State Bank of Pakistan (SBP) to alleviate recent pressures on the exchange rate, with the Pakistani rupee depreciating by 5.5 percent vis-à-vis the U.S. dollar from end-June through end-October. However, the Pakistani rupee reversed over half of its losses in November.

7. Standard & Poor's raised Pakistan's sovereign credit ratings to B+ for foreign currency instruments and BB for local currency instruments, on account of declining debt indicators and sustained economic progress. The authorities plan to issue an Islamic bond (*Sukuk*) in the international markets by the end of this year or early in 2005, to be followed by Islamic bonds for the domestic market.[1]

8. Monetary expansion remained strong so far in 2004/05, with preliminary data showing broad money growing by 19.5 percent in the 12 months through October. Credit to the private sector accelerated further, increasing by 34 percent in the 12 months through October. The SBP raised the six-month treasury bill cut-off rates by another 19 and 50 basis points in October and November, respectively. Although it may be too early for the increases in interest rates in the last few months to have an impact on monetary aggregates, in the staff's view the continued rapid private sector credit expansion, the further increase in core inflation, combined with the recent pressures on the exchange rate and associated loss in international reserves, underscore the need for the SBP to tighten its monetary policy more forcefully.

9. The Report on the Observance of Standards and Codes—Data Module, together with the authorities' response and the Detailed Assessments Using the Data Quality Assessment Framework, have been finalized and will be published on the Fund's website shortly.

[1] A *sukuk* is an asset-backed security that is in compliance with Islamic Sharia laws. *Sukuk* holders receive regular payments from the underlying assets.

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IMF Executive Board Concludes 2004 Article IV Consultation with Pakistan

On December 1, 2004 the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Pakistan.[1]

Background

Pakistan has successfully emerged from crisis. By 1998/99, foreign exchange reserves had virtually run out, public debt obligations were not being met, and economic growth had slowed to an average of below 3 percent in 1996/97–1998/99. In response, the government and the State Bank of Pakistan (SBP) implemented a strong macroeconomic stabilization program in the face of a severe drought and the adverse post-9/11 environment. These policies are now bearing fruit. Real GDP growth accelerated to 6½ percent in 2003/04 (July–June), driven by exports, investment, and consumption. Inflation has been contained to 4.6 percent in 2003/04, though, more recently, 12-month inflation has accelerated, reflecting supply side factors as well as easy monetary conditions. Foreign exchange reserves have reached 6.2 months of next year's imports of goods and nonfactor services.

Significant fiscal consolidation has been achieved largely by savings on interest payments and increases in revenues. The resulting fiscal space was used to reduce government debt while raising social- and poverty-related spending. In 2003/04, the

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. This PIN summarizes the views of the Executive Board as expressed during the December 1, 2004 Executive Board discussion based on the staff report.

budget overperformed, and the overall deficit (excluding grants) was limited to 2.4 percent of GDP. Strong revenue collection reflected the buoyant economy and administrative efficiency gains. Support to public enterprises, and particularly power utilities, was reduced, due to better financial performance by these entities.

The SBP has started to tighten monetary policy. Rapid growth of broad money in 2003/04 has been driven predominantly by private sector credit growth in an environment of low interest rates and ample liquidity. In response, the SBP has raised treasury bill cut-off rates in recent months. However, policymakers resisted market pressures to tighten more quickly in an effort to balance their inflation and growth objectives.

The external position remains comfortable. The current account registered a small surplus in 2003/04, despite high imports, reflecting strong domestic demand and rising international oil prices. The government and other entities prepaid some relatively expensive external debt, taking advantage of the favorable exchange rate and reserve inflows. SBP foreign exchange reserves increased to US$10.6 billion at end-June 2004. The real effective exchange rate appreciated somewhat since the beginning of 2004, given inflation differentials with Pakistan's trading partners and efforts by the SBP to smooth exchange rate volatility.

There is no clear evidence yet on poverty trends due to a lack of comparable current data. Encouragingly, per capita GDP has grown significantly. However, real wages in the manufacturing sector have declined by 7½ percent in real terms since 2000/01. Real per capita health expenditure grew on average by 5 percent, and real per capita education expenditure by 10 percent since 1999/00, albeit from low levels. This should at a minimum establish the preconditions for sustained poverty reduction in the future. Pakistan is still ranked low in the 2004 UNDP human development index.

Structural reforms aimed at establishing a modern economy were successful in many areas. The banking sector is more competitive and efficient following restructuring and privatization, as well as the strengthening of supervision and prudential regulations. The revenue system has benefited from administrative reforms, elimination of exemptions, as well as reductions and rationalizations of customs tariffs and tax rates. Pakistan has liberalized its trade regime substantially in recent years, reducing tariffs and removing nontariff barriers, and now has one of the most liberal trade regimes in South Asia. Reforms in the power sector are advancing with the unbundling of the Water and Power Development Authority into generation, transmission, and regional distribution companies.

The role of the state in the economy has diminished and governance has improved. Governance in fiscal and financial management has been strengthened, but weaknesses remain in the energy sector, tax and local administration, and the police. Regulatory agencies to protect the consumer and ensure stability have been established in many areas. However, government intervention continues to be evident in the wheat and cotton markets and in the pricing of petroleum products and electricity, which has undermined the budget.

Executive Board Assessment

Executive Directors noted that Pakistan has successfully recovered from the 1998/99 crisis. Growth has rebounded in 2003/04, and fiscal adjustment, supported by official inflows and debt relief, has led to a substantial improvement in public and external debt indicators. Reflecting strong export growth and remittances, the balance of payments has strengthened and international reserves now cover over five months of imports. Directors attributed Pakistan's recovery to the steadfast implementation of sound economic policies and broad-based structural reforms, while noting that external support has also played a part.

Directors observed that, notwithstanding these significant achievements, poverty remains widespread and social indicators are weak in Pakistan. Thus, they considered that the key policy challenges for the medium term are to maintain strong economic growth and to ensure that this is translated into a significant reduction in poverty. In this regard, Directors supported Pakistan's ambitious growth targets, but cautioned that these would be realized only if the reform agenda laid out in the Poverty Reduction Strategy Paper is fully implemented and external factors are favorable. In particular, Directors emphasized the need for deepening structural reforms to improve the investment climate and governance, including through continued privatization and trade liberalization. At the same time, they noted the importance of enhancing human capital and labor productivity through greater and more efficient spending on health and education. Directors also underscored that accelerating growth will require the continuation of sound macroeconomic policies. They encouraged the authorities to take advantage of the current favorable conditions in pursuing these challenges.

Directors viewed Pakistan's near-term economic outlook as positive. They thought that broad-based growth of over 6 percent could be maintained in 2004/05, and considered the projected shift in the external current account to a small deficit appropriate given Pakistan's development needs. They urged the authorities to resist any pressures for easing financial policies.

Directors commended the authorities on the progress made with fiscal consolidation. They noted, however, that Pakistan's debt burden is still relatively high. In this context, Directors viewed the fiscal policy stance in 2004/05 as appropriate, as it ensures both a further reduction in the public debt burden and an increase in social and development spending. The high oil prices represent an important risk to the budget, however, and Directors stressed that the rise in international oil prices should be passed on to domestic consumers to safeguard fiscal targets.

Directors agreed with the authorities' medium-term fiscal strategy. They welcomed the planned increase in social spending, which they considered a necessary condition to move toward the Millennium Development Goals. Directors emphasized that raising social spending while lowering the still high debt-to-GDP ratio is possible only if the targeted increase in the revenue ratio is realized. In this regard, Directors encouraged the authorities to pursue more ambitious revenue targets and to expand the tax base further into the services and agricultural sectors. Directors expressed concern about the new tax exemptions granted in the 2004/05 budget and urged the authorities to safeguard the integrity of the tax system, which has been strengthened over the last years through hard-earned reforms. Directors also noted that the fiscal strategy calls for subsidies to the energy sector to be reduced significantly. They regretted the recent delays in implementing energy sector reforms and urged the authorities to speed up the reform process, in close coordination with the World Bank.

Directors noted that the provincial and local governments will now have the main responsibility for the provision of social services. This step should, however, be followed up by administrative and financial devolution and also be supported by measures to enhance accountability, so as to enable the lower levels of government to carry out their increased responsibilities more effectively. In this context, and given the lack of recent poverty data, Directors welcomed the launching of recent household surveys that are expected to provide insights into poverty incidence and trends. They also welcomed the authorities' intention to deepen the poverty and social impact analysis of their policies. Directors considered Pakistan's prospects for achieving external debt sustainability to be good. Key indicators of external indebtedness are projected to decline significantly over the next several years. Nonetheless, given the still high external debt burden and the dependence on external nontax revenues and grants, it will be crucial to limit the budget balance, excluding grants, to about 3 percent of GDP over the medium term, as envisaged in the fiscal strategy.

Directors expressed concern about the increase in inflation over the past year. They welcomed the recent increase in interest rates, but urged the authorities to tighten monetary policy promptly and more forcefully to avoid inflationary expectations becoming entrenched. They recommended that monetary policy be focused primarily on maintaining low inflation. Directors noted that a further tightening of monetary policy will also alleviate recent pressures on the exchange rate. Directors considered the level of the real exchange rate to be broadly appropriate, but noted that external competitiveness needs to be monitored closely in view of the uncertainties facing Pakistan, particularly stemming from the removal of quotas on textile and clothes imports by industrial countries. Directors emphasized that competition-enhancing structural reforms are the most effective approach to maintaining Pakistan's competitiveness.

Directors were of the view that financial reforms have resulted in a more efficient and resilient financial system. However, they cautioned that banking supervision needs to be vigilant to ensure that rapid private sector credit growth does not weaken banks' balance sheets. Directors encouraged the authorities to continue their reform strategy and follow up on recommendations of the Financial System Stability Assessment, including strengthening the pension and insurance system. Moreover, Directors urged the authorities to divest remaining public ownership of commercial banks. Directors looked forward to the early passage of new anti-money laundering legislation in line with international standards.

Directors welcomed the authorities' efforts to improve the quality, timeliness, and reporting of data and Pakistan's participation in the General Data Dissemination System. They looked forward to further steps to address weaknesses that hamper the analysis of economic and social developments to further improve Pakistan's statistics, with a view to subscribing to the Special Data Dissemination Standard.

The Staff Report for the 2004 Article IV Consultation with Pakistan is also available.

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