits with the NBP.

5/ The gap for the first program year is assumed to be filled as illustrated in Box 1.

6/ Excluding new foreign currency deposits held with the SBP, and net of outstanding short-term foreign currency swap and forward contracts.

Table 8. Pakistan: Gross Financing Requirements, 2001/02–2003/04

(In millions of U.S. dollars)

	Prog. 2001/02	Proj. 2002/03	2003/04
Gross financing requirements	-7,345	-6,527	-6,276
External current account deficit	-355	-887	-850
Debt amortization	-6,026	-4,526	-4,023
Medium and long term debt	-2,910	-2,646	-2,198
Public sector 1/	-2,218	-2,080	-1,699
Multilateral	-559	-602	-637
Bilateral	-940	-792	-762
Bonds	-155	-232	-206
Other	-565	-454	-94
Private sector	-692	-566	-499
Short-term debt 2/	-3,116	-1,880	-1,825
Public sector	-1,505	-729	-1,120
Private sector	-1,611	-1,151	-705
Gross reserves accumulation	-779	-790	-1,014
<i>Of which:</i> official reserves	-723	-680	-903
IMF repurchases and repayments	-185	-324	-389
Available financing	5,990	4,879	4,584
Foreign direct and portfolio investment (net) 3/	140	800	1,000
Debt financing from private creditors	3,008	2,439	1,958
Medium- and long-term financing	614	180	200
To private sector	284	180	200
To public sector	330	0	0
Short-term financing	2,394	2,259	1,758
To public sector	968	1,220	1,120
To private sector	1,426	1,039	638
Trade credit	303	360	360
Other 4/	1,123	679	278
Official creditors 5/	2,293	1,640	1,626
Multilateral 1/	1,609	1,185	1,098
<i>Of which:</i> balance of payments financing 6/	1,200	895	840
Bilateral	685	455	528
<i>Of which:</i> balance of payments financing 7/	327	0	0
IMF	268	0	0
Other net capital flows 8/	280	0	0
Financing gap	1,356	1,648	1,692

Sources: Ministry of Finance; State Bank of Pakistan; and Fund staff estimates.

1/ Excluding the IMF.

2/ Original maturity of less than 1 year. Stock at the end of the previous period.

3/ Includes privatization receipts.

4/ Includes the roll-over of FE-45 deposits and Bank of China deposits at NBC.

5/ Includes both loans and grants.

6/ Includes those transactions that are undertaken for the purpose of financing a balance of payments deficit or an increase in reserves.

7/ Debt relief agreed on January 2001.

8/ Includes all other net financial flows and errors and omissions.

Table 9. Pakistan: Summary of Public External Debt and Debt Service, 1998/99–2003/04

	1998/99	1999/2000	Est. 2000/01	Proj.		
				2001/02	2002/03	2003/04
(In millions of U.S. dollars)						
Total public and publicly guaranteed external debt	29,318	29,757	32,839	33,447	34,821	36,045
Medium- and Long-term debt	25,445	26,009	29,207	30,561	32,041	33,672
Project & nonproject aid	23,101	23,834	25,810	26,348	26,676	26,983
Commercial banks and IDB	730	560	698	577	393	356
Other 1/	1,614	1,615	2,700	3,635	4,969	6,333
Short-term debt (by initial maturity)	2,049	2,253	2,069	1,509	1,728	1,709
Commercial banks and IDB	583	671	918	381	622	622
FEBCs and DBCs	196	147	90	67	45	26
Deposits of nonresidents with the SBP	1,270	1,435	1,061	1,061	1,061	1,061
Fund credit and loans 2/	1,825	3,496	1,563	1,377	1,053	664
Service of medium- and long-term						
Public and publicly guaranteed debt	3,546	3,586	3,217	3,243	3,028	2,998
Of which: to the Fund	191	347	246	237	368	426
Amortization	2,569	2,452	2,072	2,055	1,900	1,827
Of which: to the Fund	147	287	194	185	324	389
Interest	977	1,133	1,145	1,188	1,128	1,171
Of which: to the Fund	44	60	52	44	37	30
Interest on public and publicly guaranteed short-term debt	96	94	83	63	54	54
(In percent of GDP)						
Total public and publicly guaranteed external debt	50.0	48.3	55.1	57.3	57.4	56.7
Long-term	43.4	42.2	49.0	52.3	52.8	53.0
Short-term	3.5	3.7	3.5	2.6	2.8	2.7
Fund credit and loans	3.1	0.0	2.6	3.4	3.5	3.4
Service of medium- and long-term public and publicly guaranteed debt	6.1	5.8	5.4	5.6	5.0	4.7
Amortization	4.4	4.0	3.5	3.5	3.1	2.9
Interest	1.7	1.8	1.9	2.0	1.9	1.8
Interest on public and publicly guaranteed short-term debt	0.2	0.2	0.1	0.1	0.1	0.1
(In percent of exports of goods and nonfactor services)						
Total public and publicly guaranteed external debt	331.6	310.7	319.8	324.0	317.2	304.5
Of which: Fund credits and loans	20.6	15.6	15.2	13.3	9.6	5.6
Service of medium- and long-term public and publicly guaranteed debt	40.1	37.4	31.3	31.4	27.6	25.3
Of which: to the Fund	2.2	3.6	2.5	2.3	3.3	3.6
Amortization	29.1	25.6	20.2	19.9	17.3	15.4
Of which: to the Fund	1.7	3.0	1.9	2.3	3.3	3.6
Interest	11.1	11.8	11.2	11.5	10.3	9.9
Of which: to the Fund	0.5	0.6	0.5	0.5	0.4	0.3
Memorandum items:						
Implicit interest rate on public and publicly guaranteed debt	3.7	4.2	3.9	3.5	3.5	3.5
Total external debt (millions of U.S. dollars)	37,743	37,070	38,551	38,447	38,779	39,907
(In percent of GDP)	64.4	60.2	64.7	65.8	64.0	62.8

Sources: State Bank of Pakistan; Ministry of Finance; and Fund staff estimates.

1/ Includes FCBCs, eurobonds, military debt, and special U.S. dollar bonds, and part of the financing gap, which is assumed to be covered by exceptional financing to the government of Pakistan.

2/ Excludes use of Fund resources under the envisaged PRGF.

Table 10. Pakistan: Indicators of External Vulnerability, 1999/2000–2001/02

	1999/2000	Est. 2000/01	Proj. 2001/02
Financial indicators			
Net public debt (in percent of GDP)	89.4	95.4	92.4
Broad money (12-month percentage change)	9.4	9.0	9.1
Private sector credit (12-month percentage change)	2.5	6.4	14.7
180-day treasury bill yield (in percent)	8.6	10.4	...
180-day treasury bill yield, real (in percent)	5.0	6.0	...
Karachi Stock Exchange index			
End-of-period	1,521	1,366	...
Period average	1,514	1,436	...
External Indicators			
Exports (12-month percentage changes, in U.S. dollars)	8.8	9.0	-0.3
Imports (12-month percentage changes, in U.S. dollars)	-0.1	5.9	0.2
Terms of trade (12-month percentage changes)	-9.2	-1.6	-1.0
Current account balance (excluding official transfers in percent of GDP)	-3.6	-3.3	-3.6
Gross Official Reserves (in millions of U.S. dollars) 1/	908	1,681	2,385
In weeks of imports of goods and nonfactor services	3.9	7.2	9.7
In percent of broad money	3.4	7.1	9.2
In percent of short-term external debt 2/	16.1	35.6	56.2
Total external debt (in millions of U.S. dollars)	37,070	38,551	38,447
In percent of exports of goods and nonfactor services 3/	319.4	302.6	300.9
Actual debt service (in percent of goods and services) 3/ 4/	17.5	9.2	31.1
Exchange rate (Pakistani rupees per U.S. dollar, period average)	51.6	58.3	...
Real exchange rate (12-month percentage changes)	-0.6	-2.6	-6.1

Sources : Pakistan authorities; Bank for International Settlements; and Fund staff estimates.

1/ Excluding foreign deposits FE-25, and swaps and forward operations.

2/ Short-term external debt includes public and private short term at original maturity plus actual amortization payments on medium- and long-term debt of the following year (including payments on debt that was rescheduled).

3/ Exports of goods and nonfactor services including workers' remittances.

4/ Scheduled debt service minus rescheduled debt service plus debt service on previously rescheduled debt.

Table 11. Pakistan: Indicators of Fund Credit, 2000/01–2014/15 1/

	Est.	Proj.												
	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/12	2012/13	2013/14	2014/15
Outstanding Fund Credit														
In millions of SDRs	1,207	1,535	1,627	1,669	1,466	1,213	1,106	979	842	661	472	291	170	101
In millions of U.S. dollars	1,563	1,971	2,092	2,149	1,893	1,569	1,433	1,269	1,091	856	611	377	221	131
In percent of:														
Quota	116.7	148.5	157.4	161.5	141.9	117.3	107.0	94.7	81.4	63.9	45.6	28.1	16.5	9.8
GDP	2.6	3.4	3.5	3.4	2.8	2.2	1.9	1.7	1.3	1.0	0.6	0.4	0.2	0.1
Exports 2/	12.7	16.1	16.2	15.6	14.8	12.3	11.2	9.9	8.5	6.7	4.8	2.9	1.7	1.0
Public and publicly guaranteed debt	4.8	5.9	6.0	6.0	4.8	3.9	3.5	3.0	2.5	1.9	1.3	0.8	0.4	0.2
Debt service to the Fund														
In millions of SDRs	196	185	286	331	312	270	117	136	146	188	196	184	121	69
In millions of U.S. dollars	254	237	368	426	403	348	152	176	189	244	254	239	157	89
In percent of:														
Exports 2/	2.5	2.3	3.3	3.6	3.2	2.6	1.1	1.2	1.2	1.5	1.4	1.3	0.8	0.4
Gross official reserves	15.1	9.9	12.1	10.9	10.1	8.3	3.4	3.8	3.8	4.7	4.6	4.1	2.6	1.4

Sources: IMF Treasurer's Department; and Fund staff estimates.

1/ Under the assumptions of the program, assuming disbursements under the PRGF as scheduled.

2/ Exports of goods and nonfactor services.

Table 12. Pakistan: Summary Accounts of Seven Key Public Sector Enterprises,
1997/98–2001/02

(In millions of Pakistan Rupees)

	1997/98	1998/99	Prel. 1999/2000	Prel. Est. 2000/01	Proj. 2001/02
Net operating surplus 1/	-2,263	28,032	22,514	14,140	6,468
WAPDA	-7,993	19,023	7,176	-15,091	-26,373
KESC	-6,970	-7,482	-12,916	-15,975	-14,814
PTCL	12,407	17,567	21,421	25,194	28,206
OGDC	3,875	3,948	9,646	18,717	16,981
SNGPL	-250	-222	158	698	1,427
SSGCL	-1,156	-1,030	-774	-471	323
Railways	-2,177	-3,772	-2,197	1,068	719
Gross savings 2/	28,536	57,741	49,079	42,411	40,855
WAPDA	9,625	35,049	21,287	91	-5,649
KESC	-4,822	-4,756	-10,095	-13,064	-11,651
PTCL	14,348	19,802	22,725	26,273	29,118
OGDC	6,690	5,922	11,592	20,865	19,809
SNGPL	2,466	2,695	2,997	3,672	4,681
SSGCL	2,406	2,802	2,770	3,506	3,829
Railways	-2,177	-3,772	-2,197	1,068	719
Gross capital expenditure	53,401	41,329	48,975	51,210	84,669
WAPDA	19,706	17,391	24,654	23,833	25,000
KESC	6,278	2,386	2,451	4,442	3,550
PTCL	12,828	11,776	14,633	11,500	16,500
OGDC	5,187	2,707	2,910	5,173	15,894
SNGPL	4,487	2,466	2,280	2,250	10,554
SSGCL	2,697	1,215	979	1,555	6,802
Railways	2,219	3,388	1,069	2,457	6,369
Overall balance 3/	-44,190	-3,437	-22,080	-32,564	-68,849
WAPDA	-21,220	7,106	-15,095	-36,302	-43,511
KESC	-13,248	-9,868	-15,367	-20,417	-18,364
PTCL	1,520	8,026	8,092	14,773	12,618
OGDC	-700	770	5,496	12,057	-45
SNGPL	-4,102	-2,049	-1,753	-1,217	-8,744
SSGCL	-2,045	-262	-187	-70	-5,152
Railways	-4,395	-7,160	-3,266	-1,388	-5,650
(In percent of GDP)					
Net operating surplus	-0.1	1.0	0.7	0.4	0.2
Of which: WAPDA	-0.3	0.6	0.2	-0.4	-0.7
Gross savings	1.1	2.0	1.5	1.2	1.1
Of which: WAPDA	0.4	1.2	0.7	0.0	-0.1
Capital expenditure	2.0	1.4	1.5	1.5	2.2
Of which: WAPDA	0.7	0.6	0.8	0.7	0.7
Overall balance	-1.7	-0.1	-0.7	-0.9	-1.8
Of which: WAPDA	-0.8	0.2	-0.5	-1.0	-1.1

Source: Pakistan authorities; and Fund staff estimates.

1/ Gross operating revenue minus operating expenditure, including interest charges.

2/ Gross operating surplus plus other revenue minus other expenditure.

3/ Total revenue minus total expenditure.

Pakistan: Fund Relations

As of October 31, 2001

I. Membership Status: Joined: 07/11/1950; Article VIII

II. <u>General Resources Account:</u>		<u>SDR Million</u>	<u>%Quota</u>
Quota		1,033.70	100.0
Fund Holdings of Currency		2,040.42	197.4
Reserve position in Fund		0.11	0.0
III. <u>SDR Department:</u>		<u>SDR Million</u>	<u>%Allocation</u>
Net cumulative allocation		169.99	100.0
Holdings		13.18	7.8
IV. <u>Outstanding Purchases and Loans:</u>		<u>SDR Million</u>	<u>%Quota</u>
Stand-By arrangements		478.40	46.3
Extended arrangements		175.74	17.0
Contingency and Compensatory		352.70	34.1
SAF arrangements		10.93	1.1
ESAF/PRGF arrangements		358.58	34.7

V. Latest Financial Arrangements:

<u>Type</u>	<u>Approval Date</u>	<u>Expiration Date</u>	<u>Amount Approved (SDR Million)</u>	<u>Amount Drawn (SDR Million)</u>
Stand-By	11/29/2000	09/30/2001	465.00	465.00
EFF	10/20/1997	10/19/2000	454.92	113.74
ESAF/PRGF	10/20/1997	10/19/2000	682.38	265.37

VI. Projected Obligations to Fund: Under the Repurchase Obligations Assumptions (SDR Million; based on existing use of resources and present holdings of SDRs):

	<u>Overdue 09/30/01</u>	<u>2001</u>	<u>Forthcoming</u>			
			<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>
Principal	0.0	24.7	201.8	407.2	343.6	177.0
Charges/Interest	0.0	11.0	34.9	27.6	17.1	10.2
Total	0.0	35.7	236.7	434.8	360.7	187.2

Repurchase Obligations: Repurchases in the credit tranches including the Compensatory Financing Facility, are to be completed in 3 ¼-5 years. Repurchases under the Extended Fund Facility are due in 4 ½-10 years.

A. Nonfinancial Relations

VII. Exchange System

Prior to mid-1998, Pakistan implemented a fixed exchange rate system with periodic step devaluation to compensate for the inflation differential with major trading partners. On July 21, 1998, a dual exchange system was introduced consisting of a fixed official exchange rate at PRs 46 per US\$1 and a floating interbank market exchange rate (FIBR). Under this system, all authorized transactions were effectively conducted at the so-called "composite rate" which was the weighted average of the FIBR and the official exchange rate. In addition, since May 28, 1998, withdrawals from foreign currency accounts have only been allowed in rupees (at the official exchange rate). An advance import deposit of 30 percent was introduced on July 12, 1998; it was subsequently reduced to 20 percent on January 9, 1999 and to 10 percent on January 24, 1999, and was eliminated on February 24, 1999. On May 19, 1999, the official exchange rate was eliminated and the exchange rate system unified, with all international transactions conducted at the FIBR. As of October 31, 2001, the FIBR was PRs 61.45 per U.S. dollar.

VIII. Last Article IV Consultation

The last Article IV consultation discussions were held in Islamabad during September 2000. The staff report (EBS/00/230 and Supplements 1 and 2), together with Pakistan's request for a Stand-By Arrangement, was discussed by the Executive Board on November 29, 2000. In concluding the 2000 Article IV consultation, the Executive Board adopted Decision No. 12335-(00/117), adopted on November 29, 2000.

IX. Safeguards Assessments:

A Stage One safeguards assessment of the State Bank of Pakistan was completed on October 26, 2000. The assessment concluded that high risks may exist in the area of external audit mechanism, financial reporting and internal control, and recommended a Stage Two (on-site) assessment. The Stage Two (on-site) assessment was completed on February 13, 2001 and staff's findings and recommendations were reported to Fund management (EBS/01/39, Appendix IV) and to the authorities. All the recommended remedial actions have been implemented.

X. ROSCs

Fiscal Transparency Module	11/28/2000	SM/00/264
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XI. Recent Technical Assistance

a. FAD: In May/June 1997, a mission conducted a review of the public expenditure management system. In May 1997, May 1998 and again in February 1999, missions reviewed the operation of the GST, and recommended measures to improve tax administration and increase tax compliance. In April 1999, a mission reviewed the income tax system and developed a strategy to improve its efficiency, potential for long-term development and ease of administration. A mission in January-February 2000 assisted with the revision of fiscal data and advised on measures to strengthen the fiscal reporting and accounting systems. In May 2000, a mission assisted with the preparation of the fiscal module of the Report on the Observance of Standards and Codes. In August 2000, a joint FAD-STA mission reviewed progress in the strengthening of the fiscal reporting and accounting systems and assisted authorities in the preparation of revised fiscal data for 1993/1994–1998/99. In September 2000, a mission provided technical assistance on overhauling the income tax law. In January 2001, a mission provided advice on priorities and strategies for improving the tax collection operations of the Central Board of Revenue (CBR). A follow up mission on income tax policy took place in May 2001. In August 2001, a mission assisted the authorities in the preparation of tax administration reforms.

b. MAE: In May/June 1996, a mission provided technical assistance on the transition to indirect monetary control. In June/July 1997, a technical assistance mission assisted in developing a strategy to phase-out subsidized forward cover for foreign currency deposits and to improve the institutional structure of the foreign exchange market. In February, May/June, and November 1998, MAE fielded follow-up TA missions on foreign exchange market reform. In May 1999, mission provided TA in the area of integration of open market operations and the foreign exchange market. In July 2000, a joint MAE-MED mission provided technical advice on issues relating to the transformation to a financial system that is compliant with Islamic finance principles. In September 2000, a mission provided technical assistance on enhancing the market orientation of the foreign exchange market. In February 2001, a mission provided TA on the design of public finance investment that are compatible with Islamic finance principles.

c. STA: In May/June 2000, a mission reviewed the compilation of data considered most important for program design and monitoring. A follow-up mission in July helped develop a series of time-bound measures to improve the national accounts statistics. In January 2001, an expert from STA provided technical advice and training to the Federal Bureau of Statistics for a three-stage development of producer price indices.

d. LEG: In May/July 2001 a LEG consultant assisted the authorities in the preparation of the new income tax law, which has been promulgated in September 2001.

XII. Resident Representative

A resident representative has been stationed in Islamabad since August 1991.

Pakistan: Relations with the World Bank Group

Background

1. IBRD and IDA have approved 96 loans and 144 credits to Pakistan since 1952, totaling US\$6,975.3 million and US\$6,072.7 million, respectively (net of cancellations). Of these amounts, US\$3,095.5 million has been repaid and US\$700 million remain undisbursed. Current total obligations to the Bank stand at US\$7,165.2 million, of which US\$4,203.8 million are IDA and US\$2,961.3 million are IBRD, as of 31 August, 2001. IDA credits constituted 58 percent and IBRD loans 42 percent of the Bank portfolio in fiscal 2001.

2. The **volume** of Bank lending to Pakistan has varied considerably over the last 2 decades. IBRD and IDA assistance to Pakistan steadily increased during the 1980s, with average annual commitments growing from about US\$255 million in the early 1980s to US\$730 million during FY1988–91, owing in large part to substantial adjustment lending—supporting the government’s reform program. New commitments fluctuated throughout the remainder of the 1990s, from a low of US\$85 million in FY1996 to a high of US\$808 million in FY1998—the latter reflecting support for reform programs in banking, irrigation and drainage, and the second phase of the Social Action Program. After July 1999, when the Government’s reform program went off track, and since the new government took over in October 1999, the Bank focused its assistance on policy advice and nonlending services, while the Government formulated its overall reform program. New lending resumed in June 2001 with an IDA-funded US\$350 million Structural Adjustment Credit and several smaller credits in support of On-Farm Water management and Trade and Transport Facilitation plus a GEF grant for Protected Areas Management.

3. The **composition** of IBRD/IDA lending has also shifted significantly in recent years, reflecting an increasing emphasis on human development. In FY1980–90, 28 percent of total commitments went to agriculture, (including irrigation), 27.5 percent to electric, power/energy/oil and gas, and 19 percent to industry/telecommunications and transport while the social sectors accounted for 7 percent (education, health, nutrition and population). Over the last decade, commitments to the social sectors have averaged 21 percent, while commitments to agriculture declined to 11 percent, with electricity, energy and oil and gas at 24 percent, and industry/telecommunications and transport falling to 4 percent.

4. IFC and MIGA also have substantial portfolios with Pakistan. IFC’s disbursed own account portfolio is US\$444 million in 48 companies, of which US\$76 million is in equity and the balance of US\$368 million in loans. Among IFC’s 48 portfolio companies, 8 are in arrears, with principal of US\$39 million overdue as of end-August 2001. The B Loan portfolio is currently US\$235 million in 11 companies, with a strong concentration in the power sector. As of June 30, 2001, MIGA’s gross exposure in Pakistan is US\$96.7 million. Of this, approximately 60 percent relates to guarantees for financial sector projects; 22 percent for power projects; 17 percent for telecom projects; and 1 percent for a manufacturing project.

5. Since 1998, IFC has approved one new investment of US\$50 million in a US\$100 million Trade Enhancement Facility. It has restructured its existing portfolio, canceling a third of its approved investments in 23 companies. More than a third of its disbursed portfolio is in 5 IPP companies. The other main areas of investment have been financial institutions (20 percent), cement (19 percent) and textiles (10 percent). MIGA has only issued 1 guarantee in the banking sector since 1998, but is working on a number of projects for FY2002.

Program Focus

6. The overriding objective of the Bank Group's assistance strategy is to help Pakistan reduce poverty through achieving macroeconomic stability, improving human development, building a competitive environment for private sector development and sustainable growth and strengthening governance. The 2001 CAS Progress Report (approved on June 12, 2001) sets out a strategy in support of these objectives for the remainder of FY2001-02, until the full CAS is prepared. The planned program of lending and nonlending services is consistent with the strategy endorsed in the 1999 CAS Progress Report of supporting strong reforms with a series of one-tranche adjustment operations within a medium-term macroeconomic and structural reform program aiming to strengthen Pakistan's credit worthiness and investment climate.

7. More specifically, the Bank's strategy is to support up front actions in Pakistan's evolving reform program as spelled out in its Interim PRSP through a combination of lending and nonlending services in support of: (a) reform efforts to strengthen governance, the efficiency of the civil service, and the delivery of basic services; (b) governance improvements in oil, gas, petroleum, power, and banking sectors; and (c) provincial- and district-based assistance strategies focused on governance, human development and community-based services, such as rural infrastructure, water, and sanitation.

8. The Bank works closely with the IMF and the government on structural reforms underpinning macroeconomic stability, particularly in areas with an impact on the balance of payments and public finances. In this context, an IDA-financed US\$350 million Structural Adjustment Credit was approved in June 2001 in support of the government's actions in the areas of governance improvement, including taxation and financial management, economic growth, including trade liberalization, and social service delivery. The Bank is also supporting government actions to strengthen financial management and public procurement through the **Project to Improve Financial Reporting and Accounting**, and the preparation of a **Country Procurement Assessment Report**. The government's public investment program is reviewed annually by the Bank and advice provided on fiscal reform and public expenditure restructuring. The Bank is now engaged with several provinces on provincial reform strategies in the context of improved resource management and the pending devolution of many public services to local governments and communities.

9. In the social sectors, support to the Social Action Program has been the main vehicle through which the Bank supported improvements to quality and access of education, health and water, and sanitation facilities in the past. However, due to the new government strategy of devolving service delivery from provinces to districts, the Bank is now discussing with the government and other donors new mechanisms for supporting the delivery of social services in a decentralized governance environment. In addition, the Bank is assisting the government with preparation of its PRSP, through technical advice, but also through concurrent work on a poverty assessment which is expected to be complete in FY2002.

10. The Bank continues to assist Pakistan with achieving governance improvements in the banking sector. The Bank has maintained close dialogue with the government on banking sector reform following the Banking Sector Adjustment Loan in December 1997, through technical assistance to the Central Bank and preparation of a financial sector update in 2000. As a result of this dialogue, a major **Banking Sector Restructuring and Privatization Project** has been approved by the Board on October 23, 2001. In the coming year, IDA and IFC are working closely on analytical work to assist the government improve the overall investment environment.

11. Improved water management, especially through institutional reforms, is the focus of the Bank's strategy in the rural sector, particularly in light of 3 years of severe drought in Pakistan. The main vehicle for Bank assistance in this area has been the **National Drainage Program**. Other initiatives to improve the efficiency of the water conveyance system through institutional and policy reforms include the **North West Frontier On-Farm Water Management** project (approved in June FY2001) with similar projects in other provinces to follow in FY2002 and FY2003, as requested. The Bank's board also approved reallocations of US\$130 million in July from the existing portfolio to assist the Government alleviate the impacts of the recent drought.

12. Support in the energy and infrastructure sectors is increasingly focused on assisting the government improve management of entities and acceleration of privatization where feasible. Bank policy dialogue and supervision of key projects in the power sector, including the Ghazi Barotha Hydropower project, aims to assist the government improve efficiency and governance arrangements so as to enhance investor confidence and generate growth. The Bank is also working with the government on a bottom-up approach to infrastructure provision through **Community Infrastructure Projects** on a province-by-province basis. Building on the experience of the Community Infrastructure Project in NWFP, the Bank and the government of Azzad Jammu Kashmir are preparing a new project for possible board approval in FY2002 or early FY2003.

13. To undertake this program effectively, the Bank Group is working to more fully involve communities, the private sector, Pakistani NGOs and donors. Successful implementation of the program, and development of the future strategy, also calls for continued close coordination among IBRD/IDA, IFC and MIGA. On the Bank Group's future strategy for Pakistan, extensive consultations were held with government and members of civil society throughout FY2001. The results will feed into preparation of the full CAS in

FY2002. The Bank has also supported the government's efforts to better communicate its reform program to the international community, including through the first Pakistan Development Forum in two years, and to strengthen aid coordination. The Bank will co-chair a forthcoming Human Development Forum in November and assist the government with planning the next Pakistan Development Forum in March/April 2002.

New Commitments by the Bank Group

14. The Bank Group monitors the government's progress toward and pace of macroeconomic and structural reforms. If the government is making progress with implementing its macroeconomic stabilization program, preparing its PRSP and improving governance, Bank Group assistance levels can be raised.

15. Total annual new IBRD and IDA commitments in coming fiscal years could average between US\$550 million and US\$750 million, depending on the pace and depth of structural reforms and so long as Pakistan remains credit worthy for IBRD lending. The Bank does not propose any IBRD lending for the remainder of the fiscal year.

16. IFC will continue to focus on managing its existing portfolio, but is considering several new investments in the finance and gas sector where foreign investment is needed to help with the development of proven gas reserves. IFC will explore other opportunities to support private provision of infrastructure if the policy environment improves, and is ready to support the privatization process through advisory and investment work. MIGA's readiness to support infrastructure projects also depends on the policy environment and the development effects the project would generate. MIGA would like to expand its portfolio into manufacturing, IT and other priority areas such as SMEs.

Technical assistance by the World Bank

17. Many Bank-financed projects have technical assistance elements built into project design, including the Telecommunications Regulation and Privatization project with a net commitment of US\$25 million, the Project to Improve Financial Reporting and Accounting, with a net commitment value of US\$28.8 million, and the Financial Sector Deepening and Intermediation project with net commitment of US\$28 million. Several Institutional Development Fund (IDF) grants have also been approved to assist the government develop and implement policy reforms in key areas, including liberalization of the oil and gas sectors, institutional strengthening and realignment of the Central Board of Revenue, support to the National Reconstruction Bureau, and capacity building of public sector civil service training institutions. Small amounts of technical support are also provided in the areas of HIV/AIDS and immunization and transport sector policy development.

Pakistan: Financial Relations with the World Bank Group
Statement of Loans and Credits

As of August 31, 2001

(In millions of U.S. dollars)

	IBRD	IDA	Total
1. Original Principal	6975.25	6072.69	13047.94
2. Cancellations	993.15	864.16	1857.31
3. Disbursements to date	5728.54	4868.78	10597.32
4. Repayments	2545.41	550.11	3095.52
5. Undisbursed	248.91	451.16	700.07
6. Exchange Adjustment	(188.31)	-	(188.31)
7. Borrowers Obligation	2961.36	4203.83	7165.19

Pakistan: Statistical Issues

1. The staff believes that data reporting and accounting procedures are adequate for program monitoring purposes. The authorities are responsive to data requests and report to the Fund, on a routine basis, monthly data on external trade, government tax revenues, government bank borrowing, and price indices with a lag of less than a month; monetary data are reported with a lag of about one and a half months. Moreover, the authorities provide daily data through the resident representative's office on international reserves, exchange rates, and the Karachi Stock Exchange index with a one-day lag.
2. At present, the methodology for the compilation of national accounts extrapolates certain components of GDP using a variety of indicators and data sources that have limited coverage. The estimates for some activities, particularly small-scale manufacturing, dwelling services, and other services continue to be made using constant growth rates estimated from an outdated benchmark. In view of these shortcomings, the authorities have embarked on an action plan to improve national accounts statistics, based on SAD recommendations. The Federal Bureau of Statistics (FBS) is undertaking a series of sectoral studies with the purpose of better assessing the sectors contribution to GDP. So far, six studies have been finalized, and the remaining sixteen studies are expected to be completed by next spring. The findings of these studies will be used to revise national accounts statistics and establish the new base year to 1999/2000. Data on wages and employment are not reported; and systems for the compilation of quarterly GDP are not yet well developed.
3. The FBS produces three price indices: CPI, WPI, and SPI (sensitive price indicator). The CPI and WPI are compiled on a monthly basis and have been rebased to 1990/91. The SPI is compiled on a weekly basis and consists of 46 essential commodities that are consumed by the lowest income group. Weights for the 46 items are the same as in the CPI. In the context of the action plan to improve National Account statistics, the FBS is currently working on the development of producer price indices (PPIs) in line with recommendations of a technical assistance mission from STA. The establishment of satisfactory PPIs should help improve GDP deflators.
4. Data on government finances have suffered from a lack of information on economic and functional classification of government outlays; and inadequate reporting by provinces on their fiscal operations. Moreover, the quality of fiscal data has been adversely affected by a lack of coordination between the Ministry of Finance and the Accountant General Pakistan Revenue in generating fiscal reports and lack of facility to compile data on commitments or accounts payable. In line with the recommendations of recent FAD and STA technical assistance missions, measures have been taken to address these issues and further steps are being implemented. The separation of accounting and auditing functions has already been implemented and the authorities have started posting in the internet reconciled public accounts at the federal level. In addition, the adoption of a new accounting model and chart of accounts recommended under the PIFRA project should help overcome remaining deficiencies. In the context of the I-PRSP, and in view of its focus on governance and

transparency, the authority are committed to improve the accounts reconciliation process, particularly at the local level, and have designed an action plan for regularly tracking and reporting social development expenditure at the federal, provincial and district level.

5. Notwithstanding the good provision of statistics on balance of payments, the discrepancy between the customs data and those reported by the SBP would need to be addressed; and timely and more accurate reporting on capital flows, including both official assistance and private investment flows, would be desirable.

6. External debt statistics have been compiled for government and government-guaranteed debt by the Ministry of Finance and on private debt by the SBP. The balance of payments difficulties that surfaced since May 1998 revealed significant weaknesses in Pakistan's external debt reporting, as data were not available with required frequency and there was no comprehensive reconciliation of data collected by different departments. In that context, the authorities initiated a complete inventory of all public sector debt liabilities. Most of the public sector debt data were, until recently, in a manual bookkeeping system. In 1996, the authorities began developing, with the assistance of the AsDB, a computerized debt management system, covering official assistance and supplier credits to Pakistan's public sector. After a long interruption, the implementation of this project has recently resumed, and debt and debt service data covering about 90 percent of the total public external debt are now available in an electronic database. The authorities expect the system to become fully operational by end-2001.

7. Remedial actions taken by the SBP as a result of the Fund's recent safeguards assessment, have increased the integrity of the central bank's monetary statistics. However, the treatment of Fund accounts in the data reported to STA remains to be verified, in particular, as it pertains to the compilation of the central bank's foreign liabilities. Also, there are still large discrepancies in some monetary statistics compiled by the SBP for program monitoring and those published in IFS, including on net foreign assets. Staff from MED and STA have discussed these issues with the Pakistan delegation, with a view to harmonizing these statistics as much as possible.

8. The authorities have expressed interest in subscribing to the SDDS and, as a first step, some information material has been provided to them for this purpose. Preliminary discussions with STA on this issue have been held during the stay of the delegation. The feasibility of such a move and the related need for reforms and technical assistance will be assessed in the context of the forthcoming STA mission to prepare the data module of the ROSC, and incorporated at a later stage in the program.

Pakistan: Core Statistical Indicators

As of November 7, 2001

	Exchange Rates	Convertible International Reserves	Central Bank Balance Sheet	Reserve/ Base Money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance	GDP/GNP	External Debt/Debt Service
Date of Latest Observation	11/06/01	11/06/01	Sep. 2001	Sep. 2001	Sep. 2001	Sep. 2001	Sep. 2001	Sep. 2001	2000/2001 Q4	2000/2001 Q4	2000/2001	2000/2001 Q4
Date Received	11/06/01	11/06/01	10/29/01	10/29/01	10/29/01	10/29/01	10/17/01	10/31/01	8/17/01	8/17/01	8/17/01	8/17/01
Frequency of Data	D	D	M	M	M	M	M	M	Q	Q	A	Q
Frequency of Reporting	D	D	M	M	M	M	M	M	V	V	A	V
Source of Update	A	A	A	A	A	A	A	A	A	A	A	A
Mode of Reporting	C	C	C	C	C	C	C	C	V	V	C	V
Confidentiality	C	B	C	C	C	C	C	C	C	C	C	C
Frequency of Publication	D	W	M	M	M	M	M	M	A	A	A	A

Pakistan: External Debt Sustainability Scenarios

1. Pakistan's external public debt and debt service has reached levels that adversely affect economic stability and growth prospects. At end-June 2001, the public external debt was estimated at 56 percent of GDP, with an NPV of about 260 percent of exports of goods and services. Total debt service due is projected at about 40 percent of exports of goods and services in 2001/02. In the absence of any rescheduling, debt service payments would be concentrated over the next 5 years and over one-third of total public debt would have to be repaid by June 2006. The medium-term program incorporates significant measures that will help Pakistan achieve a sustainable debt position, including a continued strong fiscal adjustment to limit public borrowing, and structural reforms in the area of market liberalization and privatization, which eventually should strengthen export revenues and private capital inflows. On the financing side, new borrowing on nonconcessional terms will be strictly limited during the program period, which will help reduce the external debt burden in the long term. However, these measures are unlikely to be sufficient to get Pakistan out of the debt trap and attract private investors' much needed investment, while the authorities' poverty reduction strategy would remain constrained by high debt service payments. Debt sustainability would require substantial efforts from Pakistan's creditors, not only through cash-flow relief over the program period, but also through sizable reduction of the external debt stock in NPV terms. Given the current structure of Pakistan's external debt (Table 9), these efforts will need to be made mostly by official Paris Club and other bilateral creditors.

2. Three purely illustrative scenarios may help to provide a sense of the orders of magnitude involved: (a) a traditional flow rescheduling of public debt on Houston terms; (b) a debt restructuring on Naples terms; and (c) a restructuring of the stock of debt on more favorable (Naples plus) terms. **Traditional flow rescheduling on Houston terms** would imply the rescheduling of ODA pre-cutoff date debt maturities falling due during the next 3 years over 20 years with 10-year grace period, at favorable interest rates, while non-ODA pre-cutoff date debt maturities would be rescheduled over 18 years with 3-year grace period at market interest rates. **Restructuring on Naples terms** would consist of rescheduling of ODA pre-cutoff date debt stock over 40 years with 16-year grace period at favorable interest rates, while non-ODA pre-cutoff date debt would be restructured so as to achieve a reduction of 67 percent of the NPV of the pre-cutoff date debt. **Restructuring on "Naples plus" terms** have been defined in the third scenario as follows: ODA pre-cutoff date debt (including the stock of debt of 2001 Paris Club agreement) stock would be written-off, while the non-ODA pre-cutoff date debt would receive the same treatment as in the restructuring on Naples terms. All three scenarios assume average export and import growth at 6 percent and 5.5 percent in U.S. dollar terms and official reserves at about three months of imports of goods and non-factor services by June 2004. The Houston scenario assumes "normal" capital inflows at about the projected levels of 2001/02–2003/04 over the next 15 years, while the Naples and Naples plus scenarios assume increasingly stronger private inflows as a result of improved confidence, starting in 2004/05.

3. All three scenarios would provide about the same debt cash relief over the next 3 years (about 10 percentage points of exports). However, only the third scenario would reduce the NPV of the debt to less than 150 percent of exports at the end of the program period. The benchmark of 150 percent is used to assess the external debt sustainability of countries eligible to the HIPC initiative. Under the Houston terms, the debt service ratio would remain above 25 percent of exports, while the NPV of the debt would decline to 238 percent of exports by end-June 2004 and remain above 150 percent of exports for another 15 years. Such a debt situation would leave Pakistan highly vulnerable to less favorable private capital inflows, or shocks to export growth. Under the Naples terms, the debt service ratio would stabilize at 20 percent of exports by end-June 2004, while the NPV of the debt would decline to 192 percent by end-June 2004 but would not reach 150 percent of exports before 15 years. Finally, under the "Naples plus" terms, the debt service ratio would fall below 20 percent of exports by end-June 2004 and stabilize at 15 percent after 7 years, while the NPV of the debt would decline sharply to 150 percent of exports by end-June 2003.

Figure 1. Pakistan: Public Debt Service under Hypothetical Rescheduling Terms, 2001/02–2015/16
(In percent of exports of goods and services)

Figure 2. Pakistan: Net Present Value of the Public Debt Service Under Hypothetical Rescheduling Terms, 2001/02–2015/16

(In percent of exports of goods and services)

Pakistan: Illustrative Rescheduling Scenarios

(In U.S. millions of dollars; unless otherwise specified)

	Houston terms/ Deferral of Post- COD maturities	Naples terms	Naples plus
Post-COD ODA debt			
Consolidated debt	22	0	0
Pre-COD ODA debt			
Consolidated debt	1,624 5/	7,616	7,616
Interest rate (in percent)	2.4	2.4	0
Grace/maturity	10/20 years	16/40 years	Cancellation
Post-COD non-ODA debt			
Consolidated debt	239	0	0
Pre-COD non-ODA debt			
Consolidated debt	1,160 5/	2,561	2,561
Interest rate/NPV reduction	Market rates	67% NPV reduction	67 % NPV reduction
Grace/maturity	3/18 years	6/23 years	6/23 years
Deferral of post-COD maturities	Yes	No	No
Capitalization of moratorium interest	No	Yes	Yes
Debt flow relief over 3 years	2,844	2,784	2,784
ODA debt flow relief	1,624	1,624	1,624
Non-ODA debt flow relief	1,160	1,160	1,160
Deferral of post-COD maturities	261	0	0
Moratorium interest	-201	-698	-150
Capitalization of moratorium interest 1/	0	698	150
NPV of the debt relief 2/	-461	-4,334	-8,222
(in percent of exports) 3/	-4.8	-45	-86
NPV of ODA debt	-478	-2,535	-6,410
NPV of non-ODA debt	17	-1,812	-1,812
NPV of medium- and long-term public and publicly-guaranteed debt, end-Dec. 2001 2/	24,775	24,775	24,775
(in percent of exports) 3/	259	259	259
After debt relief end-December 2001	24,314	20,441	16,553
(in percent of exports)	254	214	173
At end-Jun 2004	25,006	20,257	15,694
(in percent of exports) 4/	238	192	149

Source: Fund staff estimates.

1/ Calculated on the total consolidated stock of ODA and non-ODA (including 2001 Paris Club agreement) at market interest rates of 5.8 percent.

2/ To calculate the NPVs, a discount rate of 5.8 percent is assumed. For rescheduling of ODA debt and non-ODA debt, interest rates of 2.4 percent and 5.8 percent, respectively, are assumed.

3/ Last 3 years average of exports of goods and nonfactor services (US\$9,562).

4/ Projected 3-year average export of goods and non-factor services (US\$10,523).

5/ Includes maturities of rescheduled debt of 1974, 1982 and 1999 agreements.

November 22, 2001

Mr. Horst Köhler
Managing Director
International Monetary Fund
Washington, D.C. 20431
U.S.A.

Dear Mr. Köhler:

The government of Pakistan has adopted an economic reform program for 2001–2004, which aims to increase sustainable growth and strengthen basic social services as the central pillars of its poverty reduction strategy. To reach these goals, the government is determined to pursue sound macroeconomic policies, create the conditions for vibrant private sector development, and strengthen efforts on basic education and health as well as social safety nets. The details of the program are set out in the attached Memorandum on Economic and Financial Policies (MEFP) and the Interim Poverty Reduction Strategy Paper (I-PRSP). In support of this program, we request a three-year arrangement under the Poverty Reduction and Growth Facility (PRGF) in an amount equivalent to SDR 1,033.7 million (100 percent of quota).

The government will provide the Fund with information on a timely basis as might be requested in connection with the progress in implementing the PRGF-supported program. The government of Pakistan believes that the policies and measures set forth in the MEFP and I-PRSP are adequate to achieve the objectives of the program, but will take any other measures as necessary for this purpose. The government will consult with the Managing Director, on its own initiative or at the request of the Managing Director, concerning the adoption of appropriate measures in accordance with the Fund's policies on such consultations. The government of Pakistan will seek to complete with the Fund the first review of the first-year PRGF-supported program no later than end-March 2002. Moreover, while the government of Pakistan has outstanding financial obligations to the Fund arising from loans under this arrangement, it will consult with the Fund from time to time, on its own initiative or at the request of the Managing Director, on Pakistan's economic and financial policies.

To facilitate wider distribution of the MEFP and I-PRSP, the government of Pakistan has authorized their publication by the Fund.

Sincerely yours,

S
Shaukat Aziz
Minister of Finance and Economic Affairs

S
Ishrat Husain
Governor
State Bank of Pakistan

Attachments:

Memorandum of Economic and Financial Policies
Technical Memorandum of Understanding

PAKISTAN

Memorandum of Economic and Financial Policies for 2001/02–2003/04

I. INTRODUCTION

1. Over the last two years, we have pursued with determination macroeconomic stabilization and wide ranging structural reforms, and all reviews under the recently expired Stand-By Arrangement were concluded as scheduled. To consolidate the progress achieved and to firmly set Pakistan's economy on a path towards high growth and poverty-reduction, we have launched an ambitious and far-reaching medium-term economic reform program, as laid out in detail in our interim Poverty Reduction Strategy Paper (I-PRSP), and for which we request Fund support under a three-year Poverty Reduction Growth Facility (PRGF) arrangement. In view of the consequences of the September 11 events, the outlook for Pakistan's economy is subject to higher-than-usual uncertainty, but this has only reinforced our determination to persist on the path of reform and macroeconomic stabilization. Successful implementation of the program will require strong and timely support of the international community, particularly in light of the adverse effects of recent events on Pakistan's economy.

II. RECENT ECONOMIC DEVELOPMENTS

2. **In FY 2000/01, despite a severe drought and weakening external conditions, we preserved a stable macroeconomic environment and met targets under the Stand-By Arrangement.** Careful economic management limited the negative impact of the worst drought in Pakistan's history, allowing the economy to grow by about 2.6 percent in 2000/01 despite an estimated 3 percent decline in agriculture output, and large increases in the energy import bill. Growth of large-scale manufacturing at about 8 percent suggests that the business community responded positively to the government's economic policies. The decision to let the rupee float led to a substantive real depreciation in 2000/01, which strengthened the competitiveness of our exporters and helped them weather weakening external demand. Cautious monetary and fiscal policy helped to contain the pass-through of the depreciation into domestic prices, and the rate of consumer price inflation for the year ending September 2001 slowed to 2.9 percent. The current account deficit, excluding official transfers, declined to 3.3 percent of GDP, with higher exports broadly offsetting higher imports of equipment by the manufacturing sector and a larger oil import bill. In the capital account, declining direct and portfolio investments were compensated by official aid and short-term capital inflows, which allowed the State Bank of Pakistan (SBP) to exceed its end-June 2001 target for international reserves. Reserves have grown further since and reached US\$2 billion on November 2, 2001 compared to US\$0.7 billion in June 2000. Partly because of lower-than-expected GDP growth and inflation, as well as the slower-than-expected impact of various administrative reforms, we have failed to meet the Central Board of Revenue (CBR) tax collection target for the year. Nonetheless, CBR revenue increased in 2000/01 by 0.4 percentage points of GDP with respect to the previous year. In response to the revenue

shortfalls, we tightened nonpriority development expenditures, and the fiscal deficit was reduced to 5.2 percent of GDP, 0.1 percent below the program target, and compared to 6.5 percent in 1999/2000.

3. Under the Stand-By Arrangement, we implemented a wide range of structural reforms which we believe form a sound basis for our future reform agenda. As detailed in the MEFP for the last review under the Stand-By Arrangement, this includes:

- **Substantial tax reforms**, notably the extension of GST to services, agricultural inputs, and retail trade; the introduction of provincial agricultural income taxes; elimination of income tax exemptions (for example, National Saving Schemes (NSS)) and promulgation of a reformed income tax law.
- **Improved governance in public finances and steps towards a streamlining of the civil service**, such as separation of accounting and auditing functions, publication of quarterly fiscal accounts of the federal government, verified by the Accountant General Pakistan Revenue (AGPR); publication, for the first time, of an account of contingent liabilities and tax expenditures with the 2001/02 budget documents; a special audit of the Central Directorate for National Savings; and implementation of all remedial measures proposed in the context of the Fund's Safeguards Assessment of the SBP. A general framework to restructure and rightsizing the federal administration has been approved by cabinet at end-July 2001.
- **Trade liberalization** through reduction in the maximum tariff to 30 percent and the number of tariff slabs to four (5, 10, 20, 30 percent); elimination of any discrimination in excise rates between imported and domestically produced goods; and the elimination of various quantitative restrictions and license requirements (for example, imports and exports of wheat, imports of oil products).
- **Market liberalization in the agricultural and energy sectors**, through steps towards deregulation of wheat procurement procedures and pricing, far-reaching liberalization of oil product prices and marketing, and adjustments in electricity and gas tariffs to better reflect costs. However, the functioning of the automatic fuel adjustment clause encountered some difficulties and will need to be kept under review.
- **Progress in the liberalization of the financial sector and the foreign exchange regime**, including by eliminating the subsidy element in the interest rate for the export finance scheme, and elimination of the limits imposed on the Nostro account positions of commercial banks.
- **Preparatory steps towards privatizing and restructuring of state-owned companies**, including launching the process for the privatization of the telecommunication company, one major state-owned bank, and government interests in nine oil fields. Numerous expressions of interest were received in each of these

cases, and closure was envisaged by December 2001. However, recent events brought the process to a temporary halt. The drought, high oil prices, and insufficient tariff adjustments prior to 1999 added to the already deteriorating financial conditions of Water and Power Development Authority (WAPDA) and Karachi Electricity Supply Corporation (KESC). The process of corporatizing WAPDA's successor companies with the technical support of the World Bank continued, and with the technical and financial support of the Asian Development Bank (AsDB), we launched the preparation for the privatization of KESC. The finances of the national air carrier (Pakistan International Airlines (PIA)) also suffered from high oil prices, but PIA recently adopted a medium-term restructuring plan, based on cost-cutting measures in several areas, including a reduction in personnel.

III. MEDIUM-TERM PROGRAM FRAMEWORK

4. The central aim of our economic strategy is to gradually raise growth closer to Pakistan's potential of at least 6 percent within a few years, while ensuring that the benefits are widely shared by the large number of poor in our country. As illustrated in greater detail in our I-PRSP, the focus of our strategy rests on sound macroeconomic policies compatible with a continuous increase in the share of public expenditure for social development and poverty reduction programs, in a framework of sustained fiscal adjustment. To move faster and more effectively towards our poverty reduction and social development objectives, the government is committed to strengthen governance, particularly by raising transparency and accountability in public resources management.

A. The Poverty Reduction Strategy

5. The government is strongly committed to undertaking specific actions to reduce the burden of poverty affecting the people of Pakistan. We believe that growth and the related income-generating opportunities are essential in reducing poverty over time, but we also know that in a context where about one-third of the population is poor, it is not possible to wait for the benefit of growth to trickle down and address the poverty issue. Policies to improve access to basic services such as primary education, preventive health care and population and welfare services, and measures that increase efficiency in the delivery of public services will take center stage over the coming year. The government has targeted quantified improvements in a series of monitorable social indicators in the area of education, health, and population welfare. To achieve those objectives, the government is committed to raising over time the resources allocated to programs deemed effective in supporting social development and responding to the poverty problem, as indicated in the I-PRSP. In addition, the government will develop institutional mechanisms and procedures to track a wide range of social and poverty related expenditures, along with progress on intermediate and final outcome indicators. Given the limited administrative capacity available at the moment, such monitoring will be limited for the first program year to a selected sub-group of social indicators; and expenditure monitoring will have to rely initially on provisional (unreconciled) quarterly data; such reports will be published to allow public participation in the monitoring process.

6. Moving towards the preparation of the final Poverty Reduction Strategy Paper (PRSP), the government will deepen its analysis of the current poverty situation and refine the objectives of the strategy. It will also define a firmer methodology for producing the social indicators it intends to track, which will be made explicit in the PRSP. For incorporation into the budget starting with fiscal year 2002/03, the government will prepare detailed costing plans for the different programs included in the poverty reduction strategy, and ensure that resource requirements are fully consistent with the fiscal objectives. All along the process towards the final PRSP, the government will ensure that the provinces and newly-elected local governments, which will be in charge of implementing most of these programs, fully share the objectives of the strategy, agree on the amounts of resources needed to achieve those targets falling under their responsibility, and have in place the necessary institutional mechanisms to monitor the expenditure and the progress towards the objectives.

B. Medium-Term Macroeconomic Objectives and Policies

7. The medium-term macroeconomic objectives are to gradually raise growth to 5.2 percent at the end of the program period, while keeping inflation at about 5 percent. While we expect some pickup in private investment as confidence returns, the tight external financing constraint and the limited room to expand public investment will contain the overall investment rate to about 17 percent of GDP through 2003/04. Realization of the growth target would thus rely mostly on enhanced productivity through structural reforms. The current account deficit (excluding official transfers) is projected to decline to 2.6 percent of GDP in 2003/04. A steady accumulation of foreign exchange reserves is targeted to raise reserves to the equivalent of at least three months of import by June 2004, which we see as the minimum for strengthening confidence in the government's ability to maintain macroeconomic stability.

8. **The government's macroeconomic policy mix will be geared to consolidate macroeconomic stabilization, and reduce the public debt burden, while directing expenditure efforts at poverty reduction and social development.** We are aware that the need to reduce the debt overhang must be sustained by substantial fiscal consolidation and a continuous reduction in the fiscal deficit over the program period. We therefore plan a sustained fiscal adjustment to reduce the budget deficit to 3.2 percent of GDP in 2003/04 and allow a reduction of our (net) public debt-to-GDP ratio to 83 percent. On the other hand, widespread and increasing poverty and large needs for basic infrastructure and services must be tackled through stepped-up social sector and development expenditures and by raising the efficiency of public expenditure. We expect our tax policy and tax administration reforms (see below) to generate a gradual but continuous improvement in our tax revenues to 14.3 percent of GDP by the end of the program period. To ensure a controlled execution of the budget, we will continue to release social sector allocations in full at the start of each fiscal exercise, while staggering the availability of other allocations according to revenue developments. In the 2002/03 budget exercise, we will likely need to make special budgetary allocations to fund a financial restructuring package needed to bring KESC to the point of sale.

9. **The maintenance of a market-based and competitive exchange rate will remain at the core of our exchange rate policy, while the functioning of the foreign exchange market will be strengthened.** The SBP will gradually discontinue its kerb market purchases and promote the integration of the kerb market into the interbank market so as to further reduce the spread between the two rates. We expect the recent narrowing of the spread to shift workers' remittances from the kerb to the interbank market, accelerating the integration of the two markets. Intervention in the inter-bank foreign exchange market will be limited at ensuring a smooth functioning of the interbank market, while ensuring the SBP's reserves accumulation objective under the program.

10. **Monetary policy will be geared towards containing inflation and support a steadfast accumulation of reserves to reduce external vulnerability.** The SBP will maintain a prudent monetary stance and we will use interest rates flexibly to preserve appropriately tight domestic liquidity conditions to ensure the inflation target, in view of the expected continued instability of money demand. In case of strong pressures on the exchange rate, monetary policy will be tightened. In addition, the SBP will deepen its analysis of the functioning of the monetary transmission mechanisms, while strengthening the operational framework of the interbank market for liquidity management purposes, in view of preparing the move to an inflation targeting framework towards the end of the program period.

IV. THE STRUCTURAL REFORM AGENDA

11. **We will implement an ambitious reform agenda aimed at raising growth, reducing poverty, and restoring the confidence of private investors in the potential of our economy.** The key areas of our agenda include: restructuring of public expenditure towards growth-enhancing and poverty-reducing outlays; improving monitoring and transparency in public finances; tax policy and tax administration reform, public enterprise restructuring and privatization; and financial sector and foreign exchange market reforms. In all these areas, the central challenge is to address governance problems that remain a major obstacle to higher growth and better social services. Two additional dimensions of governance will be tackled. First, we will assess existing regulation and procedures affecting the interaction between the administration and the business community with a view of eliminating red tape and, with it, corruption opportunities. Second, with the support of the AsDB, we are undertaking a long-term "access to justice" reform program aimed at strengthening the rule of law and enhancing the transparency and accessibility of the legal system by modernizing the court system at all levels and strengthening capacity, effectiveness, and accountability of law enforcement agents. A detailed matrix outlining the timeline for the measures we intend to take over the medium term are included as an annex to our I-PRSP. Critical measures to be taken in the current fiscal year are listed in Table 2.

Refocusing public expenditures

12. Over the medium term, we plan to allocate a rapidly growing share of budgetary expenditure to growth-enhancing and poverty-reducing outlays. Specifically, we aim to increase the development budget by 1.2 percentage points of GDP over the three-year period,

and broadly defined social and poverty-related expenditure by 0.6 percentage points. A start has been made with the 2001/02 budget, while further plans will be formulated once various major initiatives (such as the education reform strategy detailed in the I-PRSP) are costed and appropriate monitoring mechanisms are in place. At the same time, we will reduce the share of other categories of spending, including the defense related expenditure. The devolution initiative will play a key role in this strategy, as it empowers local communities to formulate and implement development strategies that correspond to local needs. Starting from next fiscal year, the districts will be in charge of preparing their own budgets, based on transfers from the provincial governments and their own resources, while being permanently subject to a "balanced budget" constraint that does not allow them to borrow from scheduled banks or the SBP. The hiring of civil servants will not be devolved to local governments over the program period.

Monitoring and transparency in Public Finances

13. Over the program period, we intend to take measures aimed at the entwined objectives of strengthening public resource management, improving transparency and access to information on public finances, and reducing corruption opportunities in the interaction between the administration and the private sector. A cornerstone of our governance strategy is again the devolution outlined above. Local governments and recently established citizen boards will be key in monitoring social service delivery and ensure that resources reach intended recipients; we expect that a key role will be played by women, which hold at least 30 percent of all local council seats. We are committed to establishing dedicated institutional mechanisms to track social development and poverty alleviation expenditures, and outcomes at the federal, provincial, and district level. Along with the implementation of our Poverty Reduction Strategy, we will regularly report to the public on our actions and outcomes. With the technical and financial support of the World Bank, we intend to implement a follow-up project to Pakistan Improvement of Financial Reporting and Accounting (PIFRA) aimed at reorganizing and modernizing our system of government accounting with the objective of establishing comprehensive recording, reconciliation, and reporting procedures. To increase accountability of public resource management, we will reform our public procurement regulation and practices with technical guidance from the World Bank.

14. During the current fiscal year, the following initiatives will be implemented. First, based on the reporting framework for social development and poverty reduction expenditures, and outcomes described in the I-PRSP, we will publish, within a delay of three months, a table on the quarterly execution of those expenditures, starting in November 2001, with annual data relative to FY 2000/01. Such data will be somewhat provisional, because in the current accounting and auditing framework, the decentralized nature of most social expenditure makes it impossible in the short term to provide fully reconciled data for the expenditure of the local governments. A few intermediate social targets and outcome indicators expected to be responsive to the selected expenditures will be reported yearly by the Poverty Center under the Planning Commission.

15. Second, building upon progress made under the Stand-By Arrangement, we will improve more generally the regular fiscal data reporting and publication. The provincial Fiscal Monitoring Committees will prepare and publish quarterly reports on progress made in fiscal accounting and data reconciliation, and fiscal transparency. Training of accounting staff at the provincial and district level will be intensified, especially in Sindh and Punjab, where progress in fiscal accounting has so far lagged behind. These and other efforts will benefit from World Bank assistance through provincial lending operations, as well as a follow-up project to PIFRA. In our final PRSP, we will commit to a path towards a full reconciliation of expenditure data at the provincial and district level within a reasonable timeframe.

16. Third, at the federal level, we will seek to improve the accounting of foreign-financed development expenditures, publish an analytical mid-year review of budget implementation no later than end-February 2002, and intensify the preparatory work for the implementation of a Medium-Term Budget Framework (MTBF). A preliminary MTBF will be prepared with the 2002/03 budget, refining our medium-term budget projections, deepening the budget's analytical underpinnings (for example, by an extended analysis of contingent liabilities, tax expenditures, and fiscal risks), analyzing follow-up capital costs, as well as recurrent cost implications of projects included in the Public Sector Development Program (PSDP), and preparing for the three-year expenditure programs in the health and education sectors linking performance indicators with costs. The latter will provide a necessary input into the preparation of the full PRSP.

Tax policy

17. To raise the revenue needed to finance development and social services, tax reform is aimed at reducing a range of exemptions, while gradually unifying corporate income tax rates towards 35 percent. Over the program period, we will neither introduce any new exemptions, nor extend the coverage or the period of time-bound preferential tax treatment. Excise taxation will be simplified and taxation of diesel brought closer in line with the taxation of other petroleum products, also for environmental reasons.

18. As detailed in Table 2 during FY 2001/02, the government will take a number of steps to strengthen the GST regime, and prepare by March 2002 a review of the experience with the higher sales tax rate (20 percent) on certain inputs, with a view to return to a single rate if that measure is found to have brought little additional revenue or compliance. The new income tax law has already been promulgated. It provides for self assessment to be universally implemented starting with filing of income tax returns for income earned from July 1, 2002, based on strengthened taxpayer services, and backed by strong audit and new book-keeping requirements that will become effective July 1, 2002. Within the 2002/03 budget law, further steps will be taken to reduce exemptions, eliminate at least two minor withholding taxes, and bring various corporate tax rates closer together. During the remainder of this fiscal year and beyond, we will also intensify taxpayer information and education activities.

19. As regards other taxes, we will streamline with the 2002/03 budget our excise tax system by: (a) eliminating at least six minor excise taxes (on polyester chips, electric batteries, metal containers, advertising agents, shipping agents, and travel agents), while recuperating the ensuing revenue losses through increases in the excise tax rates on other products (for example, beverages); (b) set a uniform ad valorem tax rate on domestically produced and imported cement; and (c) reduce the number of different excise tax rates. In light of the ongoing 2002 National Finance Award discussions, we will review the scope for unifying the petroleum levy and gas surcharge with the respective excises on these products.

Tax Administration

20. Tax administration reform is a cornerstone in our institutional reform agenda. A major overhaul of the CBR will be implemented over the program period. It aims at increasing the agency's effectiveness, reduce corruption opportunities, and raise the buoyancy of the tax system through organizational restructuring, self-assessment, elimination of personal contacts between taxpayers and collectors, simplified processes, revised terms and conditions for employment of CBR officials, and improved IT management. The reform of the CBR will need to be supported by extensive technical and financial assistance from the Fund, the World Bank, and others (for example, DFID). We will press for similar reforms at the provincial level.

21. As a first step, the government will approve shortly a medium-term reform strategy and action plan for fundamental CBR reform, and appoint a Supervisory Council (with 3–4 senior government officials, reporting directly to the Minister of Finance) to oversee the reform. The CBR will restructure its headquarters by end-February 2002 by formally establishing the functions of human resource management, IT, taxpayer facilitation, audit, legal affairs, and administration, and appoint one senior member to lead each of these functions. The new senior CBR team will prepare, for implementation with the 2002/03 budget, revised recruitment policies (with greater emphasis on skills that match the CBR's needs), incentive- and merit-based remuneration and promotion mechanisms (financed from special agency allowances linked to the modernization program), training, and a program for placing unnecessary staff in the surplus pool. In parallel, the CBR will continue to strengthen sales tax audit and enforcement activities, with monthly sales tax audit targets for the remainder of the fiscal year. A pilot Large Taxpayer Unit (LTU), based on a functional organization and encompassing all domestic taxes, will be established by end-June 2002 in one of the major cities of Pakistan. With a view to resolve deficiencies in the appeals and dispute resolution process, we will prepare by March 2002 proposals for improvements, especially with regard to the sales tax tribunals, to be implemented with the next budget.

Trade policy

22. The government is firmly committed to further trade liberalization over the medium term to reduce further the anti-export bias, promote competitive and efficient industries, and encourage investment in sectors in which Pakistan has a comparative advantage. Measures in this respect would include a reduction of the maximum tariff to 25 percent effective July 1,

2002; streamlining the number of statutory orders (SROs) that exempt certain industries from import duties from 13 to 6 by June 2003 and eliminating those remaining by June 2004; and, as agreed with the WTO, phase out Trade Related Investment Measures (TRIMs). The government does not maintain and will not introduce any quantitative import restrictions beyond the standard restrictions related to security, health, public morale, and religious and cultural concerns.

Public enterprises restructuring and privatization

23. Our original privatization program has suffered a temporary set back due to the regional uncertainty following the event of September 11; nonetheless the government's commitment to advance on this road is unchanged. We will move ahead early with two small operations involving the sale of remaining public shares in Muslim Commercial Bank and Allied Bank and with the sale through the stock market of 5 percent of the capital of National Bank of Pakistan (NBP). In the context of the restructuring and privatization program for the three large nationalized banks supported by the World Bank, and expected to be completed by the end of 2003, we plan to bring United Bank Limited (UBL) to the point of sale by end-May 2002. Pakistan Telecommunications Company Limited (PTCL), the national telecommunication company, will be brought to the point of sale in early 2002, and one generation and one distribution company originating from the restructuring of WAPDA later in 2002. Approval by cabinet of a new regulatory system of oil and gas operations, distribution and pricing that is being elaborated (with assistance from the World Bank) will allow us to move fast towards privatizing Pakistan State Oil (PSO) and OGDCL (where financial advisors have already completed their due diligence), and Pakistan Petroleum Limited (PPL), and the two gas distribution companies (where financial advisors contracts will be signed in early 2002). In order to bring KESC to the point of sale by July 2002, through transparent and open public offer for sale, the cabinet will approve a privatization strategy for KESC by end-2001. The strategy will include the set-up of an adequate transitional regulatory framework, a decision concerning the financial structure of the operation, and an arrangement in principle to provide continued police and army support in enforcing bill collection, and reducing theft for a transitory period.

24. To proceed towards establishing a well functioning, competitive, and mainly privately-owned power sector, some changes in the existing regulatory framework and its functioning are crucial, such as to ensure that the automatic fuel adjustment clause becomes fully automatic. We will also resume by March regular adjustment of gas tariffs in line with market developments. The planned new energy sector investor framework will not provide any tax concessions or guaranteed rates of return. With the objective of making the large public enterprises more accountable to their shareholder and to the taxpayers, who ultimately bear the cost of the subsidies needed to keep the companies operating, the government will conclude by end-December 2001 memoranda of understanding with KESC, WAPDA, PIA, Pakistan Railways, and Pakistan Steel Mills involving performance targets and regular reporting on such targets, as well as needed adjustments in tariffs and prices.

Pension and civil service reform

25. In collaboration with the World Bank, we intend to establish an Actuarial Office over the next few months, and with a view to ensure a sustainable pension system, prepare a public pension reform package, including proposals for parametric reforms (for example, retirement age, commutation factors) of the pension system for existing employees, and a new contributory pension system for new entrants. The latter should become effective with the 2002/03 budget. Regarding civil service reform, we will implement the right- and downsizing plan approved by the Cabinet in July 2001 for all federal ministries, and will curb total recruitment with a view to achieve an annual 2 percent decline in the government payroll through 2003/04. Further details for federal and provincial rightsizing programs will be worked out during the remainder of this fiscal year so that they could be implemented also with the next budget. During this fiscal year and next, another pay reform will be prepared that will be ready for implementation, together with the pension reform outline above, with the 2003/04 budget.

Financial sector and foreign exchange market reforms

26. The SBP has prepared a draft comprehensive strategy for the modernization and strengthening of the financial sector, which will be a key component of Pakistan's poverty reduction strategy. The strategy aims to develop a market-oriented, mainly privately-owned financial sector performing efficient financial intermediation. The main policy objectives include: (a) promoting sound, efficient, and competitive financial institutions; (b) widening the availability of financial instruments and services; (c) enhancing transparency and cost-effectiveness of financial markets; and (d) strengthening the capacity of financial regulatory agencies while reinforcing their autonomy. The assessment and suggestions of the forthcoming Financial Sector Assessment Program (FSAP) mission will be further input in the formulation of the strategy, which will be incorporated into the program. The SBP will, in particular, explore ways on how to ensure effective supervision in areas such as anti-money laundering. On the transition to an Islamic banking system, the government will develop, and seek Supreme Court approval for, an evolutionary approach that will allow and encourage the development of Islamic banking in parallel with traditional practices to allow customers maximum choice; at the same time the SBP's capacity to appropriately regulate and monitor Islamic finance products and operators will be strengthened. To avoid subsidization of the export finance scheme, the refinance rate charged by the SBP to commercial banks will be set monthly at a level equal to the average six-month treasury bill auction rate of the preceding month, with banks free to set the rate to customers. Finally, by mid-2002, we will eliminate all remaining mandatory elements related to the implementation of indicative credit allocations to specific sectors, and will ensure that all nationalized banks operate according to commercial principles.

27. In view of fully complying with Pakistan's obligations under Article VIII of the Fund's Articles, the SBP will review its foreign exchange regulations and eliminate any requirement or obligation limiting current account convertibility. In addition, the manual of foreign exchange regulations is being reviewed with the objective of streamlining the

existing regulations and eliminating ambiguities, to reduce the hassle-factor for small transactions that has contributed to the expansion of the kerb market. In order to gradually integrate the kerb and interbank market operations, the SBP will promote a consolidation of the currently large numbers of relatively unregulated moneychangers into foreign exchange companies, which will be subject to more stringent capital requirements, disclosure obligations and prudential supervision by the SBP. Banks will be allowed to create their own exchange companies.

V. MACROECONOMIC POLICIES FOR 2001/02

28. **During the first year of the program, we target a moderate increase in growth in FY 2001/02 to 3.7 percent (from 2.7 percent last year), with inflation limited to 5 percent.** The projections reflect, on the one hand, a downward revision of industry and service output due to September 11 and the ensuing regional tensions, and on the other hand, better prospects for agricultural output, especially regarding sugar cane and cotton. Our projections critically assume that normal economic activity will resume by late 2001, supporting a growth rate in the manufacturing sector of about 4 percent. The projections are obviously highly sensitive to regional developments and vulnerable to the protraction of uncertainty.

29. **Following severe disruptions in international trade operations in the aftermath of September 11, aggravated by large increase in freight, insurance, and financing costs, we expect trade to recover to its normal pattern starting in late 2001.** Under this assumption, we expect no annual export growth (in U.S. dollar terms) in 2001/02. This reflects, on the volume side, the effects of the global slow-down in world demand and of temporary dislocation linked to the regional tensions; the volume decline is compounded by a large decline in the international price of cotton, causing a major reduction in the unit value of our textile exports. However, these effects can be partially offset if our major trading partners were to increase quotas on textile and clothing exports and to reduce tariffs; we are highly encouraged by the recent proposal of the European Commission in this regard. Furthermore, also to effectively raise our exports, we are seeking to channel part of the international relief effort in favor of Afghan refugees (administered through the U.N.) through the Pakistani economy by encouraging active participation of domestic suppliers in the bidding for the delivery of food, tents, and basic consumption items to the refugees or into Afghanistan; the projections assume exports of at least US\$100 million on this account. Import growth will also slow down, reflecting downward pressure on international prices of oil and other basic commodities resulting from slowing world demand, as well as lower domestic activity. On balance, we expect a slight worsening of our trade balance. The service balance is broadly unchanged despite sharply higher freight and insurance premia and reduced travel receipts, reflecting the lower value of imports and associated insurance/freight costs, as well as reduced travel by residents. In the event, we project an increase in the current account deficit, excluding official transfers, to 3.6 percent of GDP. The capital account balance is expected to worsen, compared with last year, mainly on account of higher debt service and lower projected FDI inflows (including privatization), as it may take some time to restore investor confidence in the region following recent events. We consider it,

however, essential to pursue an ambitious build up of our stock of international reserves, to help us better weather exogenous shocks, which would otherwise be reflected in greater volatility of the exchange rate, and support the planned liberalization of the foreign exchange market. We, therefore, maintain an objective of building official reserves to US\$2.3 billion (equivalent to about 9.4 weeks of next year's imports) by June 2002. As a result, substantial financing requirements will have to be met through exceptional support of the international community (see below).

30. Fiscal adjustment remains the pillar of the government macroeconomic adjustment effort and the linchpin of our debt reduction strategy. Although revenue was lower than expected, according to preliminary estimates and the budget deficit (excluding grants) during the first quarter of the current fiscal year (July–September 2001) was broadly on track, at PRs 54.5 billion. Revenue fell short of expectation in part because of lower custom and sales tax revenue after September 11. However, revenue was also affected by the slowdown in imports during July and August, and the acceleration of refunds to exporters. The latter effect is one-off and we do not expect this level of refunds to affect net tax collection in the future. Given the current circumstances, and under the proviso that by late 2001 the situation in the region is back to normal, we estimate that revenue losses associated with the impact of September 11 for the year would be in the order of PRs 12 billion (0.3 percent of GDP), mainly explained by lower import duties and sales tax revenue. Expenditures will be kept within the budget limits to ensure the deficit (excluding grants) is contained at PRs 202 billion, or 5.3 percent of GDP. However, if actual budgetary grants received were to go beyond PRs 25 billion, the government will use additional amounts, for up to PRs 15 billion, to increase allocations in specific social sector programs as listed in the TMU (Table 4). The first such program to be enhanced is the Khushal Pakistan Program, comprising small-scale, labor-intensive community projects, which we expect to have a significant poverty alleviation impact. Any grants in kind or in cash directed to support security or operational expenditures related to the current tension, as well as grants targeted for the Afghan refugees in Pakistan, are not covered in our projections. It may not be possible to include grants in kind in our budgetary operations; we will, however, make our best efforts to keep track of those grants and related expenditure. Regarding the outlays related to the downsizing of the nationalized banks, bridge loans of the SBP to the banks to finance nonbudgeted expenditure will be limited to PRs 2.5 billions in 2001/02, and such bridge lending will be eliminated in 2002/03. We are prepared to take contingency measures as needed to preserve fiscal stability in the face of unforeseen developments, in particular, in case of an unexpected prolonged duration of current regional tension. Such measures would involve notably cuts in nonpriority expenditure. We are also committed to undertake additional tax revenue measures, if the underlying tax-collection trend would fall short from the targeted path. Such measures could include an increased petroleum levy, or accelerated elimination of GST exemptions.

31. Monetary policy will remain geared to keep inflation in check while supporting the targeted accumulation of international reserves. As we are not yet in a position to move to inflation targeting, we will maintain a quantitative framework for monetary policy implementation, based on targets for the SBP's net domestic and net foreign assets. We

envisage an expansion of broad money by 9.1 percent for 2001/02, which would allow a substantial increase in credit to the private sector given the fiscal targets. This quantitative framework will need to be kept under continuous review, given the uncertainties about money demand. In particular, the uncertainty triggered by the events of September 11 events has initially pushed up the demand for cash, creating pressures on bank liquidity. Given the recent remarkable inflation performance and the risks of declining domestic activity, the strength of the rupee, in spite of the central bank's aggressive buying on the interbank market, and declining international interest rates, the SBP has decided to reduce the discount rate by 200 basis points to 10 percent in October. However, we will closely monitor monetary developments and stand ready to raise interest rates as needed to preserve the inflation objective and achieve the net foreign assets (NFA) and net domestic assets (NDA) targets.

32. Concerning exchange rate policy, the SBP will maintain a fully flexible market determined exchange rate and proceed towards the unification of the kerb and interbank market rates. Intervention in the foreign exchange market will be limited to smoothing volatility and to pursue the targeted build-up of reserves. To further integrate the interbank with the kerb market and allow the phasing out of SBP purchases in the kerb market, the SBP will, over the coming months, reform the existing regulatory framework through several steps: first, it will pursue the consolidation of money changers in exchange companies that can be brought under appropriate supervision. Second, scheduled banks will be allowed to set up exchange companies themselves, and to purchase foreign exchange from exchange companies at freely negotiated rates. Third, to reduce the complexities of foreign exchange regulations, which may contribute to diverting transactions towards the kerb market, the foreign exchange manual will be drastically simplified. Finally, the commercial backing requirement will be lifted to allow interbank foreign exchange operations unrelated to payments and transfers for current international transactions.

VI. STATISTICAL ISSUES

33. Our plan to improve the quality and the dissemination of economic statistics, particularly in the domain of national accounts, has progressed significantly during 2000/01, and we intend to advance further on this front during the course of the program. Concerning real sector statistics, we plan to strengthen the reliability of our GDP statistics by sector of origin on the basis of the findings of the sectoral studies under preparation, which will be completed according to the following schedule:

- Slaughtering, water supply, transport (excluding shipping), and financial institutions (November 2001).
- Electricity, trade, capital formation, saving, consumption of fixed capital, and forestry (December 2001).
- Agricultural crops, small scale manufacturing, nonprofit institutions and housing, constructions, and large scale manufacturing (March 2002).

The results of these studies will strengthen the basis for constructing the estimates necessary to establish 1999/2000 as the new base year of our national accounts. We intend to start publishing real GDP statistics using the new base year in 2002.

34. With the objective of improving the quality of the existing GDP deflator, and ultimately the reliability of our National Accounts at constant prices, we will continue implementing the plan designed with Fund technical assistance to publish adequate producer price indices (PPIs) for the different sectors of the economy. As a first step, we are committed to start monthly publication of product-based PPIs for four agricultural and 50 non agricultural products by December 2001. The project is scheduled to be completed at the end of the program period.

35. As part of the forthcoming mission from the Fund Statistics Department for the data module of the Review of Standard and Codes (ROSC), we will assess the status of our economic statistics and establish an action plan to address existing shortcomings in different areas, with the objective of subscribing to the Special Data Dissemination Standards towards the end of the program period.

36. In the context of our poverty reduction strategy framework, the Federal Bureau of Statistics, several ministerial departments, and other administrative agencies will need to devote substantial efforts to the collection, elaboration, and analysis of data that are crucial for monitoring the implementation of the poverty-reduction strategy and our success in meeting its objectives. For this purpose, we will establish a clear allocation of responsibility and credible coordination to ensure the effective flow of data from the primary sources to those in charge of exploiting and analyzing them. In the final PRSP, we will determine the final set of social indicators we want to target, indicate the methodology to assess progress towards achieving targets and establish procedures for adequate monitoring.

VII. PROGRAM FINANCING AND DEBT ISSUES

37. Pakistan will need to mobilize large financial support from the international community to cover the external financing gap of the next three years, after taking into account expected disbursements from the World Bank (US\$1.5 billion) and the AsDB (US\$1.5 billion). To cover the gap, we will seek additional multilateral financing, further rescheduling from Paris Club and other bilateral creditors on concessional terms, and grants from bilateral donors, including the extension of the Saudi oil grant beyond September 2002. We will also seek to complete voluntary refinancing of the special U.S. dollar bond (issued in exchange for foreign currency deposits frozen in 1998 and mostly held by residents), as this also represents a claim on our reserves, although it is not part of our external debt. For FY 2001/02, we have clear indications regarding bilateral grants and the lifting of textile imports restrictions in the E.U., although some of these elements will still need parliamentary approval to become effective. We will do our part to ensure timely disbursements of the World Bank and AsDB program loans by pursuing the related policy reforms, and will work closely with the relief agencies to ensure active participation by Pakistan suppliers in supplying food and relief items to Afghanistan and Afghan refugees.

38. Beyond covering the financing gap, one of the government's key objective is to achieve a return to a sustainable external debt levels at the end of the three-year program, which we consider critical to enhance business and investor confidence. Our exit strategy from the current debt overhang involves seeking external financing at highly concessional terms, along with a substantial debt restructuring in order to reduce the net present value of the external public debt to sustainable levels. We, therefore, intend to approach the Paris Club and other bilateral creditors to request the needed flow relief along with a debt stock restructuring on concessional terms.

VIII. RISKS AND CONTINGENCIES

39. As discussed above, the projections and policies underlying our program are predicated on a resolution of the current regional tensions by end-2001 and a return to normal conditions for economic activity and trade. Should current tensions prevail for much longer, the adverse effects on the Pakistani economy could be much larger. In particular, were regional tensions at current levels to prevail for another two quarters, that is, through the end of the current fiscal year, and prevent a return to normal economic activity, we would estimate that our balance of payments would deteriorate by another US\$0.6 billion, growth would probably be close to nil, and nonagricultural and tax revenue would fall by another 0.6 percent of GDP. These estimates are, of course, subject to very large uncertainty. In such circumstances, we would activate the fiscal contingencies described above in order to contain fiscal imbalances. Flexibility of the exchange rate would be another critical element in the defense of external balances, although we would, if needed, allow some use of reserves to avoid dislocation and preserve orderly external trade activity and debt servicing. We would also quickly seek additional donor support. Should such a situation arise, we would obviously consult rapidly with the Fund on any further action needed to preserve macroeconomic stability.

IX. PROGRAM MONITORING

40. The new PRGF arrangement will involve quarterly reviews and disbursements. The period for the first year of the program is October 2001–September 2002. The first review will be completed by end-March 2002 and will focus on the implementation of macroeconomic policies, progress in tax administration reforms, and progress in monitoring fiscal expenditure, especially for social expenditures and outcomes. The second review will be completed by end-June 2002. Quantitative performance criteria and benchmarks are indicated in Table 1, structural performance criteria, benchmarks, and measures that are to be implemented prior to the consideration of the program by the Executive Board are listed in Table 2. Definitions of monitoring variables, adjustors, and program reporting requirements are described in the attached Technical Memorandum of Understanding (Annex 1). Quarterly external financing assurances reviews will also apply, as part of the regular reviews under the program.

Table 1. Pakistan: Quantitative Targets, December 2001–June 2002 1/

(Cumulative flows from July 1, 2001 unless otherwise specified)

	Outstanding Stock End-Jun. 2001	Est. End-Sep. 2001	Prog. End-Dec. 2001	Prog. End-Mar. 2002	Prog. End-Jun. 2002
Net foreign assets of the SBP (floor in millions of U.S. dollars)*	-382.0	-167.5	461.5	93.5	311.5
(In billions of Pakistan rupees)					
Net domestic assets of the SBP *	557.6	-8.4	11.0	28.5	29.2
Overall budget deficit *	...	-54.5	-107.8	-160.5	-202.2
Net government bank borrowing *	512.9	24.6	-9.6	-4.0	-7.0
CBR revenue (floor) *	...	75.5	183.3	295.8	429.9
Net credit to public sector enterprises *	110.6	-2.7	5.5	14.0	22.5
Accumulation of budgetary arrears to WAPDA by list of priority connections *	...	0.0	0.0	0.0	0.0
Social and poverty-related spending ("I-PRSP budgetary expenditure")	...	30.8	62.0	96.6	136.4
(In millions of U.S. dollars)					
Contracting of short-term public and publicly guaranteed * external debt	...	...	500.0	700.0	800.0
Contracting of nonconcessional medium- and long-term Public and publicly guaranteed external debt * 2/	...	...	600.0	600.0	600.0
Of which: External debt with an initial maturity Of over one year and up to five years *	...	...	300.0	300.0	300.0
Accumulation of external payments arrears (continuous performance criterion during the program period) *	...	...	0.0	0.0	0.0
SBP's forex reserves held with foreign branches of domestic banks	320.0	270.0	250.0	175.0	100.0
Of which: other than current account *	200.0	172.0	150.0	75.0	0.0
Contracting of foreign currency swap and forward sales *	...	0.0	0.0	0.0	0.0
Memorandum items:					
Net external program financing	...	-130.4	109.7	-63.5	225.2
External cash budget grants	...	0.0	616.5	801.4	817.9
Poverty alleviation and other programs eligible for additional grant-financed expenditure (in billions of Pakistan rupees) 3/	...	17.3	41.3	63.4	90.1
Foreign currency deposits with the SBP (incl. reserve requirements)	410.0	0.0	4.0	20.0	60.0
Daily cash reserve requirement ratio (in percentage points)	4.0	4.0	4.0	4.0	4.0

Sources: Quarterly macroeconomic projections agreed between the Pakistan authorities and the Fund staff.

1/ The relevant variables are defined in the Technical Memorandum of Understanding (TMU) dated November 2001 and are subject to adjustments specified in the TMU. For variables marked "*" the end-December 2001 and end-March 2002 flows represent ceilings (or floor, if indicated) that constitute performance criteria. All other targets are indicative.

2/ Excluding PRGF loans.

3/ See definition in the TMU, Table 4.

**Table 2. Pakistan: Structural Performance Criteria, Benchmarks and Prior Actions
Under the First Year Under the PRGF (Continued)**

Measures	Timing	Status
I. Structural Performance Criteria		
No new exemptions or special privileges regarding income tax, custom duties, or GST to be granted, no new regulatory import duties to be imposed (except for anti-dumping measures), and all time bound exemptions and regulatory import duties to lapse without extension, except for existing contracts and exemptions based on international commitments.	Continuous	
Implement new organizational set-up for CBR headquarters per approved CBR reform plan, as described in MEFP, para. 21.	February 28, 2002	
Apply standard GST penalty regime to retailers and eliminate GST exemptions for all fertilizer wholesale and retail trade.	March 31, 2002	
Adopt timetable for the phasing out, during the program period, of the GST subsidy on electricity and of GST exemptions for edible oil, vegetable ghee, and pharmaceuticals (except life-saving drugs).	March 31, 2002	
Implementation of universal self-assessment effective for all income earned from July 1, 2002.	July 1, 2002	
Start operations of a Large Taxpayer Unit, integrating all domestic tax operations.	July 1, 2002	
Implementation of income tax reform package effective for income earned from July 1, 2002 including: elimination of at least two minor withholding taxes; elimination of at least 55 income tax rebates, concessions, and non-standard exemptions from the CRITO-list; and lowering the threshold on NSS schemes subject to withholding tax on interest income from PRs 300,000 to PRs 150,000.	July 1, 2002	
Bring KESC to point of sale, as detailed in MEFP, para. 23	July 31, 2002	
Issue circular allowing banks to purchase from August 1, 2002 foreign exchange from money changers at freely negotiated rates.	August 1, 2002	

Table 2. Pakistan: Structural Performance Criteria, Benchmarks and Prior Actions
Under the First Year Under the PRGF (Concluded)

Measures	Timing	Status
II. Structural Benchmarks		
Prepare list of intermediate indicators (selected from Table 5.3 and Tracking/Monitoring Matrix in Annex I of I-PRSP) with baseline data for 2000/01, and preliminary annual targets for the period 2001/02-2003/04.	December 31, 2001	
Quarterly published progress reports on implementation of Poverty Reduction Strategy, including "I-PRSP expenditure".	To start end-December 2001 for 2001/02 Q1 data, and continued on the basis of the same quarterly schedule throughout fiscal year 2001/02	
Publish rules and regulations including for record-keeping under the universal self assessment scheme for income tax to become effective July 1, 2002.	March 31, 2002	
Prepare proposals for revised income and sales tax appeals and dispute resolution process with a view to implement them with the 2002/03 budget.	March 31, 2002	
Bring United Bank Ltd. and PTCL to the point of sale through transparent and open public offer for sale.	May 31, 2002	
Issuance of a streamlined foreign exchange manual to simplify and clarify rules regarding access to foreign exchange and current account transactions.	July 1, 2002	
Establishment of a contributory pension scheme for new recruits in the civil service, and preparation of a third phase public pension reform package, prepared in collaboration with the World Bank and involving actuarially fair reform of early retirement and of commutation tables.	July 1, 2002	
III. Prior Actions		
Approve medium-term strategy and action plan on CBR reform for the period October 2001-June 2004 (MEFP para. 20-21).		
Approve audit program which includes monthly sales tax audit targets for the period November 2001-June 2002.		

Table 2. Pakistan: Structural Performance Criteria, Benchmarks and Prior Actions
Under the First Year Under the PRGF (Concluded)

Measures	Timing	Status
Provision of first progress report covering fiscal year 2000/01 on social and poverty-related spending ("I-PRSP expenditure") in format set out in the TMU.		
SBP official reserves to reach at least US\$1,850 million by November 15, 2001.		
CBR revenue for July–October 2001 to reach at least PRs 109 billion.		
Issue the following texts to ensure compliance with Article VIII obligations and avoid MCP (a) circular clarifying that unlimited access to foreign exchange on the interbank market for all current transactions (including dividends and profit repatriation), beyond the current bonafide limits, will be granted on the basis of appropriate, clearly specified documentation; and (b) directive lifting the commercial backing requirement on interbank foreign exchange transactions with effect from November 25, 2001.		

PAKISTAN

Technical Memorandum of Understanding on the Program Supported by Poverty Reduction and Growth Facility

(November 2001)

1. This memorandum sets out the understandings between the Pakistan authorities and the Fund staff relating to the monitoring of the first year under the PRGF-supported program (October 2001–September 2002). It specifies the adjustors for the quantitative performance criteria and indicative targets set out in Table 1 of the MEFP; the content and frequency of the data to be provided for monitoring the financial program; the mechanism for monitoring the structural performance criteria and structural benchmarks as listed in Table 2 of the MEFP; and definitions of the relevant financial variables.

I. ADJUSTORS

2. The floors on the **net foreign assets (NFA) of the SBP** will be adjusted:
- (a) upward/downward by the cumulative excess/shortfall in net external program financing (as defined below), downward adjustments will be capped at US\$250 million;
 - (b) upward/downward by the cumulative excess/shortfall in external cash budget grants (as defined below).
3. The ceilings on the **net domestic assets (NDA) of the SBP** and on **net bank borrowing by the government** will be adjusted downward/upward by the cumulative excess/shortfall in net external program financing (as defined below) evaluated at the exchange rate as of end-June 2001 (PRs 63.98 per U.S. dollar). The upward adjustment will be capped, however, at US\$250 million.
4. The ceilings on the **NDA of the SBP** will also be adjusted downward/upward by the amount of: (a) any cumulative excess/shortfall in external cash budget grants above program levels; (b) banks' rupee reserves freed/seized by any reduction/increase of the daily CRR of 4 percent; (c) banks' reserves freed/seized by any reduction/increase in the total reserve requirements on foreign currency deposits of 25 percent; and (d) any reduction/increase in the reservable deposit base that is related to definitional changes, as per the following formula: $\Delta NDA = \Delta r B_0 + r_0 \Delta B + \Delta r \Delta B$, where r_0 denotes the reserve requirement ratio prior to any change; B_0 denotes the level of the reservable deposits in the initial definition; Δr is the change in the reserve requirement ratio; and ΔB denotes the change in the reservable deposits as a result of definitional changes.
5. The ceilings on the consolidated government fiscal deficit excluding grants will be adjusted upward for any excess in the external cash budget grants for budget support above PRs 25 billion. The upward adjustment will be capped at PRs 5 billion at end-December 2001, PRs 10 billion at end-March 2002, and PRs 15 billion at end-June 2002. Upward adjustments in the deficit will have to be matched by identical increases in actual budgetary expenditures above the program levels for the categories listed in Table 4 (with the

restriction that additional spending for federal police and civil armed forces will be limited to PRs 1 billion).

II. FINANCIAL PROGRAM REPORTING REQUIREMENTS

6. The following information, including any revisions to historical data, will be provided to the Middle Eastern Department of the Fund through the office of the Senior Resident Representative of the IMF in Pakistan, within the delays indicated:

- Monthly provisional statements on federal tax and nontax revenue, within one month.
- Deposits into and withdrawals from the privatization accounts for each quarter of 2000/01. Withdrawals will be reported with the following breakdown: (a) those which constitute budgetary use of privatization proceeds; (b) those which constitute costs of privatization; and (c) other (with explanation of the purpose of other withdrawals), within one month.
- Quarterly statements on budgetary capital receipts and disbursements, including repayments of bonds, recovery of loans from provinces and "others", within two months.
- Monthly (unreconciled) provisional data on federal expenditure, within one month.
- Quarterly statement on consolidated budgetary expenditure, with federal data approved by the AGPR, within two months.
- Quarterly provisional data (from AGPR and AG) on social sector and poverty-related budgetary expenditures, as defined below, as well as on the subcategories eligible for additional grant-financed expenditure, as defined in Table 4.
- Quarterly data on the stock of domestic government debt, broken down by instrument, within two months.
- Quarterly data on budgetary arrears to and from WAPDA (see Table 2 below), within two months.
- Monthly provisional data on external budget financing and net external program financing proceeds from the Saudi oil facility, and cash external grants for budget support (as defined below), within one month.
- Quarterly data on the revenues and expenditures of the five public enterprises as per Tables 5(a) to 5(e), within two months (WAPDA, KESC, PLI, Pakistan Steel Mill Corporation, Pakistan Railways).

- The following monthly monetary data on a last-Saturday basis, both at current and program exchange rates, within four weeks:
 - (i) monetary survey;
 - (ii) accounts of the SBP;
 - (iii) consolidated accounts of the scheduled banks; and
 - (iv) banks' lending to the government;
- The same tables as in the preceding item, but on an end-quarter basis (last business day), both at current and program exchange rates, within six weeks.
- Daily data on SBP's sales and purchases in the kerb and interbank foreign exchange markets, swaps and forward outright sales, within two business days.
- Monthly data on the outstanding stock of the SBP's forward foreign currency operations, including swaps and outright forward sales and purchases, within one month. The terms of any new transactions will also be provided.
- Monthly data on the SBP's foreign exchange reserves, with details on the currencies, instruments, and institutions in which the reserves are held, within one month.
- Quarterly data on bank credit to the nine major public enterprises (with breakdown), and on SBP bridge loans to naturalized banks in the context of the BSAC and any other quasi-fiscal operations, within six weeks.
- The following quarterly data on external debt, within six weeks:
 - (i) Stock of public and publicly-guaranteed external debt (including deferred payments arrangements), by maturity (initial maturities of up to and including one year, and over one year), by creditor and by debtor (central government and publicly guaranteed), and for Paris Club debt, with breakdown in pre- and post-cutoff date stock.
 - (ii) Loan-by-loan detail of the contracted new medium- and long-term nonconcessional public and publicly-guaranteed external debt with separate identification of the contraction of debt with an initial maturity of over one year and up to and including five years; grace periods and scheduled repayments; currency denominations; and interest rates; and
 - (iii) Monthly statements on rescheduling agreements on public- and publicly-guaranteed debt reached with creditors;
- Monthly data on external payments arrears on public- and publicly-guaranteed debt with details as in (i) of the preceding item.

- Copies of new or revised ordinances/circulars regarding changes in: tax policy, tax administration, foreign exchange market regulations, and banking regulations no later than three days after official issuance, or notification that ordinances have been posted on the CBR and SBP website.
- Monthly data on the import parity prices as well as central depot prices of the six major oil products, within one month.

III. DEFINITIONS OF MONITORING VARIABLES

Valuation of Foreign Exchange Denominated Assets and Liabilities

7. For the purposes of monitoring under the program, all assets and liabilities denominated in SDRs and in currencies other than the U.S. dollar will be converted into U.S. dollars at their rates prevailing as of June 30, 2001, as published in the IFS. The U.S. dollar value of all foreign assets and liabilities will be converted into Pakistan rupees at the end-June 2001 exchange rate of PRs 63.98 per U.S. dollar.

Reserve money

8. Reserve money (RM) is defined as the sum of: currency outside scheduled banks (deposit money banks); scheduled banks' domestic cash in vaults; scheduled banks' required and excess rupee as well as foreign exchange deposits with the SBP; and deposits of the rest of the economy with the SBP excluding those held by the federal government, the provincial governments, Cotton Export Corporation (CEC), Rice Export Corporation of Pakistan (RECP), and counterpart funds.

Net foreign Assets of the SBP

9. The NFA of the SBP are defined as the difference between its foreign assets and foreign liabilities. Foreign assets of the SBP consist of gold, foreign exchange, balances held outside Pakistan, foreign securities, foreign bills purchased and discounted, net IMF position and SDR holdings. The definition of foreign assets of the SBP will be fully consistent with the Data Template on International Reserves and Foreign Currency Liquidity. Gold will be valued at SDR 35 per fine troy ounce. Foreign liabilities of the SBP include deposits with the SBP of foreign governments, foreign central banks, foreign deposit money banks, and international organizations.¹

¹The definition of net foreign assets of the SBP used here implies that, for program monitoring purposes, disbursements and/or purchases from the Fund are to be recorded in the monetary accounts as external liabilities of the SBP, rather than deposits of the government.

Net domestic assets of the SBP

10. The NDA of the SBP are defined as the difference between reserve money and the NFA of the SBP.

Net borrowing from the banking system by the government

11. Net borrowing from the banking system by the government is defined as the difference between the banking system's claims on the central and provincial governments and the deposits of the central and provincial governments with the banking system. For purposes of this memorandum, claims on government exclude credit for commodity operations; government deposits exclude Zakat deposits.

Overall budget deficit (excluding grants)

12. The definition of the budget deficit under the program will be the consolidated budget deficit excluding grants. It will be measured from below the line by the sum of: (a) the total net financing to the federal and provincial governments; and (b) the total external grants to the federal and provincial governments. The former is defined as the sum of net external budget financing (defined below), net borrowing from the banking system (as defined above), and net domestic nonbank financing (defined below). The latter is defined as the sum of project grants, the rupee counterpart of the Saudi oil facility, and the cash external grants for budgetary support.

13. **Net external budget financing** is defined as net external program financing plus all other external loans for the financing of public projects or other federal or provincial budget expenditures. **Net external program financing** is defined to include external privatization receipts, budget support loans from multilateral (other than the Fund), bilateral, and private sector sources, and rescheduled debt service net of government debt amortization due on foreign-currency denominated public loans. It includes foreign loans onlent to, financial institutions and companies (public or private), emergency relief lending, and the World Bank's BSAC. Program financing excludes all external financing counted as reserve liabilities of the SBP (defined to include all net deposits of foreign banks and agencies with the SBP, and net purchases and disbursements from the IMF). Amounts assumed for net external program financing and external grants are provided in Tables 1(a) and 1(b) below:

Table 1(a). Pakistan: Net external Program Financing FY 2001/02
(Cumulative from July 1, 2001)

(In millions of U.S. dollars)

	Sep. 2001	Dec. 2001	Mar. 2002	Jun. 2002
Program financing (a+b+c+d+e+f-g+h)	-130.4	109.7	-63.5	225.2
(a) World Bank	0.0	174.0	208.0	665.0
(b) AsDB loans	0.0	300.0	350.0	535.0
(c) Other multilaterals	0.0	0.0	0.0	0.0
(d) Bilateral loans	0.0	0.0	0.0	0.0
(e) Commercial bank borrowing	257.0	532.0	718.0	918.0
<i>Of which: IDB</i>	134.0	234.0	320.0	420.0
(f) Privatization receipts	0.0	0.0	0.0	0.0
(g) Amortization due	714.5	1,586.8	2,385.4	3,246.4
Multilateral creditors	143.0	302.9	440.6	599.2
Bilateral creditors	196.2	429.4	652.1	828.3
Commercial banks	359.0	819.0	1,238.0	1,748.0
Other	16.2	35.5	54.7	70.9
(h) Debt service rescheduled/arrears	327.1	690.5	1,045.9	1,353.6
Multilateral creditors	0.0	0.0	0.0	0.0
Bilateral creditors (Jan. 2001)	327.1	327.1	327.1	327.1
Bilateral creditors additional debt relie	0.0	363.4	718.8	1,026.5
Commercial banks	0.0	0.0	0.0	0.0
Other	0.0	0.0	0.0	0.0

Sources: Ministry of Finance; and Fund staff projections.

Table1(b). Pakistan: External Grants for FY 2001/02
(Cumulative from July 1, 2001)

(In millions of U.S. dollars)

	Sep. 2001	Dec. 2001	Mar. 2002	Jun. 2002
External cash budget grants	0.0	616.5	801.4	817.9
United States	0.0	600.0	600.0	600.0
European Union	0.0	9.2	36.6	45.8
Japan	0.0	0.0	150.0	150.0
United Kingdom	0.0	7.4	14.8	22.2
Other	0.0	0.0	0.0	0.0
Saudi oil facility	173.2	359.1	544.9	730.7
Project grants	9.4	20.2	32.5	44.7
Memorandum item:				
Grants for Afghan refugees	0.0	162.7	226.5	298.6

Sources: Ministry of Finance; and Fund staff projections.

Net domestic nonbank financing of the budget

14. Net domestic nonbank financing is defined as domestic privatization receipts plus the change, during each fiscal year, in the stock of: (a) permanent debt, which consists of non-bank holdings of prize bonds, all federal bonds and securities (including the new Pakistan Investment Bonds); plus (b) floating debt held by nonbanks; plus (c) public account (or unfunded debt), which consists of NSS debt, Postal Life Insurance, and the Provident Fund; plus (d) stock of deposits and reserves received by the government; plus (e) suspense account; plus (f) any other government borrowing from domestic sources net of repayments; minus (g) government deposits with NBFIs.

15. Nonbank holdings of permanent and floating debt is defined as total debt outstanding, as reported by the SBP, minus holdings of banks as per the monetary survey. Total treasury bill and other relevant government debt is valued at discount value.

Net credit to public sector enterprises

16. Banking system's credit from July 1, 2001, to all public sector enterprises, net of outstanding deposits on the special account with the SBP for payments on public enterprises' rescheduled debt.

Public and publicly guaranteed external debt

17. The performance criteria on contracting of nonconcessional medium- and long-term public and publicly guaranteed external debt and on contracting of short-term public and publicly-guaranteed external debt apply not only to debt as defined in point No. 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt (adopted on August 24, 2000), but also to commitments contracted or guaranteed for which value has not been received. Public and publicly-guaranteed external debt also includes the following: (a) guarantees provided by the SBP; (b) partial credit guarantees from external creditors, if covered by a government counter guarantee; and (c) external debt contracted by state-owned enterprises or banks when they are clearly only motivated by balance of payments considerations. It excludes: (a) the foreign currency deposit liabilities of the banking system; and (b) the outstanding stocks of FEBCs, DBCs, and FCBCs. Short-term external debt is defined as loans with original maturity of up to and including one year. Medium- and long-term external debt consists of debt with initial maturity of over one year. The external debt will be expressed in U.S. dollar terms, with debts in currencies other than the U.S. dollar converted into U.S. dollars at the market rates of the respective currencies prevailing on June 30, 2001 as published in IFS.

Nonconcessional borrowing

18. Nonconcessional borrowing is defined as borrowing with a grant-element of at least 35 percent, following the methodology set out in the staff report SM/96/86 and approved by the IMF Executive Board on April 5, 1996. The discount rates used to calculate the grant element will be the six-month and ten-year Commercial Interest Reference Rates (CIRRs)

averages, as computed by the Policy Review Department of the Fund. Six-month CIRRS are updated mid-February and mid-August (covering the six-month period preceding the date of update) and the ten-year CIRRS averages are updated mid-December (covering a period of 10 years preceding the date of the update). Six-month CIRRS averages are to be used for loans whose maturity is less than 15 years, while ten-year CIRRS averages are to be used for loans whose maturity is equal or more than 15 years.

Budgetary arrears to WAPDA

19. Budgetary arrears to WAPDA are defined as electricity bills of public entities overdue by more than 30 days, as reported by WAPDA in the following format:

Table 2. Pakistan: Position of Billing/Receivables and Reconciliation in Respect of Federal and Provincial Government Departments Vis-à-Vis WAPDA for the Quarter of ____ to ____

SR. NO.	CATEGORY	RECEIVABLES AT THE END OF PREVIOUS QUARTER	AMOUNT WITHDRAWN AGAINST PREVIOUS QUARTER	BILLING DURING QUARTER	AMOUNT RECONCILED AGAINST COLUMN 5	TOTAL	PAYMENT DURING QUARTER	RECEIVABLES AT THE END OF THE QUARTER
1	2	3	4	5	6	7=3-4+5	8	9=7-8
A	Federal Govt.							
I.	Federal Govt. agencies							
II.	AJK							
	Subtotal							
B	Provincial Govt. debts							
I.	Punjab							
II.	NWFP							
III.	Sindh							
IV.	Baluchistan							
	Subtotal							
C	Total Govt (A+B) Of which: Priority connections 1/							
	WAPDA debt service Liability to government							
	Net position							

1/ Priority connections consist of: President Secretariat (president house), Chief Justice of Pakistan (office/residence), Chairman's Senate (office/residence), Governors' (office/residence), and Federal and provincial government hospitals.

20. Poverty-related and social public spending ("I-PRSP expenditure") consists of central provincial and district government spending under the current budget and the Public Sector Development Program, as defined in Table 3.

Table 3. Pakistan: I PRSP Expenditure, 1999/2000–2001/2002

(In billions of Pakistani rupees)

	Year			Q1	
	Act.	Prov.	Proj.	Prel. Act.	Prov.
	1999/2000	2000/2001	2001/2002	2000/2001	2001/2002
Total	114.4	119.3	136.4		
Education	54.0	56.4	63.2		
Current	51.6	54.4	59.0		
Development	2.4	2.0	4.1		
Health	17.3	17.5	19.3		
Current	14.3	15.0	15.9		
Development	3.0	2.5	3.4		
Population planning	3.4	1.6	2.1		
Current	0.0	0.0	0.0		
Development	3.4	1.5	2.1		
Social security & other welfare	2.1	1.6	1.7		
Current	2.0	1.5	1.6		
Development	0.1	0.1	0.1		
Natural calamities	1.2	0.9	1.0		
Rural development 1/	6.5	12.0	15.2		
Current	1.3	3.9	2.8		
Development	5.3	8.1	12.5		
Land reclamation	0.9	1.4	1.5		
Food subsidies	9.9	8.2	8.7		
Water supply and sanitation	5.6	4.5	5.5		
Current	1.9	2.1	2.0		
Development	3.7	2.4	3.5		
Other	13.4	15.3	18.2		
Irrigation	8.3	8.2	9.4		
Current	5.4	5.8	4.8		
Development	2.9	2.4	4.6		
Roads	5.1	7.1	8.9		
Current	1.9	3.0	1.3		
Development	3.3	4.2	7.6		
Memorandum items:					
Khushal program	3.5	5.2	7.0		
Federal	...	5.1			
Provincial	...	4.3			

Source: Ministry of Finance.

1/ Includes the Khushal program.

Table 4. Pakistan: Poverty Alleviation and Other Programs Eligible for Additional Grant-Financed Expenditure, 2001/02 1/

(In billions Pakistani of rupees)

	Budget Accounting Code	2001/02	2001/02			
		Year	Q1	Q2	Q3	Q4
		Budget	Est.		Proj. (cumulatively)	
Total		90.05	17.28	41.3	63.4	90.1
Recurrent expenditure		12.60	2.42	5.8	8.9	12.60
Food support program	74900	2.90	0.56	1.3	2.0	2.90
Federal assistance to provinces for law and ord	22000	9.70	1.86	4.5	6.8	9.70
Development expenditure		77.45	14.86	35.6	54.5	77.45
Khushal program	2100	7.00	1.34	3.2	4.9	7.00
Devolution	2100	3.01	0.58	1.4	2.1	3.01
On-farm water management	52100	0.70	0.13	0.3	0.5	0.70
Primary education	41500	31.00	5.95	14.2	21.8	31.00
Secondary education	41400	18.44	3.54	8.5	13.0	18.44
General hospitals and clinics	42200	9.10	1.74	4.2	6.4	9.10
Other health facilities and preventive measures	42500	2.50	0.48	1.2	1.8	2.50
Population planning	43000	1.80	0.35	0.8	1.3	1.80
Social security and other welfare	47000	3.90	0.75	1.8	2.8	3.90

Source: Ministry of Finance

1/ Federal and provincial expenditure.

Table 5 (a): Financial Accounts of Water and Power Development Authority (Power Wing)

(In million of Pakistani rupees)

	1998/99	1999/200 Prov.	2000/01 Prel. Est.	2001/02				2001/02 Proj.
				Q1	Q2 (cumulative)	Q3	Q4	
Operating revenue and expenditure								
Revenue	129,016	137,145	150,500					170,121
From electricity	127,753	131,046	146,260					165,584
Other operating revenues	1,263	6,099	4,240					4,537
Operating expenditure	109,993	129,969	165,591					196,494
Cost of fuel	19,536	26,457	29,895					37,139
Purchase of power from IPPs	42,532	54,150	84,612					104,637
Capacity payments	22,602	23,563	33,340					59,828
Energy payments	19,930	30,587	51,272					44,809
Operating, maintenance, administrative expense	12,960	15,151	15,674					17,782
Hydel profit to provinces	6,000	6,000	6,000					6,000
Interest charges	18,413	16,444	16,850					18,074
Other operating expenditure	10,552	11,767	12,560					12,862
Net operating balance incl. interest charges	19,023	7,176	-15,091					-26,373
Savings, investment and net borrowing								
Gross savings	35,049	21,287	91					-5,649
Net operating balance incl. interest charges	19,023	7,176	-15,091					-26,373
Other income	5,474	2,383	2,622					7,862
Other operating expenditure	10,552	11,767	12,560					12,862
Capital expenditure	17,391	24,654	23,833					25,000
Net financing requirements	-17,658	3,367	23,742					30,649
Financing	-17,658	3,367	23,742					30,649
Net cash collection from previous operations	1,301	-17,214	-31,885					2,802
Change in accounts receivables (- = increase)	-10,448	5,299	-5,805					-2,913
Changes in current liabilities (+ = increase)	11,749	-22,513	-26,080					5,715
External borrowing (capital expenditure)	7,970	12,246	14,216					13,034
Debt amortization (due basis)	-13,953	-22,398	-19,644					-14,086
Of which: to the government								
Rural electrification (budget CD loan)	1,129	1,151	713					1,037
Capital contributions	2,618	2,935	3,140					3,360
Debt-equity conversion	0	36,383	0					0
Other 1/	-16,723	-9,736	57,202					24,502
Memorandum items:								
Production (in GWh)	54,222	56,259	58,352					60,472
Units generated	38,334	38,395	37,065					37,951
Power purchased	15,888	17,864	21,287					22,521
Unit sold	38,906	40,910	43,757					46,382
Average tariff (in rupees per kWh)	3.3	3.2	3.3					3.6
Average cost (in rupees per kWh)	2.8	3.2	3.8					4.2
Of which: fuel and electricity	1.6	2.0	2.6					3.1
Total bank credit outstanding								
Of which: guaranteed by the government								
TFC outstanding								
Of which: guaranteed by the government								

Sources: Ministry of Finance; and Fund staff estimates.

1/ Please provide explanation for this residual item.

Table 5 (b). Accounts of the Karachi Electricity Supply Corporation

(In million of Pakistani rupees)

	1998/99	1999/200	2000/01 Prel. Est.	2001/02				2001/02 Proj.
				Q1	Q2	Q3	Q4	
				(cumulative)				
Operating revenue and expenditure								
Revenue	23,782	26,042	29,986					35,777
Sale of energy	23,285	25,035	29,011					34,962
Other income	496	1,007	975					815
Expenditure	31,265	38,958	45,961					50,590
Fuel and electricity	20,713	23,560	31,897					34,176
Fuel and oil consumed	9,312	13,916	18,301					19,870
Electricity purchased (incl. capacity charges)	11,401	9,644	13,596					14,306
Operation and maintenance expenses	3,452	3,314	3,652					4,158
Financial charges	3,042	5,481	6,486					8,044
Other operating expenses	4,058	6,603	3,926					4,212
Of which: depreciation	2,726	2,821	2,911					3,163
Net operating revenue incl. interest charges	-7,482	-12,916	-15,975					-14,814
Savings, investment and net borrowing								
Gross savings	-4,756	-10,095	-13,064					-11,651
Net operating balance incl. interest charges	-7,482	-12,916	-15,975					-14,814
Depreciation	2,726	2,821	2,911					3,163
Capital expenditure	2,386	2,451	4,442					3,550
Net financing requirements	7,142	12,546	17,506					15,201
Financing								
Net financing from the budget								
Scheduled repayments of CDL (-)								
Scheduled repayments of onlent foreign loans (-)								
Debt for equity swaps (+)								
Arrears to budget								
Change in outstanding liabilities to suppliers + = increase)								
Change in receivables (+ = decrease)								
Of which: from government								
Net Bank financing								
Amortizations on existing loans								
New loans								
Other 1/								
Memorandum items								
Production (in GWh)								
Units generated	6,613	7,745	7,941					8,678
Power purchased	4,007	3,701	3,688					3,657
Unit sold	6,131	6,430	6,974					8,132
Average tariff (in rupees per kWh)	3.8	3.9	4.2					4.3
Average cost (in rupees per kWh)	5.1	6.1	6.6					6.2
Of which: fuel and electricity	3.0	3.7	4.6					4.2
Total Bank credit outstanding								
Of which: guaranteed by the government								
TFC outstanding								
Of which: guaranteed by the government								

Sources: Ministry of Finance; and Fund staff estimates.

1/ Please provide explanation for this residual item.

Table 5 (c). **Pakistan International Airways, 1999–2002**

(In million of Pakistani rupees)

	1999	2000	2001 proj	Q1	Q2	Q3	Q4	2002 Proj.
				2001 (cumulative)				
Operating revenue and expenditure								
Operating revenue								
Operating expenditure								
Operating costs								
<i>Of which:</i> salaries and pensions								
<i>Of which:</i> fuel								
Interest expenses								
Net operating revenue incl. interest charges								
Savings and investment								
Gross savings								
Net operating balance incl. interest charges								
Other income								
Depreciation								
Capital expenditure								
Net financing requirements								
Financing								
Financing from Federal government (net)								
Gross lending								
Amortization								
<i>Of which:</i> onlent foreign loans								
Net bank financing								
Repayments								
New loans								
<i>Of which:</i> guaranteed by the government								
TFC								
Other 1/								
Memorandum items								
Total Bank credit outstanding								
<i>Of which:</i> guaranteed by the government								
TFC outstanding								
<i>Of which:</i> guaranteed by the government								

Sources: Ministry of Finance; and Fund staff estimates.

1/ Please provide explanation for this residual item.

Table 5 (d). Pakistan Railways, 1998/99–2001/02

(In million of Pakistani rupees)

	1998/99	1999/200	2000/01 Prel. Est.	2001/02 (cumulative)				2001/02 Proj.
				Q1	Q2	Q3	Q4	
Operating revenue and expenditure								
Operating revenue	11,443	13,340	16,308					17,170
Revenue receipts	9,292	9,572	11,908					12,370
Passengers	4,447	4,779	5,657					5,850
Goods	3,698	3,760	5,038					5,380
Others 1/	1,147	1,033	1,213					1,140
Transfers from the budget 2/	2,151	3,767	4,400					4,800
Expenditure	15,215	15,537	15,240					16,451
Operating expenditure	11,892	12,395	12,727					14,233
Of which: salaries and pensions								
Interest charges	3,323	3,142	2,513					2,219
Net operating balance incl. interest charges	-3,772	-2,197	1,068					719
Savings, investment and net borrowing								
Gross savings	-3,772	-2,197	1,068					719
Net operating balance incl. interest charges	-3,772	-2,197	1,068					719
Capital expenditure	3,388	1,069	2,457					6,369
Net financing requirements	7,160	3,266	1,388					5,650
Financing	7,160	3,266	1,388					5,650
External financing net	1,287	401	-690					...
Amortization								
New loans								
Of which: guaranteed by the government								
Budget investment transfer	997	1,035	1,767					1,629
SBP overdraft	4,430	1,830	311					-3,000
Other 3/	509	0	0					0
Memorandum items:								
Overall balance (cash basis)	-7,160	-3,266	-1,388					-5,650
Passenger traffic								
Number of passengers (in million)	64.9	67.5	70.2					71.0
Number of kilometers traveled (in million)	18,980	18,495	19,706					21,000
Average kilometer per passenger	292.4	274.0	280.7					295.8
Average rate per passenger kilometer (in rupees)	0.23	0.26	0.29					0.28
Freight traffic								
Number of tons (in thousands)	5,500	4,800	5,760					5,900
Number of kilometers traveled (in million)	3,966.5	3,612.1	4,736.7					4,800.0
Average kilometers per ton	721	753	822					814
Average rate per ton per kilometer (in rupees)	0.93	1.04	1.06					1.12
Number of employees	100,643	94,243	92,500					90,000

Sources: Ministry of Finance; and Fund staff estimates.

1/ Includes public service obligation, which are transfers from the budget to cover the cost of public services provided by Railways.

2/ Transfers from the budget to cover operational shortfalls.

3/ Please provide explanation for this residual item.

Table 5 (e). Pakistan Steel Mills Corporation

(In million of Pakistani rupees)

	1998/99	999/200	2000/01 Prel. Est.	2001/02				2001/02 Proj.
				Q1	Q2 (cumulative)	Q3	Q4	
Operating revenue and expenditure								
Operating revenue								
Net sales								
Operating expenditure								
Raw material costs								
Salaries and pensions								
Depreciation								
Other operating expenses								
Interest charges								
Net operating balance incl. interest charges								
Savings, investment and net borrowing								
Gross savings								
Net operating balance incl. interest charges								
Other income								
Depreciation								
Capital expenditure								
Net financing requirements								
Financing								
Net budgetary financing								
Amortization (due basis)								
New loans								
Net bank financing								
Amortization								
New loans								
<i>Of which:</i> guaranteed by the government								
Other 1/								
Memorandum items:								
Tons of steel produced (in thousands)								
Tons of steel sold (in thousands)								
Number of employees								

Sources: Ministry of Finance; and Fund staff estimates.

1/ Please provide explanation for this residual item.

**Statement by the IMF Staff Representative
December 6, 2001**

This Statement provides information on developments since issuance of the staff report (EBS/01/197, 11/26/01). These developments do not change the thrust of the staff appraisal.

1. **Recent developments are broadly in line with the program.** There are indications that activity has been significantly affected by the disruptions related to the conflict in Afghanistan and the global slowdown, mainly through the reduction of export orders, in particular in the textile industry. In the agriculture sector, the cotton crop will probably be lower than expected, due to pest attacks in some areas of Punjab. As measured by the CPI, inflation declined to 2.7 percent over the twelve months ending October 2001, in part owing to the strength of the rupee against the U.S. dollar. On December 3, the dollar traded against the rupee at PRs 61 on both the interbank market and kerb market; any spread has virtually disappeared in recent weeks. In October, broad money and reserve money expansion (10.5 percent and 7.9 percent, respectively, on a twelve month basis) were broadly in line with program projections, in spite of a substantial reduction in key interest rates. The rate on six-month treasury bills dropped to 8.3 percent at the last auction on November 29. The SBP has reduced accordingly the rate applied to credits under the export finance scheme.

2. **Provisional fiscal data for the first quarter of 2001/02 suggest that the consolidated budget deficit was 0.3 percent of GDP higher than expected.** This reflects mainly lower-than-projected interest receipts from state-owned enterprises (chiefly from WAPDA). Overall tax revenue and expenditure were broadly as expected.

3. **Pakistan's overall external position has been somewhat stronger than expected, with official foreign exchange reserves rising by about US\$1 billion in less than two months.** The main factor was the rapid disbursement of budget assistance from the United States, as well as short-term private capital inflows that are likely to be temporary and apparently induced by the strength of the rupee, confidence factors following the lifting of sanctions, and stronger enforcement of banking and money-changer supervision rules abroad. A secondary factor was a more pronounced slowdown of imports compared to exports so far; in October 2001, exports increased by 2.2 percent from the same month last year, while imports declined by 14.1 percent.

4. **All prior actions (EBS/01/197, Attachment I, Table 1) have been implemented.** In particular:

- The Cabinet approved a medium-term strategy and an action plan to reform the Central Board of Revenue (CBR) on November 17, 2000. In line with the strategy described in the MEFP (paragraphs 20–21), the action plan includes a reorganization of the CBR management, entailing the filling of senior staff positions as heads for the newly established functional departments by end-February 2002, and the establishment of one model large taxpayer unit in Karachi by July 2002.
- Monthly sales tax audit targets have been adopted for the period November 2001–June 2002. A substantial number of auditors have recently

- over -

been added to the CBR staff, which should allow the CBR to more than double the number of sales tax audits in 2001/02 compared to last year.

- A first progress report on social and poverty-related federal and provincial expenditures over the period 1995/96–2000/01 (the so-called I-PRSP expenditures) has been provided, including a detailed data breakdown (see EBD/107/01, Annex V). In line with provisions in the MEFP, given the large amounts of budget grants already disbursed, the Cabinet has decided to allocate an additional PRs 13 billion (0.3 percent of GDP) to specific social and other programs for the present fiscal year. The Khushal program will benefit from an additional allocation of PRs 8 billion, while PRs 2 billion will be added to health and PRs 3 billions to primary education programs.
- Official reserves stood at US\$2.05 billion on November 15, 2001, exceeding the US\$1.85 billion target by a large margin. As of December 3, official reserves reached US\$2.8 billion, the equivalent of 11 weeks of imports of goods and services, with the increase reflecting the disbursement of US\$600 million grant assistance from the United States, as well as substantive SBP purchases of foreign exchange, mostly on the interbank market.
- CBR revenue for July 2001–October 2001 reached PRs 110.7 billion, exceeding slightly the target of PRs 109 billion.
- The SBP issued two circulars to ensure compliance with Article VIII obligations and deepen the interbank market. Circular No. 20, dated November 21, 2001, eliminates the restriction that bank transactions on the foreign exchange market should be backed by commercial transactions; Circular No. 21, dated November 22, 2001, ensures that the release of foreign exchange for travel, education, and medical treatment abroad, is granted beyond bona fide limits on the basis of appropriate documentation.

In addition, the office of the Accountant General Pakistan Revenue has posted on its website consolidated fiscal accounts for the first quarter of 2001/02, in line with the standard practice agreed upon under the previous Stand-By Arrangement. In November, the Federal Bureau of Statistics completed, as scheduled, four additional studies on specific sectors as preparatory steps for the revision of the national accounts. The final version of the Interim Poverty Reduction Strategy Paper was posted on the website of the Ministry of Finance on December 3, and endorsed by the Board of the World Bank on December 4.

5. Paris Club creditors provided assurances that they would consider Pakistan's request for debt rescheduling of the debt service payments falling due during the program period, but the terms remain to be decided. A Paris Club meeting on Pakistan's request is scheduled for December 11–12.

6. On making a Joint Staff Assessment of the I-PRSP (EBD/01/106), the staffs of the Bank and the Fund do not intend to make any judgment on the legal or other status of any disputed territories or to prejudice the final determination of the parties' claims.

Press Release No. 01/51
FOR IMMEDIATE RELEASE
December 7, 2001

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Approves US\$1.3 Billion PRGF Credit to Pakistan

The Executive Board of the International Monetary Fund (IMF) has approved a three-year arrangement for Pakistan under the Poverty Reduction and Growth Facility (PRGF)¹ totaling SDR 1.034 billion (about US\$1.322 billion). As a result of today's decision, Pakistan will be able to draw SDR 86.16 million (about US\$109.6 million) under the arrangement.

Following the Board discussion on Pakistan, Eduardo Aninat, Deputy Managing Director and Acting Chairman, said:

"Over the last two years, Pakistan has established a record of sound macroeconomic management and timely implementation of structural reforms, as confirmed by the recent completion of a Stand-By Arrangement with the Fund. However, a move to higher sustainable growth and a better sharing of the fruits of growth remain essential to tackle Pakistan's widespread poverty and weak social development indicators.

"The government, in broad consultation with local communities and other stakeholders, has prepared an Interim Poverty Reduction Strategy Paper (I-PRSP), which provides a sound basis for concessional assistance from the Fund and the World Bank. In preparing the full PRSP, the authorities will need to develop a more thorough costing of poverty alleviation and social programs, and a fuller articulation of strategies in key sectors, particularly for human development. Solid support by domestic stakeholders, clear allocation of responsibilities, a detailed devolution plan, accountability at all levels of the administration, and continued donor assistance will be key in achieving the strategy's objectives.

"Under the PRGF-supported program and in line with the objectives stated in the I-PRSP, the government will implement an ambitious reform agenda aimed at raising growth and reducing poverty, while consolidating macroeconomic stability and external viability. The strategy centers on sustained fiscal adjustment supported by a major reform of tax administration and a widening of the tax net, while increasing public spending for poverty alleviation. A cautious monetary

¹ PRGF loans carry an annual interest of 0.5 percent, and are repayable over 10 years with a 5 ½ year grace period on principal payments.

policy, under the floating exchange regime, will aim at keeping inflation below 5 percent and raising official reserves to three months of imports by the end of the three-year program.

"Medium-term fiscal consolidation, combined with significant external assistance, will allow a substantial reduction in the public debt as a share of GDP and free up resources for growth-enhancing and poverty-reducing expenditure. However, in order to achieve the targeted social outcomes, the government will need to complement higher resource mobilization with better prioritization of public expenditure allocation, so as to allow higher outlays on social sectors, especially health and education. Enhanced governance and transparency in public finances, particularly in the context of the devolution of responsibility for most social service delivery to local governments, will also be important.

"Over the program period, the government will pursue a broad agenda of restructuring and privatization of public enterprises, reducing the government's role in agricultural marketing, ensuring that administered gas and electricity prices broadly reflect market conditions, deepening the liberalization of the financial sector, and integrating the kurb and interbank foreign exchange markets.

"Pakistan's economic outlook is now clouded by considerable uncertainty in view of the impact of September 11 events and the ongoing slowdown in world demand, which adversely affect Pakistan's prospects for growth, exports, and capital flows. Achieving the objectives of the program will be highly dependent on a rapid return to regional stability. At the same time, the international community has indicated its strong support for the reform program over the next three years, with exceptional financial assistance of about US\$9.5 billion in form of bilateral support, including debt relief, and assistance from international financial institutions. In this connection, and in line with the Managing Director's statement that the Fund is prepared to provide advice and additional support to members that adopt suitable policies, as part of a joint international effort to strengthen confidence in the global economy, we will keep under review Pakistan's PRGF program and Fund support for it," Mr. Aninat said.

ANNEX

Recent Economic Developments

In FY 2000/01, Pakistan's performance under the Stand-By Arrangement (see Press Release No. 00/64) was generally good, despite a severe drought and weakening external conditions. While the economy grew by only about 2.7 percent in the period, manufacturing growth was strong, partly offsetting an estimated 3 percent decline in agricultural output. The fiscal deficit was held to the program target of 5.2 percent of GDP even though the improvement in tax revenue collection fell short of the program goal. A cautious monetary policy helped slow the 12-month rate of consumer price inflation to 2.5 percent by end-June 2001. The floating of the rupee led to an effective real depreciation in 2000/01 of 2.6 percent, which strengthened the competitiveness of Pakistan's exporters amid weakening external demand. The current account deficit, excluding official transfers, declined to 3.3 percent of GDP, driven by strong export growth. Progress was made with a range of structural reforms during 2000/01, including in the areas of tax reform, fiscal management, restructuring of the enterprise and banking sectors, and governance, which strengthened the foundation for sustainable growth and poverty reduction.

Following the September 11 events, available data point to a deterioration of the real economy. In the period July–October 2001, sluggish export growth of 1.9 percent in U.S. dollar terms, compared to the same period a year earlier, reflects a slowdown in world demand, as well as a significant rise in freight and insurance costs. Cancellations of export orders since mid-September, especially from the United States, have affected export prospects and appear to have slowed investment and production. Imports dropped by 9.9 percent (in U.S. dollar terms) compared to the year-earlier period. Price developments through October have remained benign and the 12-month CPI inflation rate remained at 2.7 percent.

Preliminary indications are that the budget deficit for the quarter July–September 2001 was slightly higher than programmed, reflecting mainly shortfalls in non-tax revenue, and even though overall expenditure was on track. Tax collection in recent months has been negatively affected by the large decline in imports and higher-than-expected tax refunds to exporters, but was in line with program assumptions through October. Preliminary indications are that revenues in November were more adversely affected.

International reserves reached US\$2.8 billion in early December, the highest level in a number of years. This reflects large disbursements of foreign grant assistance and repatriation of holdings abroad by Pakistani residents in recent months, allowing the State Bank of Pakistan (SBP) to step up, in October–November, its foreign exchange purchases on the interbank market.

Program Summary

The central goal of Pakistan's PRGF-supported economic program is to gradually raise growth closer to a medium-term objective of at least 6 percent annually, while ensuring that the benefits of stronger growth are widely shared by the nation's poor. Though global economic conditions raise significant uncertainties about Pakistan's outlook, during the first year of the program (FY

2001/02), Pakistan is targeting a moderate increase in growth to 3.7 percent from 2.7 percent last year. Inflation is expected to be limited to 5 percent over the three-year the IMF-supported program.

Monetary policy is to remain geared to keeping inflation in check, while supporting the targets for international reserves. The exchange rate will continue to be fully flexible, and the SBP intends to proceed towards unification of the kerb and interbank foreign exchange markets. Fiscal adjustment, centered on strengthening revenue collection through tax and tax administration reforms, remains a pillar of the government's macroeconomic adjustment efforts, and is key to Pakistan's debt-reduction strategy.

Pakistan will need to mobilize large financial support from the international community to cover its external financing gap over the next three years, which has been substantially revised upward following the events of September 11. The expected support of around US\$9.5 billion includes multilateral financing, grants and loans from bilateral donors, and debt rescheduling by bilateral creditors. A key objective of the authorities is to achieve sustainable external debt levels by the end of the three-year PRGF-supported program.

Poverty Reduction

Pakistan's I-PRSP, which was endorsed by the World Bank and IMF Executive Boards on December 4, 2001, and December 6, 2001, respectively, sets out the main elements of the authorities' approach over the next three years to broader structural reform and poverty reduction. The I-PRSP, which has been published on the Government of Pakistan's website, outlines a range of measures designed to improve access to basic social services such as primary education and preventive health care, along with steps aimed at increasing efficient delivery of public services and addressing governance issues. The I-PRSP is the result of a consultative process that has involved district and provincial governments, civil society organizations and bilateral and multilateral development agencies.

As part of the poverty reduction effort, the authorities envisage a range of structural reform measures to enhance growth and poverty-reducing outlays, along with steps to address governance issues that present obstacles to higher growth and better social services. Under the PRGF-supported program, the focus will be on improving monitoring and transparency in public finances; the reform of tax policy and tax administration; public enterprise restructuring and privatization; and financial sector and foreign exchange market reforms.

Pakistan joined the IMF on July 11, 1950. Its quota² is SDR 1.0337 billion (about US\$1.305 billion), and its outstanding use of IMF resources totaled SDR1.383 billion (about US\$1.768 billion) as of end-October 2001.

² A member's quota in the IMF determines, in particular, the amount of its subscription, its voting weight, its access to IMF financing, and its allocation of SDRs.

Pakistan: Selected Economic and Financial Indicators, 1998/99–2003/04

	1998/99	1999/2000	Est. 2000/01	Prog. 2001/02	2002/03	2003/04
(Annual changes in percent)						
Output and prices						
Real GDP at factor costs	4.2	3.9	2.7	3.7	5.0	5.2
Real GDP at market prices	3.7	4.4	3.4	3.9	5.0	5.2
Partner country demand	2.7	4.0	3.2	2.0	2.9	3.8
Consumer prices (p.a.)	5.7	3.6	4.4	5.0	5.0	5.0
Consumer prices (e.o.p.)	3.7	5.1	2.5	5.9	...	...
Rupees per U.S. dollar (p.a.)	17.0	3.0	12.8	11.3	...	...
(In percent of GDP)						
Savings and investment						
Gross national savings	11.9	13.5	12.8	14.6	14.7	15.5
Government	-3.0	-3.6	-1.8	0.7	1.0	1.8
Nongovernment 1/	15.0	17.2	14.6	13.8	13.8	13.7
Gross capital formation	15.6	15.6	14.7	15.2	16.2	16.8
Government	3.7	3.2	2.7	3.4	3.6	3.9
Nongovernment 1/	11.9	12.4	12.0	11.8	12.6	12.9
(In percent of GDP)						
Public finances						
Budgetary revenue (excluding grants)	16.2	16.5	15.7	16.5	17.3	17.6
Budgetary expenditure	22.2	23.0	21.0	21.9	21.4	20.8
Budgetary balance (excluding grants)	-6.0	-6.5	-5.2	-5.3	-4.1	-3.2
Primary balance	1.3	1.1	1.5	1.5	2.3	2.7
Net public debt	91.6	89.4	95.4	92.4	87.9	84.6
Net domestic public debt	40.3	40.8	39.0	36.0	32.7	29.4
Implicit interest rate on public debt (percent) 2/	8.9	9.0	8.2	7.8	7.6	7.5
(Annual changes in percent of initial stock of broad money)						
Monetary sector						
Net foreign assets	1.6	2.0	5.2	2.6	...	...
Net domestic assets	4.5	7.4	3.7	6.5	...	...
Of which: credit to the private sector	8.5	1.4	3.4	7.7	...	...
Of which: net credit to government	-3.8	6.1	-3.4	-2.8	...	...
Broad money	6.2	9.4	9.0	9.1	...	...
Six-month treasury bill rate (in percent, p.a.)	13.1	8.6	10.4	...	...	...
(In percent of GDP)						
External sector						
Merchandise trade balance	-3.6	-2.3	-2.1	-2.2	-2.1	-1.7
Merchandise exports	12.8	13.3	15.0	15.2	15.8	16.2
Merchandise imports	16.4	15.6	17.1	17.4	17.8	18.0
Current account excluding official transfers	-4.6	-3.6	-3.3	-3.6	-3.1	-2.6
Current account including official transfers	-3.6	-2.1	-1.9	-0.6	-1.5	-1.3

Pakistan: Selected Economic and Financial Indicators, 1998/99–2003/04

	1998/99	1999/2000	Est. 2000/01	Prog.		
				2001/02	2002/03	2003/04
(In percent of exports of goods and services)						
External public and publicly guaranteed debt	331.6	310.7	319.8	324.0	317.2	304.5
Debt service 3/	41.2	38.4	32.1	32.0	28.1	25.8
Implicit interest rate (in percent) 4/	3.7	4.2	3.9	3.8	3.5	3.5
Gross reserves (in millions of U.S. dollars) 5/	1,672	908	1,681	2,385	3,029	3,895
In weeks of next years' imports of goods and services	7.7	3.9	7.2	9.7	11.6	14.3
In percent of short-term external debt 6/	35.2	19.2	63.8	75.1	96.2	130.2
Memorandum items:						
ICOR, three-year moving average	4.5	4.7	4.6	4.3	3.4	3.1
Real effective exchange rate (percentage change)	-9.1	-0.6	-2.6	-6.1	-3.2	-2.1
Terms of trade (in percentage change)	4.1	-9.2	-1.6	-1.0	2.5	4.2
Real per-capita GDP (in percentage change)	1.3	2.1	1.1	1.6	2.7	2.9
GDP at market prices (in billions of Pakistani rupees)	2,938	3,183	3,472	3,788	4,179	4,623

Source: Data provided by the Pakistani authorities; IMF staff, INS and World Economic Outlook.

1/ Includes public sector enterprises.

2/ The implicit interest rate on public debt is calculated as interest payments in percent of the end-of-period debt stock of the previous year.

3/ Including interests on short term debt

4/ The implicit interest rate on external public debt is calculated as interest payments in percent of the average stock of debt of the current and previous fiscal year.

5/ Excluding gold, foreign assets relating to foreign currency deposits contracted after May 1998 (FE-25s), and short-term foreign exchange swaps and outright forward sales by the SBP.

6/ Data on short-term external debt includes public and private short-term at original maturity and amortization payments on public medium- and long-term debt of the following year.

Statement by Abbas Mirakhor, Executive Director for Pakistan
December 6, 2001

My authorities thank staff, management, and the Executive Board for their advice, guidance, and support. As the staff report indicates, Pakistan's performance under the Stand-By Arrangement was solid. In 2000/01, before September 11, manufacturing output recovered strongly, and inflation was kept under control despite the drought which constrained the overall GDP growth. The fiscal deficit was brought down to 5.2 percent of GDP, and official reserves rose to \$1.7 billion at end-June 2001—more than double their level in the previous year. Significant strides were made in the implementation of structural reforms in the areas of tax policy, fiscal management and transparency, restructuring of the banking sector, and governance.

Pakistan has thus far established a good track record of policy implementation and has laid the foundation for higher sustainable growth and poverty reduction. My authorities have always felt that, as a poor and heavily indebted country, Pakistan can effectively address its economic problems only in the context of a medium-term framework, with an appropriate sequencing of reform measures supported by generous debt relief and concessional resources. They are therefore determined to build on the accomplishments of the reform process, initiated by the Government two years ago and, subsequently, supported by the Fund under the Stand-By Arrangement. In doing so, they will be focusing on the critical issues of poverty alleviation, higher growth, improved governance, and sustainable debt situation in the context of their new program to be supported by the PRGF.

The present macroeconomic situation in Pakistan is marked by downward revisions in activity amid a background of heightened uncertainty. The fallout from the September 11 events, the global slowdown, and the on-going military operations have had widespread negative effects on the economy. Latest data indicate that export growth has virtually come to a halt and that there has been a dramatic rise in freight and insurance costs, while the precipitous fall in imports has seriously impacted fiscal revenues. The balance of payments for 2001 has significantly worsened from earlier projection, with lower inflows of FDI and privatization proceeds. While recent indications of favorable crops suggest that the growth in agriculture could be well-sustained, reports of pest contamination make the cotton crop subject to wide margins of uncertainty. More positively, however, inflation has been subdued and international reserves have been built up to more comfortable levels, in part due to stepped-up purchases of the State Bank of Pakistan (SBP) in the interbank market to stem upward pressure on the exchange rate.

Assuming that military operations in the region give way to more normal conditions by early 2002, real GDP growth in 2001/02 is projected at 3.7 percent. However, this outcome is clouded by more than the usual degree of uncertainty. Even under a best case scenario of a timely cessation of military operations there are potential high risks to the economy, e.g., from cascading waves of new refugees until conditions in Afghanistan are normalized and all refugees repatriated, and continuing uncertainties attached to foreign and domestic

investment. Already the fiscal position has come under pressure. The revised assumptions, again envisioning a return to normal conditions early next year, embody a revenue shortfall of 0.3 percent of GDP and a somewhat higher overall deficit to make room for additional social spending to be financed by grants.

At the heart of the authorities' adjustment and reform strategy is the I-PRSP anchored on three pillars: raising economic growth, ensuring durable improvements in Pakistan's social indicators, and strengthening the resilience of the economy. In line with these objectives, the authorities will pursue further fiscal consolidation based on a broadening of the tax base along with a reprioritization of public expenditure allocations in favor of the social sectors. They will also exert maximum effort to foster the development of the private sector by providing a stable macroeconomic environment and building confidence. Strengthening the economy's resilience to cope with shocks will be pursued through, inter alia, a flexible exchange rate policy, a build-up of reserves, and attaining substantial reduction in the debt burden.

It is imperative that success is achieved in raising the tax revenue-to-GDP ratio in a sustainable and equitable manner to redress inadequacies in social services. Forceful and timely implementation of fundamental reform of the Central Board of Revenue (CBR) is the most critical element of the reform strategy. My authorities are committed to implementing the reform measures described in the I-PRSP and MEFP and outlined in Box 2 of the staff report. Their demonstrated ability to take tough decisions, in the face of resistance from vested interests over the past two years, should reassure the Board that reforms will be implemented. It should be recognized that, given the fundamental nature of the reforms being undertaken, which involve a sea change in the culture and administration of taxation, discrete and quantum progress is likely to take time to materialize.

Higher tax revenues will need to be accompanied by a significant reorientation of public expenditures with declining defense and interest payments, to make room for a projected increase in development and poverty-related expenditures. The I-PRSP targets in education and health reflect the urgency of catching-up in an area where Pakistan has performed poorly even when the economy grew strongly. In addition to higher spending levels, the authorities expect significant efficiency gains in the delivery of social services arising from the ongoing fiscal devolution initiative that should help strengthen the formulation of projects and the monitoring of expenditures. They recognize the importance of having a system in place for tracking social expenditures and key intermediate targets as well as for timely reporting of performance. While a good start has been made in this regard, the authorities are aware of the challenges they face in this area as they move toward a full PRSP. They welcome the envisaged joint Bank-Fund study on the poverty and social impact analysis (PSIA) of reform measures.

The scope and depth of other reforms being implemented are fully described in the I-PRSP and MEFP. These include better governance and transparency in public finances, deeper civil service as well as a pension reform to place the system on an actuarially sound footing. The reform agenda also includes the exchange system (including, efforts to speed up the integration of the official and kerb market and converting moneychangers into foreign

exchange companies under strict SBP supervision) continued efforts to restructure and privatize the state-owned entities in the banking, financial and energy sector, and further agriculture and trade liberalization. The authorities look forward to the FSAP mission, which has now been rescheduled to early 2002, and stand fully committed to implementing best-practice prudential and anti-money laundering regulations.

In sum, despite the tensions and uncertainties surrounding short-term prospects, the authorities intend to be vigilant and resolute in their reform efforts and stand ready to take prompt corrective action, if warranted. They believe their program is ambitious and offers a hope for durably raising the living standards of their people. Their strong ownership of the program is reflected in the transparent and participatory approach that has underlaid the I-PRSP and the recognition of areas where more work needs to be done.

As noted earlier, the September 11 events and recent developments in the region have led to significant revisions of the balance of payments projections, requiring substantial exceptional financing in over the program period. For 2001/02, based on present assumptions, the program is fully financed, thanks to exceptional support in terms of bilateral grant pledges, enhanced market access for exports, and support from IFIs. On the latter, the authorities had hoped that the strength of the program, the financial needs of the country, and their performance under the Stand-By Arrangement would have justified a larger access than presently envisioned. They are still hopeful that the Board will consider their request for higher access favorably.

As staff underscore, the success of Pakistan's PRGF program hinges on a "clear and credible path towards a sustainable external debt position." Appendix IV demonstrates that, given Pakistan's high debt burden, achieving debt sustainability could only be possible if the country is granted substantial support from its creditors in form of significant reduction of the external debt stock in NPV terms. In the absence of such support, there is a high risk that the economy will remain trapped in a low-growth equilibrium with a rising incidence of unemployment and poverty (as resources for the latter are pre-empted by heavy debt service payments), and a debt overhang that will continue to cast a pall of uncertainty over the economy and discourage private investment. For these reasons, my authorities hope that the Board will strongly endorse their efforts to seek a substantial debt relief at the forthcoming meeting of the Paris Club on terms that are fully compatible with the ground realities that would have classified Pakistan for debt relief under the enhanced HIPC-Initiative rather than as an IDA-blend country. Only then can Pakistan reach a sustainable external debt position with sufficient fiscal room to break out of the present low equilibrium and reduce the level of poverty widely recognized as a breeding ground for the types of problems faced today by the world community.

Provided that such a debt relief is forthcoming, my authorities view the main risk to the program to emanate from the prolongation of the conflict in the region and an increase in the magnitude and intensity of associated deleterious effects, which would impact the economy in more serious ways than presently assumed. Should this risk materialize, they will consult promptly with the Fund.