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Pakistan: 2004 Article IV Consultation, Ninth Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility, and Request for Waiver of Performance Criteria—Staff Report; Staff Statement; Public Information Notice and Press Release on the Executive Board Discussion; and Statement by the Executive Director for Pakistan

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of a combined discussion of the 2004 Article IV consultation with Pakistan, ninth review under the three-year arrangement under the Poverty Reduction and Growth Facility, and request for waiver of performance criteria, the following documents have been released and are included in this package:

- the staff report for the 2004 Article IV consultation, ninth review under the three-year arrangement under the Poverty Reduction and Growth Facility, and request for waiver of performance criteria, prepared by a staff team of the IMF, following discussions that ended on September 7, 2004, 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 16, 2004. 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 November 30, 2004 updating information on recent economic developments.

- a Public Information Notice (PIN) and a Press Release summarizing the views of the Executive Board as expressed during its December 1, 2004 discussion of the staff report that concluded the Article IV consultation and completed the request and review.

- a statement by the Executive Director for Pakistan on December 1, 2004.

The documents listed below have been or will be separately released.

Letter of Intent sent to the IMF by the authorities of Pakistan*
Memorandum of Economic and Financial Policies by the authorities of Pakistan*
Report on the Observance of Standards and Codes—Fiscal Transparency Module—Update
Selected Issues Paper and Statistical Appendix
*May also be included in Staff Report

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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PAKISTAN

Staff Report for the 2004 Article IV Consultation, Ninth Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility, and Request for Waiver of Performance Criteria

Prepared by the Middle East and Central Asia and
Policy Development and Review Departments

(In consultation with other departments)

Approved by Saleh M. Nsouli and Michael T. Hadjimichael

November 16, 2004

- Discussions for the 2004 Article IV consultation and the ninth review under the Poverty Reduction and Growth Facility (PRGF) arrangement were held in Islamabad during August 30–September 7, 2004. The staff team consisted of Messrs. Zavadjil (head), van Rooden, Schimmelpfennig (all MCD), Baig (FAD), Finger (PDR), and Singh (ICM). Messrs. Khan (MCD) and Mirakhor (Executive Director) joined the mission during August 30–31. The mission was assisted by Mr. Lorie (Senior Resident Representative).
- The mission met with Prime Minister Aziz, State Bank of Pakistan (SBP) Governor Husain, Finance Advisor Shah, Finance Secretary Ahsan, and other government officials. The mission also met with representatives of commercial banks, private and public enterprises, labor unions, and nongovernment organizations.
- Pakistan's request for a three-year arrangement under the PRGF, with access of 100 percent of quota (SDR 1.03 billion), was approved by the Executive Board on December 6, 2001 (IMF Country Report No. 01/222). So far, Pakistan has drawn SDR 861 million under the current arrangement. As of September 30, 2004, total Fund credit and loans outstanding to Pakistan amounted to SDR 1.3 billion (126 percent of quota).
- The last Article IV consultation was discussed by the Executive Board on November 1, 2002 (IMF Country Report No. 02/246). At that time, Executive Directors noted the progress made in achieving macroeconomic stability, but urged the authorities to further improve public debt dynamics, address Pakistan's social gap, and deepen structural reforms. Pakistan's Poverty Reduction Strategy Paper (PRSP) was discussed by the Executive Board on March 8, 2004 (IMF Country Report No. 04/24 and 04/70). Directors noted that it represented an adequate framework for Pakistan's efforts toward sustainable growth and poverty reduction and provided a sound basis for Fund concessional assistance. The Executive Board completed the eighth program review on June 23, 2004 (IMF Country Report No. 04/211), when Directors commended the authorities for the country's impressive recovery from macroeconomic crisis, despite sometimes difficult domestic and external circumstances. They stressed that the country still faced major challenges to ensure that growth was maintained and translated into sustained poverty reduction.
- Pakistan has accepted the obligations of Article VIII. It maintains a restriction subject to Fund approval in the form of a 50 percent limit on advance payments for some imports.
- The principal authors of this report are Milan Zavadjil, Ron van Rooden, and Axel Schimmelpfennig, with contributions from Taimur Baig, Harald Finger, and Abhisek Banerjee.

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List of Acronyms

ABL	Allied Bank Limited
AML/CFT	Anti-Money Laundering/Combating Terrorist Financing
AsDB	Asian Development Bank
CBR	Central Board of Revenue
CWIQ	Core Welfare Indicators Questionnaire
DFID	U.K. Department for International Development
FBS	Federal Bureau of Statistics
FDI	Foreign direct investment
FIBR	Floating interbank market exchange rate
FRL	Fiscal Responsibility Law
FRP	Financial Recover Plan
FSSA	Financial System Stability Assessment
GDDS	General Data Dissemination System
GFS	Government Finance Statistics
GRA	General Resources Account
GSP	Generalized System of Preferences
HBL	Habib Bank Limited
IDBP	Industrial Development Bank of Pakistan
KESC	Karachi Electric Supply Corporation
LTU	Large taxpayer unit
MEFP	Memorandum of Economic and Financial Policies
MTU	Medium taxpayer unit
NAM	New Accounting Model
NEPRA	National Electric Power Regulatory Agency
NFC	National Finance Commission
NSS	National Saving Schemes
NWFP	North West Frontier Province
PCs	Performance criteria
PIA	Pakistan International Airlines
PIB	Pakistan Investment Bonds
PIFRA	Project for Improvement of Fiscal Reporting and Auditing
PIHS	Pakistan Integrated Household Survey
PPM	Post-Program Monitoring
PRGF	Poverty Reduction and Growth Facility
PRSP	Poverty Reduction Strategy Paper
SBP	State Bank of Pakistan
SDDS	Special Data Dissemination Standard
TB	Treasury bill
WAPDA	Water and Power Development Authority

Executive Summary

Pakistan has successfully recovered from the 1998/99 crisis. Growth has rebounded to 6½ percent. 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 turned around and international reserves now cover six months of imports. Still, poverty and unemployment remain high.

Implementation of the PRGF program remains broadly on track. All quantitative performance criteria (PCs) and indicative targets for end-June 2004 were met. Structural reforms continue to be advancing, although four structural PCs were breached. A temporary intensification of an existing and the imposition of a new exchange restriction, however, were quickly reversed, and new tax exemptions have been offset by other tax measures, while a missed PC in the energy sector has since been implemented.

The discussions focused on the key policy challenges of sustaining strong economic growth and reducing poverty. To help lift a significant share of the population out of poverty, the authorities are aiming to increase the pace of economic growth to 8 percent annually over the medium term. This is ambitious and will require a substantial increase in private and public investment. Improvements in the investment climate through structural reforms, including in the energy sector, are necessary to raise domestic investment and attract more foreign investment. Accelerating growth will also require the continuation of sound macroeconomic policies.

The government's medium-term fiscal strategy aims to balance the need for higher levels of social and investment spending with reducing the debt burden. The 2004/05 budget is consistent with this strategy and aims to limit the overall fiscal deficit (excluding grants) to 3.2 percent of GDP, helping to reduce the public debt ratio to 63 percent of GDP. Creating room for a further increase in health and education spending, as well as infrastructure investments, will depend on raising tax revenues and further reducing transfers to state-owned enterprises.

Inflation picked up in 2003/04 and the SBP has stepped up its efforts to tighten monetary policy. While inflation appears to have leveled off recently, the SBP should tighten monetary policy further to avoid that inflationary expectations become engrained. A tighter monetary stance would also alleviate pressures on the exchange rate and reduce the need for exchange market intervention.

Pakistan will not seek a successor arrangement once the current PRGF arrangement expires in December 2004. The authorities remain committed, however, to maintaining a close dialogue with Fund staff. The staff's position is that Post-Program Monitoring (PPM) is not warranted for Pakistan, even under the proposed framework for extending PPM to PRGF resources. The outstanding combined PRGF/GRA resources at end-2004 will be only 117 percent of quota, given the authorities' commitment not to draw the final PRGF tranche, while Pakistan's external position has strengthened considerably.

I. Introduction

1. **In the attached letter dated November 12, 2004 and the accompanying Memorandum of Economic and Financial Policies (MEFP), the government of Pakistan requests completion of the ninth and final review under the PRGF arrangement**. The authorities also request waivers for the nonobservance of four structural PCs. While the tenth disbursement is conditional upon completion of this review, the authorities state in the attached letter that they will not draw the final tranche.

2. **The political and security situations remain complex**. A new government was announced in August 2004. Prime Minister Aziz retained the finance portfolio, which bodes well for the continuation of reforms. Pakistan's National Assembly has approved a bill to allow President Musharraf to continue as both president and army chief, much to the ire of the opposition. Operations against militants in the border areas are ongoing and have prompted retaliation from affected groups, including an attempt on the prime minister. The dialogue with India is progressing, though differences over Kashmir remain.

II. Background

3. **As part of the Article IV consultations, the staff took a fresh look at developments and reforms since the 1998/99 crisis, and particularly performance under the 2000 Stand-By Arrangement and the subsequent PRGF arrangement**. By 1998/99, Pakistan had virtually run out of foreign exchange reserves and public debt obligations were not being met. Economic growth had slowed to an average of below 3 percent in 1996/97–1998/99. The Stand-By Arrangement focused therefore on restoring macroeconomic stability. The subsequent PRGF arrangement centered on further strengthening macroeconomic stability, raising growth, and reducing poverty.[1] The PRGF arrangement included wide-ranging structural reforms, focusing on revenue administration, expenditure management, and the energy and financial sectors. Unlike under previous programs, quantitative targets were mostly met or exceeded, and structural reforms measures were largely followed through, though in some cases with delays.

4. **The fiscal and monetary policy mix yielded quick macroeconomic stabilization** (Table 1, see also Box 1). Significant fiscal consolidation was achieved largely by savings on the interest bill and increases in nontax revenues. The resulting fiscal space was used to reduce government debt while raising social- and poverty-related spending. Monetary policy was tightened immediately after the crisis, and inflation was brought down successfully. Large remittances strengthened the Pakistani rupee and helped to achieve an unprecedented accumulation of foreign exchange reserves. This allowed the SBP to reduce interest rates,

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[1] This strategy is further elaborated in Pakistan's Poverty Reduction Strategy Paper (IMF Country Report No. 04/24).

Box 1. Pakistan's Macroeconomic Improvement—Windfall or Homemade?

Of great interest in both Pakistan and abroad has been the question of whether the stronger macroeconomic situation stems primarily from an improved external setting in the aftermath of the September 11, 2001 events, or because of domestic adjustment. Many, sometimes complex, external factors have affected Pakistan's economy. On the positive side, Pakistan has benefited from higher external grants and remittances, and increases in textile and clothing quota allowances. On the negative side, Pakistan has suffered from high petroleum prices, a prolonged drought (2000–02) and the perception of a worsened security situation. These factors are not easily quantified, but a decomposition of the fiscal and external accounts can shed some light on the contribution of external versus domestic factors.

Pakistan: External Performance, 1993/94–2003/04
(in millions of U.S. dollars)

	Average 1993/94–2000/01	Average 2001/02–2003/04
SBP reserves accumulation (+) increase	200	2,943
Balance of trade on goods and nonfactor services	-3,272	1,181
Of which: defense receipts	0	676
Other private flows 1/	2,908	3,670
Other official flows 2/	563	455
Official gross inflows	4,077	4,622
Official gross outflows (-)	3,679	3,997
Other net flows	165	-171

1/ Private net income, transfers and capital flows; and commercial bank reserve accumulation.
2/ Official income, transfers and capital flows; exceptional financing; and privatization receipts.

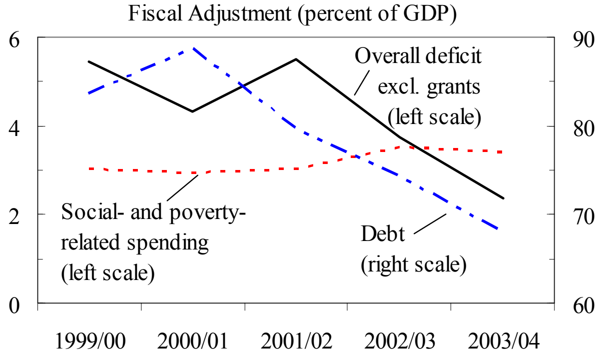
On the external side, domestic adjustment seems to have been the key to the macroeconomic improvement, although external factors played some role. The main element underscoring the increase in reserve accumulation was an improvement in the trade and nonfactor service accounts (see table). This was helped by higher defense receipts ($676 million) and increased access to foreign markets, but also by strong performance of Pakistan's export-oriented industries. Higher defense receipts reflected payments to cover costs in the war against terror. Moreover, strong reserve accumulation was helped by higher remittances. The latter may partly reflect the tighter scrutiny of financial holdings of Pakistanis living in some industrialized countries, providing an extra incentive to transfer funds to Pakistan. However, it also reflects efforts to bring informal remittances into the official net, and enhanced confidence in the Pakistani rupee and in Pakistan's financial system. By contrast, official flows have not contributed to Pakistan's reserve build-up, as higher gross inflows merely helped to meet the increase in Pakistan's external obligations. On the fiscal side, the improvement in the overall balance (including grants) was helped by significantly higher grants, but were facilitated also by improvements in nontax revenue (including defense receipts), along with substantial savings on domestic interest expenditure (see table). Lower domestic borrowing costs reflected improved macroeconomic policies and financial reforms.

Pakistan: Fiscal Performance, 1993/94–2003/04
(in percent of GDP)

	Average 1993/94–2000/01	Average 2001/02–2003/04
Tax revenue	11.2	11.2
Nontax revenue	2.5	3.4
Defense-related receipts	0.0	0.8
Grants	0.3	1.6
Expenditure	19.2	18.7
Current expenditure	16.1	15.5
Of which		
Interest payments	5.5	4.5
Domestic	4.4	3.5
Foreign	1.1	1.1
Defense	4.0	3.4
Development expenditure and net lending	3.1	3.2
Budget balance (including grants)	-5.3	-2.3

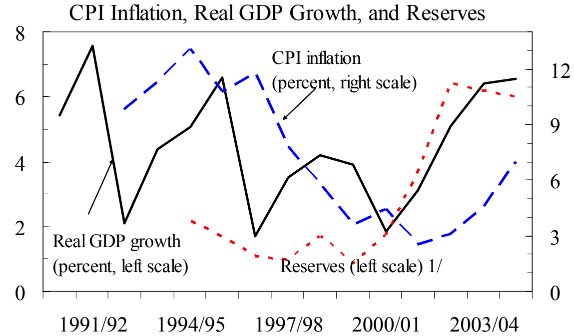
stimulating growth and benefiting the budget, though very recently inflation has increased modestly. Taken together, Pakistan successfully reduced external vulnerabilities, though debt remains high.

Fiscal Adjustment (percent of GDP)



Source: Pakistani authorities.

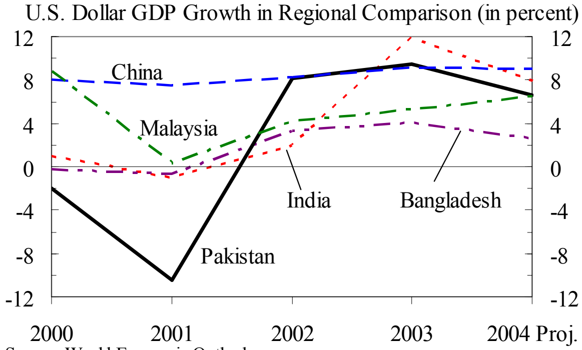
CPI Inflation, Real GDP Growth, and Reserves



Source: Pakistani authorities; and Fund staff estimates and projections.
1/ In months of next year's imports of goods and nonfactor services.

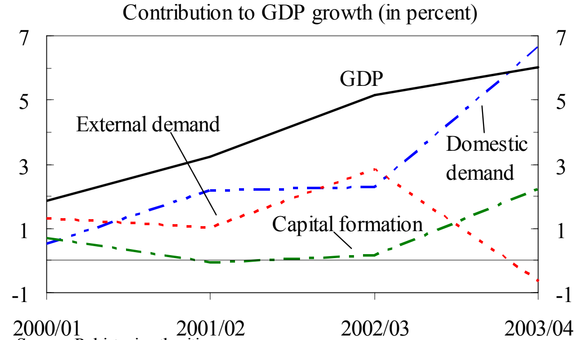
5. **Growth has recovered from crisis and adverse circumstances.** After emerging from the financial crisis, a severe drought, and the post-September 11 environment, Pakistan's growth performance compares well with regional peers. Initially, net external demand supported growth. However, in 2003/04, the contribution of net external demand turned negative and domestic demand has taken over as the engine of growth.

U.S. Dollar GDP Growth in Regional Comparison (in percent)



Source: World Economic Outlook.

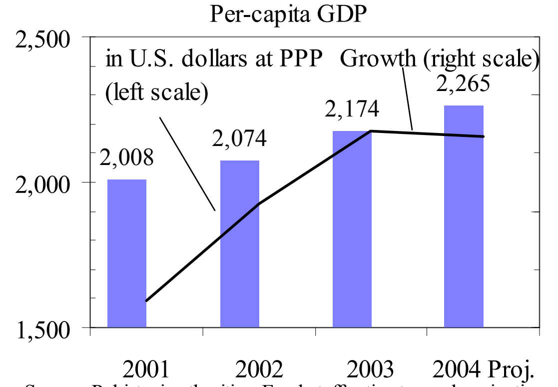
Contribution to GDP growth (in percent)



Source: Pakistani authorities.

6. **There is no clear evidence yet on poverty trends, reflecting a lack of comparable current data** (see Box 2). Encouragingly, per capita GDP has grown significantly. Social- and poverty-related expenditures have been raised to 4.7 percent of GDP in 2003/04, from 3.8 percent of GDP in 2001/02. However, many intermediate outcome indicators for the health and education sectors have yet to show significant improvements (Table 2). This may partly reflect the still

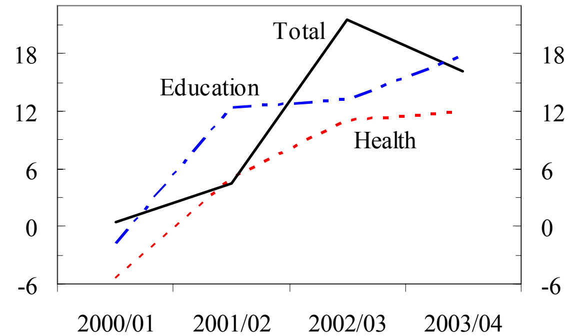
Per-capita GDP



Source: Pakistani authorities; Fund staff estimates and projections.

limited administrative and institutional capacity at the local government level that continues to be a constraint to rapid progress in poverty reduction. Meanwhile, real wages in the manufacturing sector have declined by 7½ percent in real terms since 2000/01. Pakistan is still ranked low in the 2004 UNDP human development index. Overall, poverty remains widespread and Pakistan faces a major challenge in trying to meet its Millennium Development Goals (Table 3).

Social Spending (real per-capita growth in percent)



Source: Pakistani authorities; Fund staff calculations.

Box 2. Poverty Trends

A government survey conducted in early 2004 suggests that poverty has fallen over the last three years. The survey showed a decline by 4 percentage points in the poverty rate, to 23 percent. However, the results of this survey are not fully comparable with those from earlier household surveys, as its sample size was much smaller and the poverty line may have been underestimated. But even taking this into account, the recent survey does seem to indicate a positive trend. Other, more comprehensive surveys have been launched recently (MEFP, paragraph 25), but their results will only become available in the second half of 2005. A firm assessment of poverty trends cannot be made until the results of these surveys are known. Reports from nongovernmental organizations and labor unions meanwhile claim that the poor have yet to benefit from the recovery and that inequality has been rising in recent years.

7. **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.[2] Foreign exchange transactions have been further liberalized, including through allowing banks to purchase foreign exchange from money changers. Finally, Pakistan has liberalized its trade regime substantially in recent years, reducing tariffs and removing most nontariff barriers.

8. **Fiscal reforms also made progress**. The revenue system has been strengthened through administrative reforms, the introduction of universal self-assessment, as well as reductions and rationalizations of customs tariffs and tax rates. However, despite these reforms, revenue collection has strengthened only modestly in recent years, and Pakistan's revenue-to-GDP ratio remains low in international comparison.[3] Improvements have been

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[2] See also the Financial Sector Stability Assessment (IMF Country Report No. 04/215).

[3] See the accompanying Selected Issues paper (refer to www.imf.org) for an analysis of Pakistan's tax collection in international comparison. The paper also examines the impact of recent tax measures and makes recommendations for strengthening the revenue intake.

made in expenditure releases and fiscal reporting, but systems still have to catch up with the devolution process. In a few areas, the legislative agenda still has to be completed, including the implementation of the fiscal responsibility, *benami,*[4] and anti-money laundering laws.

9. **The role of the state in the economy has diminished and governance 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, while the Water and Power Development Authority (WAPDA) has been split into smaller companies to improve governance and facilitate privatization. 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. Political devolution has laid the groundwork for improving social service delivery, but full administrative and financial empowerment of local governments is still lacking.

III. Recent Performance Under the PRGF Arrangement

10. **The PRGF program is broadly on track**. All quantitative PCs and indicative targets for end-June 2004 have been met (see MEFP, Table 1a). Moreover, all but four structural PCs have been met (see MEFP, Table 2, and Box 3).

Box 3. Structural Conditionality

1. **Coverage of structural conditionality for the last review under the PRGF program**

The focus of structural conditionality for the last review has been on broadening the tax base, strengthening tax and customs administration, and advancing electricity sector reforms (MEFP, Table 2). The large number of energy sector measures reflects the importance of this sector for the achievement of macroeconomic objectives, notably fiscal consolidation, as well as frequent delays in implementing reforms in this sector.

2. **Status of structural conditionality from earlier reviews**

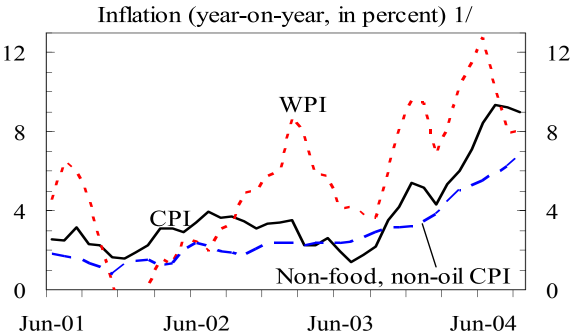
Despite some delays, all of the structural conditionality has been largely met. Some tax exemptions that should have expired were extended, while some new exemptions were introduced. The impact on the budget, however, has been negligible.

3. **Structural areas and conditionality covered by World Bank lending**

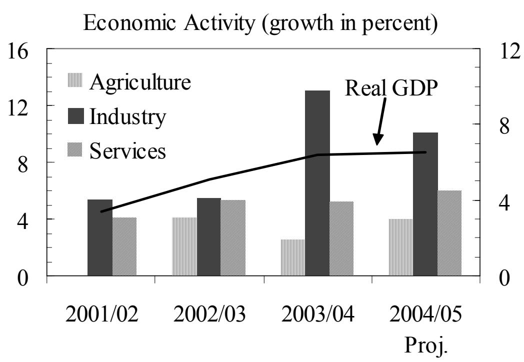
The World Bank approved in September the first of three Poverty Reduction Support Credits. Conditionality aims predominantly at (a) maintaining macroeconomic stability; (b) accelerating power and gas sector reforms; (c) increasing fiscal space for health and education expenditures; and (d) improving governance through (i) reforms in financial management, procurement, and other anti-corruption and accountability institutions; (ii) civil service reform; and (iii) devolution, through the transfer of increased resources to lower levels of government.

[4] Under the *benami* practice an asset is held in the name of one person for the benefit of another.

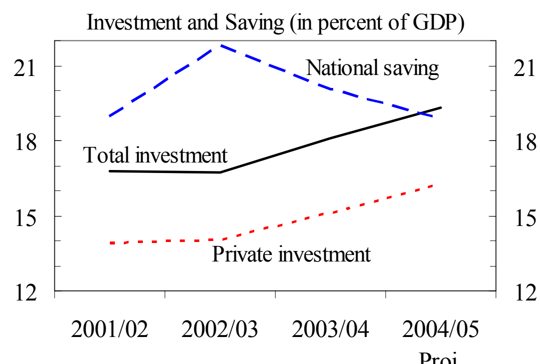
11. **Macroeconomic performance is strong, but inflation is edging up**. Real GDP growth accelerated to 6½ percent in 2003/04 (July–June), driven by large-scale manufacturing (see also Box 4 on recent revisions to the national accounts). On the demand side, there was an encouraging pickup in private and public investment, as well as consumption—in particular consumer durables. Inflation accelerated throughout 2003/04, reflecting pressures emanating from the partial liberalization of the wheat market, rising oil prices, as well as domestic demand supported by easy monetary conditions. Twelve-month consumer price inflation reached 9 percent in September 2004, with nonfood, nonenergy (core) inflation at 6.8 percent.



Source: Pakistani authorities.
1/ Last observation refers to September 2004.

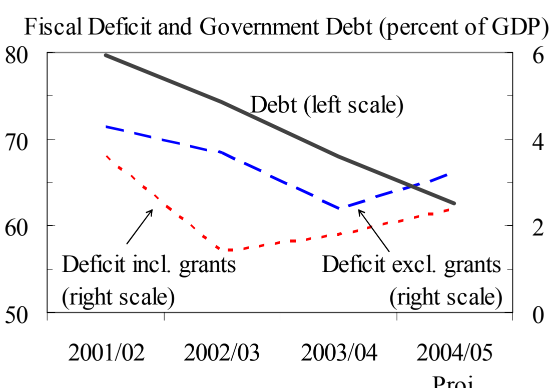


Source: Pakistani authorities; Fund staff estimates and projections.



Source: Pakistani authorities; Fund staff estimates and projections.

12. **The budget overperformed in 2003/04**. Strong Central Board of Revenue (CBR) collection and possible underspending at the provincial level contributed to an overall deficit (excluding grants) of 2.4 percent of GDP, some 0.8 percent of GDP better than programmed (Tables 4 and 5).[5] CBR collection reflected the buoyant economy and administrative efficiency gains, which offset some revenue-reducing measures in the 2003/04 budget. Encouragingly, the target for social spending was met (Table 6). Support to public enterprises, and particularly power utilities, was reduced, reflecting better financial performance by these entities.



Source: Pakistani authorities; Fund staff estimates and projections.

[5] Analysis of expenditure trends is complicated by the large statistical discrepancy at the provincial level, which suggests underspending.

Box 4. Rebasing of National Accounts Statistics

In the spring of 2004, the Federal Bureau of Statistics completed a revision of Pakistan's national accounts statistics. The objective was to bring Pakistan's national accounts closer in line with the 1993 UN System of National Accounts. As part of the exercise, the base year was moved from 1980/81 to 1999/2000. The new statistics capture better the changes that have occurred in the Pakistani economy in the past 20 years, as several areas of economic activity had been either seriously underestimated or not captured at all.

The rebasing exercise resulted in GDP estimates for 1999/2000 and following years that were almost 20 percent higher compared to the old base estimates. This, however, leaves the fundamental policy assessment largely unchanged. Per capita income, while improved, remains low. The debt-to-GDP ratio is lower, but is still relatively high. Revenue collection and social spending now appear even lower in the relation to the new GDP, underscoring the need for continued policy efforts.

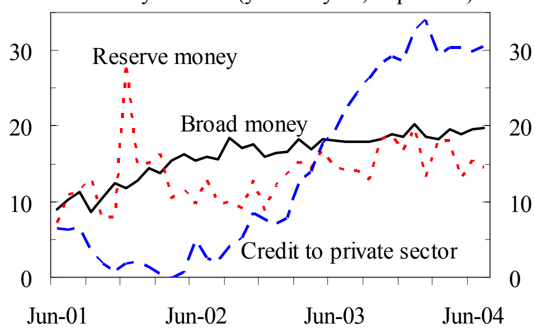
Pakistan: Effects of the Rebasing of National Accounts

	2002/03		2003/04		2004/05	
	Old	New	Old	New	Old	New
	(In percent of GDP; unless indicated otherwise)					
Public finances						
Revenue (including grants)	20.8	17.3	18.5	15.1	18.3	14.7
Expenditure	22.4	18.7	20.7	16.9	21.2	17.0
Budget balance (including grants)	-1.7	-1.4	-2.2	-1.8	-2.9	-2.3
Budget balance (excluding grants)	-4.5	-3.7	-2.9	-2.4	-4.0	-3.2
Total government debt	89.2	74.3	84.2	68.7	79.1	63.6
External sector						
Current account (including official transfers)	6.1	5.1	2.4	2.0	-0.9	-0.7
Current account (excluding official transfers)	4.6	3.8	1.7	1.4	-1.3	-1.1
GDP at market prices (billions of Pakistani rupees)	4,018	4,821	4,455	5,458	4,960	6,164
GDP at market prices (billions of US$)	68.8	82.6	77.5	94.9	84.1	104.5
Per capita GDP (in US$)	471	566	521	638	555	690

Sources: Pakistani authorities; and Fund staff estimates.

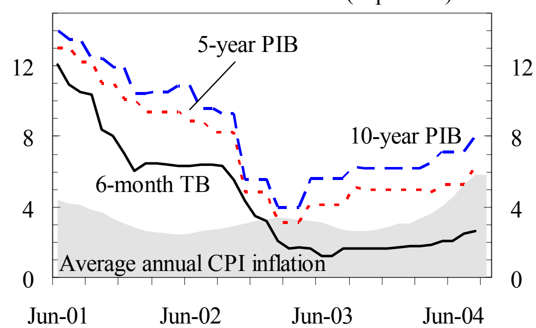
13. **The SBP has started to tighten monetary policy**. Rapid growth of broad money has been driven predominantly by strong private sector credit growth, fueled by low interest rates and ample bank liquidity (Tables 7 and 8). The SBP has raised treasury bill (TB) cut-off rates in recent months; the six-month TB rate was increased by around 100 basis points between January and August 2004, and by another 39 basis points in September 2004. Policy makers resisted market pressures to tighten more quickly in an effort to balance inflation and growth objectives. Real interest rates for maturities up to three years remain negative.

Monetary Growth (year-on-year, in percent)



Source: Pakistani authorities.

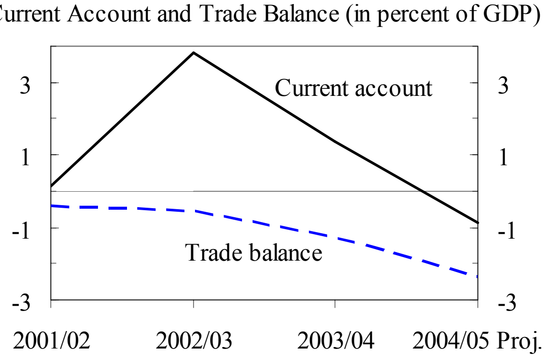
Interest Rates and Inflation (in percent)



Source: Pakistani authorities.

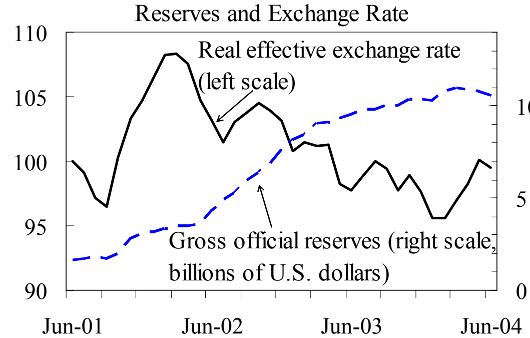
14. **The accumulation of foreign exchange reserves in 2003/04 was lower than programmed** (Table 9). Despite higher-than-projected private transfers, the current account surplus was smaller than targeted. This reflected high imports during the second half of the fiscal year on account of rising oil prices and strong domestic demand. The capital account was also weaker than expected, because of shortfalls in project lending and prepayment of relatively expensive external debts. Still, SBP foreign exchange reserves increased to $10.6 billion at end-June 2004 (six months of next year's imports of goods and nonfactor services), despite sales by the SBP in the fourth quarter to slow the depreciation of the Pakistani rupee. These pressures continued in the first quarter of 2004/05. Given the inflation differential to Pakistan's trading partners, this led to an appreciation of the real effective exchange rate, partly reversing the sustained depreciation that took place since 2002. In November 2004, the SBP imposed a new and intensified an existing exchange restriction on advance payments of imports (first missed structural PC, MEFP, paragraph 21), but shortly thereafter reversed the measure.

Current Account and Trade Balance (in percent of GDP)



Source: Pakistani authorities; Fund staff estimates and projections.

Reserves and Exchange Rate



Source: Pakistani authorities; and Fund staff calculations.

15. **Revenue administration and fiscal reporting have been strengthened, but new tax exemptions have been introduced**. Additional medium- and large-taxpayer units, as well as a pilot customs office, have been opened, organized along functional lines and stressing taxpayer facilitation. The 2004/05 federal budget was prepared according to a new chart of accounts that is largely Government Finance Statistics compatible. Five minor tax exemptions were introduced or extended (second missed structural PC, see MEFP, paragraph 10) in the 2004/05 budget, but it also included offsetting measures, for example the introduction of a capital value tax on stock transactions and of duties on IT equipment and oil exploration. Overall, revenue projections have been revised up.

16. **Reforms in the power sector are advancing, though measures were again delayed**. The financial performance of the two power utilities in 2003/04 was better than projected, largely because of a weather-related better fuel mix (Tables 10 and 11). A restructuring of the power sector has now been completed with the unbundling of WAPDA into generation, transmission, and regional distribution companies. However, preparation of financial recovery plans for WAPDA's successor companies has been delayed because the regulator has yet to determine tariffs in line with the cost recovery principle (third missed structural PC, see MEFP, paragraph 13). Implementing the determination would have implied much higher than budgeted subsidies to the utilities, which would have put the fiscal targets at risk. The government announced an energy tariff subsidy policy in early November after some delay (fourth missed structural PC).

IV. Report on the Discussions

17. **In the Article IV discussions, the staff underscored three core themes that had emerged from the experience under the Stand-By Arrangement and the PRGF program**:

- **High growth and rising social- and poverty-related expenditures by themselves do not guarantee rapid poverty reduction**. Poverty remains widespread and intermediate outcome indicators do not (yet) show significant improvements. Analysis of poverty trends is made difficult by the lack of reliable data.
- **Pakistan made major gains in macroeconomic stabilization, but these trends can easily reverse**. While inflation is still relatively low, it has picked up quickly in the last year, and there has been pressure on international reserves.
- **Structural reforms were pursued forcefully in many areas**. But energy pricing and expansion of the tax net have proved politically difficult. It will take a strong sustained effort to enhance the capacity of local governments to improve social services delivery.

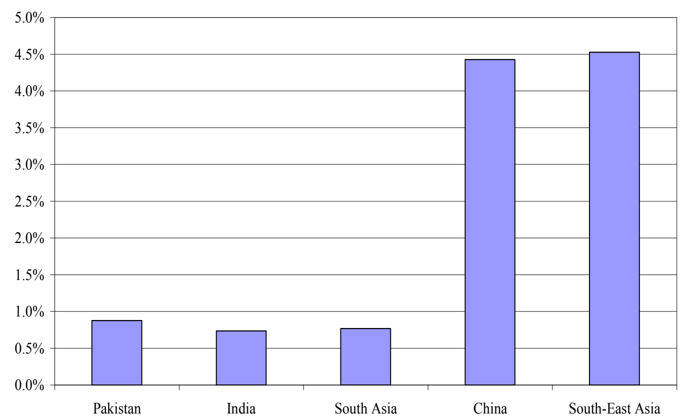
18. **With these themes in mind, the discussions focused on how to maintain and possibly accelerate economic growth, while ensuring that this translates into a lasting reduction in poverty**. Also central to the discussions was the need to maintain macroeconomic stability and further reduce external vulnerabilities.

A. Macroeconomic Prospects and Vulnerabilities

19. **The Pakistani authorities aim to further accelerate the rate of economic growth to 8 percent annually by 2007/08** (MEFP, paragraph 15). This is ambitious, but appropriate in light of the strong current performance and the experience in Pakistan that only growth of over 6 percent reduces poverty significantly.[6] The authorities recognize that higher growth will require first and foremost the continuation of sound economic policies and market-oriented structural reforms, as envisaged in the PRSP.

20. **Achieving such high rates of growth will require a substantial increase in private and public investment, and a major improvement in factor productivity**. Higher investment in turn will require increased saving, both domestic and foreign. Given the need to further reduce Pakistan's debt burden and with the current account moving into a deficit, higher foreign saving should ideally come through foreign direct investment (FDI). However, international investors often have a perception of poor security in Pakistan, and this may affect FDI flows. Domestic investors have learned to adapt to the security situation, and if they can obtain sufficient access to domestic and foreign saving—facilitated by a stronger banking system—they could generate the investment levels needed to realize the authorities' growth objectives. Meanwhile, increased investment in human capital is also needed, as government spending on health and education, both as a ratio to GDP and per capita, in Pakistan is among the lowest levels in the world.[7]

FDI Flows
(In percent of GDP, annual averages 1994-2003)



21. **Higher rates of growth and less poverty will be difficult to achieve without a sizable improvement in productivity in agriculture**. Agriculture still accounts for almost one quarter of Pakistan's economy and poverty incidence is much higher in rural areas. In the coming years, major investments are planned to improve the availability of water, which could remove a key constraint to agricultural growth.

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[6] See Pakistan's Poverty Reduction Strategy Paper (IMF Country Report No. 04/24).

[7] A cross-country analysis exploring differences in growth rates among low and middle income countries finds that weak human capital indicators are an important constraint to growth in Pakistan (see the accompanying Selected Issues paper (refer to www.imf.org)).

22. **Even with somewhat lower-than-targeted rates of growth, progress toward achieving public debt sustainability should be possible**. Historically, Pakistan has experienced average growth rates of almost 5 percent annually. With an average annual growth rate of 6 percent in the coming years (the baseline scenario in Annex I), and maintaining a budget deficit (excluding grants) of about 3 percent of GDP, Pakistan's debt indicators would improve substantially in the future.

23. **Although several risks remain, Pakistan is now much better placed to cope with potential shocks than at any time in the past decade**. The main risks include domestic or regional instability, adverse weather conditions, and a weaker-than-envisaged external environment, including possibly because of the end of the textile quota system. The continuation of sizable grants and nontax revenues is not assured. Also, strong macroeconomic outcomes have led to domestic political pressures for more accommodating policies. Stress tests, however, indicate that even under considerably worse scenarios, Pakistan would still make progress toward further reducing the debt burden, albeit at a slower pace.

B. Fiscal Policy

24. **The government's medium-term fiscal strategy aims to balance the need for higher levels of social and investment spending with reducing the debt burden**. These twin goals imply increased efforts to raise revenues and social spending, while maintaining an overall deficit (excluding grants) of about 3 percent of GDP. With 6 percent economic growth, this would result in a decline in the public debt-to-GDP ratio to about 50 percent by 2008/09, consistent with the path set out in the PRSP and the draft Fiscal Responsibility Law, which is expected to be approved soon. CBR revenues are targeted to increase gradually by 1 percentage point of GDP over the next 4–5 years, owing mainly to administrative measures. This, combined with a reduction in transfers to state-owned enterprises, allows for further increases in social and development spending in the period up to 2008/09.

25. **The staff supports the authorities' medium-term fiscal strategy, although it could be more ambitious on tax revenues**. Higher revenue targets should be feasible in light of ongoing efforts to strengthen revenue administration and the potential to widen the tax net further (see below). This would give the government the option of increasing social spending beyond the level envisaged in the PRSP, provided the capacity of local governments can be strengthened to absorb the additional funds. Meanwhile, the authorities' strategy involves a substantial reduction in energy subsidies over the coming years, which will depend on allowing electricity tariffs to cover costs.

26. **The 2004/05 budget is consistent with the authorities' medium-term strategy and the prospects for meeting this year's fiscal targets are good** (MEFP, paragraphs 17–19). A 15 percent wage and pension increase and much lower-than-programmed petroleum levies, as oil price increases are not being passed on to consumers, resulted in a gap compared to the program, but this will be offset by higher-than-budgeted tax and nontax revenues. The main

downside risk to the budget comes from the possibility that international oil prices will be higher than assumed in the latest World Economic Outlook and that the power sector may require higher subsidies because of a lower-than-expected availability of hydro energy and higher oil prices. This would need to be offset elsewhere within the expenditure envelope, or by higher nontax revenues, which are still estimated conservatively. The staff urged the authorities to start passing on the higher oil prices to consumers promptly, as it is not certain when international oil prices will come down. The authorities are considering this issue and expect an adjustment to take place in the next few weeks.

C. Monetary and External Policies

27. **The SBP's monetary policy is geared to both control inflation and support growth**. In addition, exchange market intervention is targeted at maintaining competitiveness and limiting fluctuations of the exchange rate of the Pakistani rupee. During the past few years, ample slack in the economy combined with a strong demand for money permitted the SBP to keep interest rates low and support economic growth, while inflation remained very low. Inflation—including core inflation—started to pick up, however, in the second half of 2003, signaling that monetary conditions had gradually become too loose (MEFP, paragraph 6).

28. **The SBP has stepped up its efforts to stem inflation**. The SBP started to raise interest rates in October 2003, but it initially did so in very small steps, in order not to choke off the economic recovery. The SBP felt that inflation was largely the result of supply-side factors and not easy monetary conditions, so that a tightening would not be effective.[8] However, as inflation continued to trend upwards, the SBP started to tighten monetary policy more forcefully in September 2004 (MEFP, paragraph 21). With this, the SBP aims to reduce 12-month inflation to below 5 percent by June 2005, implying an annual average rate of inflation of about 7 percent for 2004/05.

29. **The staff welcomes the SBP's more aggressive monetary stance**. While annual average inflation is still in single digits, the staff believes that the increase in inflation could fuel inflation expectations. If left unchecked, a harsher tightening will be required later on, with more adverse effects on growth. While inflation appears to have leveled off in the last three months, the staff urges the SBP to tighten monetary policy more forcefully. More generally, the staff recommends the SBP to focus monetary policy primarily on curbing inflation, as it is currently pursuing too many objectives.

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[8] While modeling inflation is difficult in Pakistan, an empirical study in the accompanying Selected Issues paper (refer to www.imf.org) suggests that rapid private sector credit growth is associated with higher inflation.

30. **A tighter monetary stance should also alleviate pressures on the exchange rate and reduce the need for exchange market intervention**. The SBP has allowed some greater nominal exchange rate flexibility in recent years, while trying to limit volatility in the market. It has also monitored closely Pakistan's real effective exchange rate with a view to maintaining competitiveness. This approach has contributed to the recovery of confidence in the Pakistani rupee, export-led growth, and strong foreign exchange reserves. The staff noted that if substantial pressures were to arise in the foreign exchange market, additional exchange rate flexibility could relieve pressures on monetary policy.

31. **The current level of the real exchange rate is appropriate**. Assuming a broadly unchanged real exchange rate, progress will continue to be made toward achieving external sustainability. The staff projects that exports and imports will continue to grow strongly, with the current account shifting into a small deficit. Exports will benefit from the expanding world economy and possibly from the end of the textile quota system, while imports will increase due to strong domestic demand. External competitiveness will need to be monitored closely, though, in view of the uncertainties related to the removal of the textile quotas. The SBP is projected to accumulate reserves for 2004/05 as a whole, but at a slower pace than in the past few years. The program remains fully financed (Table 12).

32. **The government has pursued an active public debt management policy**. The objectives have been to reduce the debt-to-GDP ratio and the share of interest payments in government expenditures, while also reducing external vulnerability and, more recently, re-establishing a presence in international capital markets. A tighter fiscal policy and debt relief have been key to achieving these goals, but early repayment of relatively expensive foreign debts, swapping fixed-interest obligations for floating ones, and an increased reliance on short-term TBs have helped to reduce the interest cost. This has, however, resulted in additional interest rate risk. The staff acknowledged that Pakistan will rely increasingly on international capital markets and therefore needs to keep a presence in these markets. The staff observed that local debt markets currently provide a cheaper funding source compared to prevailing Eurobond yields and urges that the overall borrowing strategy also strive to limit interest and exchange rate risks, and that the further issuance of Eurobonds (and Islamic bonds) be considered carefully.[9] The staff urges the authorities to finalize the remaining rescheduling agreements with Paris Club and non-Paris Club bilateral creditors, consistent with the December 2001 Paris Club agreement.

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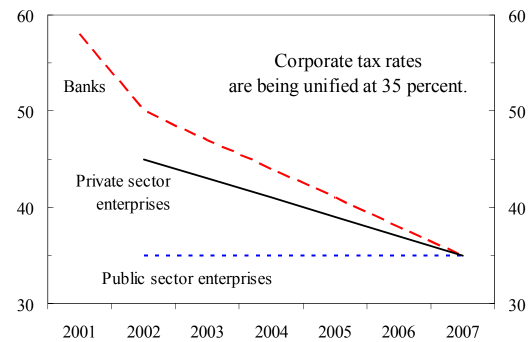
[9] A more elaborate description of Pakistan's external and domestic borrowing strategy can be found in the accompanying Selected Issues paper (refer to www.imf.org).

D. Structural Policies

Fiscal reforms

33. **Raising the share of tax revenues to GDP will be critical to realizing the fiscal strategy** (Table 13). By making the tax regime more taxpayer-friendly and improving governance in this area, the authorities hope to further stimulate growth and thus raise additional revenues. While the staff supports measures such as the stepwise reduction in corporate income tax rates to align all top income tax rates at 35 percent, it is important to maintain the integrity of the tax system and to avoid providing ad hoc tax benefits to individual sectors or enterprises. Rather, tax policy should aim at further broadening the tax base by expanding taxation more into the agricultural and service sectors and by reducing remaining exemptions.

Corporate Tax Rates



Source: Pakistani authorities.

34. **Revenue collection will continue to be strengthened through the CBR reform project**. Efforts are directed at bringing more taxpayers under the tax net and improving compliance of existing taxpayers. Key elements are the shift to a functional organization that relies on self-assessment and risk-based auditing, to minimize and streamline interaction between taxpayers and officials, and thus to reduce corruption.

35. **Devolution is a key element of the fiscal strategy**. As part of the devolution process, the main responsibility for the provision of key social services, including health care, education, and water supply and sanitation, now rests with provincial and local governments. For service delivery to improve, political devolution now needs to be followed up by administrative and financial devolution, to ensure that the provincial and local governments have the administrative and financial means to carry out their increased responsibilities. In this context, the staff hopes that an agreement can be reached soon on a new National Finance Commission award that would transfer a greater share of the divisible pool of taxes to provinces, with the expectation that the additional resources will be passed on to local governments through the Provincial Finance Commission mechanism. Local governments will also need to receive full authority over their civil servants from provincial governments. Measures are also being taken to strengthen fiscal reporting and eventually introduce a medium-term budget framework (MEFP, paragraph 24).

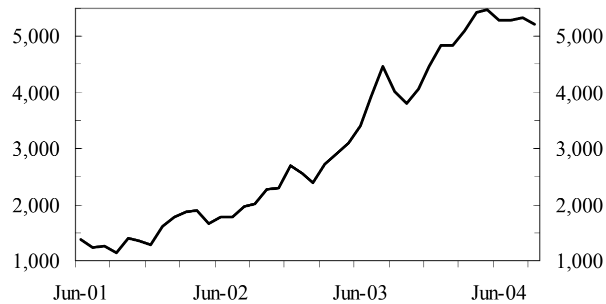
Financial reforms

36. **Financial sector reforms have resulted in a more efficient and resilient banking system that is better placed to channel domestic savings to their most productive use**. About 75 percent of the banking sector is now privately owned. The government still has the

majority share in the country's largest bank—the National Bank of Pakistan—and minority stakes in some smaller banks, which it may wish to divest. The recent Financial System Stability Assessment (FSSA) (IMF Country Report No. 04/215) found that financial soundness indicators have greatly improved in recent years (Table 14). It also found good compliance with international supervisory standards. The authorities agreed with the findings of the FSSA and its recommendations.

37. **A potential cause for concern is the rapid increase in private sector credit, with banks entering into new lending areas**. This could undermine loan quality. With interest rates expected to rise further, the staff urges the SBP to continue to monitor closely banks' financial health. In this regard, the staff welcomes the decision to double the minimum capital requirement to PRs 2 billion by end-2005, with an increase to PRs 1.5 billion by end-2004 as an intermediate step. The sharp rise in equity and housing prices is another indicator that the financial sector is heating up, though price-earnings ratios do not yet appear to be excessively high. With the phased introduction of margin financing over the next year, replacing *badla*[10] financing, the stock market should become less vulnerable to speculative exuberance. The reform process will now need to focus on nonbank financial services (insurance and pensions) to strengthen domestic savings. A draft anti-money laundering (AML) law will be submitted to parliament in the near term. The SBP, meanwhile, has strengthened its AML and Combating Terrorist Financing (CFT) regulations, tightening requirements for record keeping and reporting of suspicious transactions. The assessment of the AML/CFT framework by the Asia Pacific Group has been postponed until the new AML legislation has been passed.

Karachi Stock Exchange Index 1/



Source: Pakistani authorities.
1/ Last observation refers to September 2004.

Trade policy

38. **Pakistan continues to liberalize its trade regime, while working to reduce trade barriers with major partners**.[11] Currently, the maximum tariff rate is 25 percent and the number of slabs has been reduced to four (5, 10, 20, and 25 percent). With the 2004/05

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[10] *Badla* is a facility for financing share purchases extended by brokerages and banks that allows buyers to obtain highly leveraged positions in the market.

[11] Trade relations with India and the future South Asia Free Trade Area are discussed in more detail in the accompanying Selected Issues paper (refer to www.imf.org).

budget, selective tariffs on capital goods were lowered, and the average customs duty was reduced to 14.9 percent. In April 2004, a cooperation agreement between Pakistan and the European Union (EU) came into force, providing an overall framework for economic cooperation. Pakistan is to lose Generalized System of Preferences (GSP) status for clothing exports to the EU at the beginning of 2005. However, the EU has announced a general overhaul of its GSP policy for 2006 and there is a possibility that Pakistan could regain its status under the new policy. Following the Trade and Investment Agreement signed last year by the United States and Pakistan, bilateral trade talks are proceeding. Pakistan's long-term objective is to achieve a bilateral free trade area with the United States and to achieve GSP status in the short run.

39. **At the end of 2004, the global system of bilateral quotas in textiles will expire, leading to changes in global trade patterns**. Pakistan is vulnerable to such shifts because the share of clothes and textiles in total exports exceeds 70 percent. Nevertheless, based on a number of studies, Pakistan is in a group of countries that is expected to gain from the removal of quotas, though a short-term negative impact on prices could be experienced.[12]

Enterprise reforms and investment climate

40. **Following through on power sector reforms will be crucial to reduce the sector's drain on the budget**.[13] With the unbundling of WAPDA and the establishment of a regional tariff and subsidy policy, crucial steps have been taken to improve efficiency in the power sector. But the authorities will now need to complete power sector reforms, with the assistance of the World Bank, by strengthening governance and accountability—including through privatization—setting economically sound tariffs, and reducing costs—through a greater use of natural gas and reducing technical losses. Plans for the privatization of KESC, the Faisalabad Electric Supply Corporation, the Jamshoro generation company, and the Kot Addu Power Company are at an advanced stage (MEFP, paragraph 26).

41. **The authorities will continue to deregulate the economy so as to reduce the cost of doing business in Pakistan**. A recent World Bank analysis found that it is easier to enforce contracts or to start up a new business in Pakistan than elsewhere in the region—the time for a business start-up has been cut in half to 24 days in 2003—but that labor laws are more restrictive, making it more difficult to hire and fire staff than elsewhere in the region. The authorities are currently working on a major rationalization of industrial and commercial labor laws. Meanwhile, independent regulatory agencies have been established for the electricity and the oil and gas sector, while the government's deregulation policy for the

[12] Studies on the textile sector were prepared inter alia by the U.S. International Trade Commission (2004), the World Bank (2004), and the World Trade Organization (2004).

[13] Performance of two other state-owned enterprises, Pakistan International Airlines and Pakistan Steel Mills, has also improved, while less progress has been made in turning around Pakistan Railways. For details on these companies, see the accompanying Selected Issues paper (refer to www.imf.org).

telecommunications sector provides for an open licensing regime, both for fixed-line and cellular services. The authorities plan to divest remaining state assets through strategic sales and public offerings.

E. Statistical Issues

42. **The authorities are working on further improvements in Pakistan's statistics, with a view to subscribing to the Special Data Dissemination Standard**. The staff believes that data are broadly adequate for effective surveillance and program monitoring purposes (see Appendix III). The lack of recent poverty indicators, however, hampers the tailoring of expenditures to better achieve policy objectives. Improvements in some statistical practices and databases—particularly in the national accounts and government finance statistics, and to a lesser extent in monetary statistics—are being made. A Report on the Observance of Standards and Codes—Data Module, combined with a Detailed Assessments Using the Data Quality Assessment Framework, is expected to be finalized shortly, pending finalization of the authorities' response.

V. Fund Relations

43. **Pakistan will not seek a successor arrangement once the current PRGF arrangement expires in December 2004**. Instead, Pakistan will rely on domestic and international capital markets to meet its financing needs, complemented by continued support from the World Bank, the Asian Development Bank, and bilateral donors.

44. **The staff's position is that PPM would not be warranted for Pakistan, even under the proposed framework for extending PPM to PRGF resources,[14] because:**

- **The outstanding combined PRGF/GRA resources at end-2004 will be only modestly over 100 percent of quota**. This takes into account the authorities' commitment not to draw the final tranche under the PRGF arrangement, leaving projected outstanding resources at 117 percent of quota (Table 15).

- **Pakistan's external position has strengthened considerably and the external outlook is favorable** (Table 16). The public debt burden, though still high, has been significantly reduced, external reserves are at comfortable levels, and access to international capital markets has been regained. In the staff's opinion, PPM is not required for the purpose of safeguarding Fund resources. The authorities announced as early as June 2003 that the country would not seek another Fund arrangement and instead would move to a standard Article IV surveillance relationship.

[14] The Executive Board agreed on March 31, 2004 to extend PPM to include outstanding use of PRGF resources. A Board paper implementing this decision will be circulated to the Board shortly. The analysis in this staff report is in anticipation of the new policy.

- **The authorities remain committed to maintaining a close dialogue with Fund staff**. In addition to the annual Article IV consultation discussions, staff will field a visit to prepare an assessment of the economy to be presented at the Pakistan Development Forum, which will also be issued to the Executive Board. The added benefits of PPM in providing an update to the Executive Board in between Article IV consultations and in providing a signal to donors would be limited.

VI. Staff Appraisal

45. **Pakistan's economic performance and prospects are now more favorable than at any time in the past decade**. The economy has recovered strongly from the crisis of the late 1990s. Tighter macroeconomic policies and structural reforms have resulted in a stronger external position, a lower public debt burden, renewed access to international capital markets, and a revival in growth, albeit accompanied lately by some increase in inflation. External support has played a part in Pakistan's recovery, but the increase in national saving in response to effective and strongly owned government policies has been the key. The recovery has been remarkably resilient to regional and domestic political turmoil.

46. **Pakistan's strong recent macroeconomic performance should continue in the short term**. Broad-based growth of over 6 percent is likely to be maintained in 2004/05. The main risks relate to water availability, which could affect the agricultural and energy sectors. Because of strong domestic demand, the external current account is projected to shift to a small deficit in 2004/05 and foreign exchange reserves are not projected to increase significantly. Monetary policy should continue to be tightened, but more forcefully. The fiscal policy stance in 2004/05 is appropriate, ensuring both a reduction in the public debt burden and an increase in social and development spending, though high oil prices represent an important risk to the budget.

47. **While the immediate outlook is good, Pakistan faces major economic and social challenges in the medium term**. Poverty is relatively high and social indicators are weak, with little evidence of a strong improving trend recently. Per capita social spending is low and the public debt burden, though reduced, is high. The infrastructure is weak in many areas. There is still some way to go toward creating a modern institutional structure and improving governance.

48. **The government has targeted economic growth to continue accelerating and reach 8 percent per annum in 4–5 years**. This is an ambitious but appropriate target in light of the need to reduce poverty. The removal of quotas on textile and clothes imports by industrial countries and South Asian trade integration could both boost growth, if Pakistan continues to advance structural reforms. In particular, the increase in investment and productivity needed to achieve and sustain 8 percent growth will require a favorable external environment and a further improvement in the investment climate and governance, including through continuing privatization and trade liberalization. The development of infrastructure,

especially irrigation systems to accelerate productivity growth in agriculture, will also be important.

49. **While focusing on growth, macroeconomic stability should not be taken for granted**. There is some risk that fiscal and monetary policies could be relaxed to support growth, as is already the case with monetary policy to some extent. Strong popular pressures for lower energy prices and public sector wage increases are also evident. Against these pressures, the authorities need to protect the strong external position and macroeconomic stability, which are preconditions for strong growth.

50. **The staff supports Pakistan's medium-term fiscal strategy**. With a gradual increase in tax revenues, the government should be able to increase per capita social and development spending, while further reducing the debt burden in terms of GDP. To tackle poverty over the medium term, the government will need to provide for at least the increase in social spending envisaged in the PRSP, while strengthening local institutions. The fiscal strategy also involves a substantial reduction in energy subsidies, which should be possible with the completion of power sector reforms, assuming pressures to reduce tariffs are avoided. The targeted 1 percentage point of GDP increase in the revenue ratio between 2003/04 and 2007/08 should be seen as a minimum in view of the need to increase social and development spending. The fiscal reform strategy should be reinforced by the early approval of the fiscal responsibility law.

51. **Revenue mobilization needs to be strengthened**. Despite the recent reforms, the tax effort remains modest in Pakistan. The administrative reforms envisaged by the CBR, especially moving toward a functional organizational structure, should help to enhance tax efficiency, as well as improving the tax climate and governance. However, expanding taxation gradually into the agricultural and service sectors would bring greater yields, as would efforts to reduce evasion.

52. **Devolution of key social functions to local governments has major implications for fiscal management**. These reforms have the potential of substantially improving service delivery, but local governments need to receive full administrative authority. Expeditious agreement on a new National Finance Commission award could help to facilitate financial management at the regional and local level.

53. **Financial reforms have resulted in a more efficient and resilient financial system**. The authorities should continue their reform strategy and follow up on FSSA recommendations. In particular, strengthening of the pension and insurance systems should be pursued and the authorities should consider divestment of remaining public ownership of commercial banks. There is also a need to broaden access to financial services to underserved segments of the population. The SBP, which has made considerable strides in strengthening its supervision capacity, needs to ensure that rapid private credit growth does not weaken banks' balance sheets.

54. **Based on current policies, prospects for achieving external debt sustainability are good**. Key indicators of external indebtedness are projected to decline significantly in the next several years. Nevertheless, Pakistan remains vulnerable, with still a substantial external debt burden and some dependence on external nontax revenues and grants. This reinforces the need to implement the fiscal strategy effectively, while maintaining cautious monetary and flexible exchange rate policies. Accessing of international capital markets should be consistent with an overall borrowing strategy geared inter alia toward reducing interest and exchange rate vulnerabilities.

55. **The authorities' exchange rate policy has served the country well**. It has contributed to the recovery of confidence in the Pakistani rupee, strong export growth, and high foreign exchange reserves. The level of the real exchange rate is broadly appropriate, but external competitiveness needs to be monitored closely in view of the uncertainties facing Pakistan.

56. **Pakistan maintains an exchange restriction on payments for current international transactions that should be lifted**. Under this restriction, advance payments for certain imports are limited to 50 percent (see Appendix I). Staff only learned that this restriction is subject to Fund approval in the context of a temporary intensification (see below). Staff is discussing with the authorities options to remove this restriction which seems unnecessary in light of the strong external position, but is not proposing approval at this stage given that the authorities have not committed to a timetable for lifting the restriction.

57. **Pakistan is nearing the successful completion of its arrangement under the PRGF**. The program is broadly on track. All quantitative performance criteria for end-June 2004 were met. However, four structural performance criteria were breached. Nevertheless, after some delay, an electricity subsidy policy has been announced. Staff concurs with the government's decision not to notify the recent tariff determination which would have led to increased subsidies to the power utilities. However, the government needs to work closely with the regulator to ensure that a revised tariff determination based on the cost recovery principle is issued soon. In addition, while five new tax exemptions were granted, offsetting measures have been taken and the revenue target for 2004/05 (July–June) has been raised by 0.2 percent of GDP. Moreover, the exchange restrictions were reversed within a few days of implementation. In light of these corrective actions, the staff recommends approval of the requested waivers and the completion of the ninth review.

58. **In light of Pakistan's progress toward external viability, management recommends that Pakistan should not be subject to PPM**. Outstanding combined PRGF/GRA resources at end-December 2004 will not be substantially above 100 percent of quota given that Pakistan will not draw the final tranche under the PRGF arrangement. Moreover, the external position has strengthened considerably in recent years and the outlook is quite favorable, some recent pressures notwithstanding. Also, the authorities are committed to keeping a close dialogue with the Fund on developments and policies.

59. Pakistan's statistics are broadly adequate for surveillance and program monitoring purposes, but further improvements are needed in the monetary, fiscal, and especially the social areas.

60. It is proposed that the next Article IV consultation with Pakistan be held on the standard 12-month cycle.

Table 1. Pakistan: Selected Economic Indicators, 2000/01–2004/05

	2000/01	2001/02	2002/03	2003/04		2004/05	
				Prog. 1/	Prel. Est.	Prog. 1/	Proj.
	(Annual changes in percent)						
Output and prices							
Real GDP at factor costs	1.8	3.1	5.1	6.4	6.4	6.0	6.5
Partner country demand (WEO definition)	3.4	1.9	2.6	3.4	3.5	3.7	3.8
Consumer prices (period average)	4.4	2.5	3.1	4.1	4.6	5.0	7.0
Consumer prices (end-of-period)	2.5	3.4	1.9	...	8.5	...	4.4
Pakistani rupees per U.S. dollar (period average)	12.8	5.2	-4.7	...	-1.5	...	...
	(In percent of GDP)						
Savings and investment							
Gross national savings	15.6	19.0	21.8	...	20.1	...	19.2
Government	-1.3	0.2	0.8	...	0.9	...	0.7
Nongovernment 2/	16.9	18.8	21.0	...	19.2	...	18.5
Gross capital formation	17.2	16.8	16.7	...	18.1	...	19.9
Government 3/	2.2	2.9	2.7	...	2.9	...	3.0
Nongovernment 2/	15.0	13.9	14.1	...	15.1	...	16.8
	(In percent of GDP)						
Public finances							
Revenue (including grants)	14.3	16.1	17.4	14.9	15.1	13.9	14.7
Expenditure 4/ 5/	17.6	19.7	18.8	17.5	16.9	16.8	17.0
Budget balance (excluding grants)	-4.3	-5.5	-3.8	-3.2	-2.4	-3.2	-3.2
Budget balance (including grants)	-3.3	-3.6	-1.4	-2.7	-1.8	-2.8	-2.3
Primary balance (including grants)	2.3	2.0	3.0	1.0	1.8	0.6	1.1
Total government debt	88.8	80.2	74.3	68.7	68.7	63.3	63.6
Domestic government debt	43.3	40.4	39.3	36.5	36.8	34.9	33.8
	(Annual changes in percent of initial stock of broad money)						
Monetary sector 6/							
Net foreign assets	5.1	13.4	18.9	4.9	2.1	0.7	1.2
Net domestic assets	3.9	2.0	-0.4	12.6	17.5	12.1	12.1
Of which: credit to the private sector	3.5	2.5	9.1	11.2	14.3	7.9	8.4
Of which: net claims on the government	-3.3	1.5	-1.4	3.2	2.8	4.1	3.0
Broad money	9.0	15.4	18.3	17.5	19.6	12.8	13.3
Six-month treasury bill rate (period average, in percent)	10.4	8.1	4.1	...	1.7	...	...
	(In percent of GDP)						
External sector							
Merchandise trade balance	-1.8	-0.4	-0.5	-0.8	-1.3	-1.3	-2.8
Merchandise exports	12.5	12.7	13.2	12.8	13.1	12.6	13.1
Merchandise imports	14.3	13.1	13.7	13.6	14.3	13.8	15.9
Current account excluding official transfers	-2.7	0.1	3.8	1.7	1.4	-0.1	-1.1
Current account including official transfers	-1.6	2.2	5.1	2.3	2.0	0.4	-0.7

Table 1. Pakistan: Selected Economic Indicators, 2000/01–2004/05 (concluded)

	2000/01	2001/02	2002/03	2003/04		2004/05	
				Prog. 1/	Prel. Est.	Prog. 1/	Proj.
	(In percent of exports of goods and nonfactor services)						
External public and publicly guaranteed debt	309.4	295.8	238.0	225.3	218.2	217.8	209.8
Debt service 7/	27.8	33.8	26.3	27.1	29.8	24.5	20.1
Implicit interest rate (in percent) 8/	4.3	4.2	3.4	3.0	2.8	2.9	3.0
Gross reserves (in millions of U.S. dollars) 9/	1,679	4,330	9,521	11,657	10,556	11,745	10,789
In months of next year imports of goods and services	1.7	3.7	6.5	7.6	6.0	7.4	5.9
In percent of short-term external debt 10/	26.1	73.1	195.5	206.7	168.2	251.2	258.0
Memorandum items:							
Real effective exchange rate (period average, percentage change)	-2.5	-1.1	-1.5	...	-3.4	...	...
Terms of trade (percentage change)	-1.6	-0.5	-0.9	4.1	2.3	-0.6	-4.7
Real per-capita GDP (percentage change)	-0.2	1.2	3.1	4.4	4.0	3.9	4.6
GDP at market prices (in billions of Pakistani rupees)	4,163	4,402	4,821	...	5,458	...	6,164
GDP at market prices (in billions of US$)	71.5	71.9	82.6	...	94.9	...	...
Per capita GDP (in US$)	509	502	566	...	638	...	...
Population (millions)	140.4	143.2	146.0	...	148.7	...	...

Sources: Data provided by the Pakistani authorities; Fund staff; and World Economic Outlook.

1/ Program as updated during the eighth review (IMF Country Report No. 04/211). Program numbers where possible recalculated using the new, rebased GDP series.
2/ Includes public sector enterprises and changes in inventories.
3/ Expenditures included in the Public Sector Development Program.
4/ Including the statistical discrepancy.
5/ Including KESC recapitalization and CBR bonds in 2001/02.
6/ Program data for 2002/03 and 2003/04 are evaluated at program exchange rates.
7/ Including interest on short-term debt.
8/ Current-year interest payments devided by previous period debt stock.
9/ Excluding gold, foreign deposits held with the SBP, and net of outstanding short-term foreign currency swap and forward contracts.
10/ Short-term debt is defined on the basis of remaining maturity.

Table 2. Pakistan: Intermediate Outcome Indicators, 2000/01–2003/04

(In percent, unless otherwise indicated)

	2000/01	2001/02	2002/03	2003/04
Health sector				
Utilization rate of first level care facilities (average cases/day/facility)	34	113	115	110
Population covered by lady health workers 1/	30	41	44	50
Immunization coverage of children/pregnant mothers	76	80	69	65
Birth attended by skilled birth attendants	13	13	14	12
Number of skilled female birth attendants (in thousands)	96	96	96	n.a.
Percentage of first level care facilities not experiencing stock-outs of five key supplies	26	28	35	27
Share of first level care facilities meeting staffing norms	30	34	30	n.a.
Share of first level care facilities with four contraceptives available	68	83	85	68
Education sector				
Number of functioning schools (in thousands)	145	150	144	149
Primary	133	137	132	135
Middle	13	13	12	14
Share of functional schools with basic facilities				
Water	51	53	50	52
Primary	50	51	48	50
Middle	59	72	68	71
Electricity	21	22	21	30
Primary	19	19	18	27
Middle	44	53	59	58
Sanitary	37	37	48	49
Primary	36	36	46	47
Middle	46	46	67	70
Boundary wall	42	42	41	47
Primary	41	41	40	46
Middle	47	47	53	62
Share of trained teachers	98	98	98	98
Primary	98	98	98	98
Middle	99	99	99	99

Sources: Pakistani authorities; and Fund staff calculations.
PRSP Secretariat, *PRSP–Fourth Quarter Progress Report FY2003/04,* September 2004.

1/ Lady health workers are outreach workers providing preventive health and family planning services through house-to-house visits.

Table 3. Pakistan: Millennium Development Goals, 1990–2015 1/

	1990	1995	2000	2001	2002	PRSP targets 2005	2015
Goal 1. Eradicate extreme poverty and hunger							
Target 1. Halve, between 1990 and 2015, the proportion of people whose income is less than one dollar a day.							
1. Population below $1 a day (percent)	...	...	...	...	...	...	...
2. Poverty gap at $1 a day (percent)	...	...	...	...	...	...	...
3. Share of income or consumption held by poorest 20 percent (percent)	...	...	...	8.8	...	...	...
Target 2. Halve, between 1990 and 2015, the proportion of people suffering hunger.							
4. Prevalence of child malnutrition (percent of children under 5)	40.2	38.2	...	...	...	...	...
5. Population below minimum level of dietary energy consumption (percent)	25.0	...	...	19.0	...	...	...
Goal 2. Achieve universal primary education							
Target 3. Ensure that, by 2015, children will be able to complete a full course of primary schooling.							
6. Net primary enrollment ratio (percent of relevant age group)	...	...	...	66.2	...	...	...
7. Percentage of cohort reaching grade 5	...	...	...	...	...	...	...
8. Youth literacy rate (percent, ages 15–24)	47.4	53.0	...	57.8	58.7	60.0	86.0
Goal 3. Promote gender equality and empower women							
Target 4. Eliminate gender disparity in primary and secondary education preferably by 2005 and to all levels of education by 2015.							
9. Ratio of girls to boys in primary and secondary education (percent)	46.8	...	...	60.7	...	...	...
10. Ratio of young literate females to males (percent, ages 15–24)	49.0	53.8	...	60.0	...	65.0	93.0
11. Share of women employed by the nonagricultural sector	...	...	...	...	...	...	...
12. Proportion of seats held by women in the National Assembly	10.0	...	...	...	21.0	...	...
Goal 4. Reduce child mortality							
Target 5. Reduce by two-thirds, between 1990 and 2015, the under-five mortality rates.							
13. Under five-mortality rate (per 1,000)	128.0	118.0	...	109.0	107.0	65.0	52.0
14. Infant mortality rate (per 1,000 live births)	96.0	90.0	...	84.0	80.0	63.0	40.0
15. Immunization, measles (percent, children under 12 months)	50.0	53.0	...	54.0	...	...	...
Goal 5. Improve maternal health							
Target 6. Reduce by three-quarters, between 1990 and 2015, the maternal mortality ratio.							
16. Maternal mortality ratio (modeled estimate, per 100,000 live births)	...	200.0	...	...	...	...	...
17. Births attended by skilled health staff (percent of total)	18.8	18.0	...	20.0	...	...	...
Goal 6. Combat HIV/Aids, malaria, and other diseases							
Target 7. Halt by 2015, and begin to reverse, the spread of HIV/AIDS.							
18. HIV prevalence among females (percent, ages 15–24)	...	...	...	0.1	...	...	...
19. Contraceptive prevalence rate (percent of women, ages 15–49)	14.0	17.8	...	27.6	...	...	...
20. Number of children orphaned by HIV/AIDS	...	...	...	25,000	...	...	...
Target 8. Halt by 2015, and begin to reverse, the incidence of malaria and other diseases.							
21. Prevalence of death associated with malaria	...	...	...	...	...	...	...
22. Share of population in malaria risk areas using effective prevention and treatment	...	...	...	...	...	...	...
23. Incidence of tuberculosis (per 100,000 people) 2/	...	...	...	174.5	...	133.0	45.0
24. Tuberculosis cases detected under DOTS (percent)	...	1.0	...	3.0	...	...	...

Table 3. Pakistan: Millennium Development Goals, 1990–2015 (concluded)

						PRSP targets	
	1990	1995	2000	2001	2002	2005	2015
Goal 7. Ensure environmental sustainability							
Target 9. Integrate the principles of sustainable development into policies and programs. Reverse the loss of environmental resources.							
25. Forest area (percent of total land area)	3.6	...	...	3.2	...	...	...
26. Nationally protected areas (percent of total land area)	...	4.8	...	4.8	4.9	...	...
27. GDP per unit of energy use (PPP $ per kg oil equivalent)	3.4	3.8	...	4.1	...	...	...
28. CO2 emission (metric tons per capita)	0.6	0.7	...	0.7	...	...	...
Target 10. Halve by 2015 proportion of people without access to safe drinking water.							
29. Sustainable access to safe water (percent of population)	83.0	...	...	90.0	...	90.0	93.0
Target 11. Achieve by 2020 significant improvement for at least 100 million slum dwellers.							
30. Access to improved sanitation (percent of population)	36.0	...	...	62.0	...	...	...
31. Access to secure tenure (percent of population)	...	...	...		...	...	...
Goal 8. Develop a global partnership for development							
Target 16. Develop and implement strategies for productive work for youth.							
45. Unemployment rate of population ages 15–24 (total)	3.6	8.9	...	...	...	...	...
Target 17. Provide access to affordable essential drugs.							
46. Proportion of population with access to affordable essential drugs	...	...	...		...	...	...
Target 18. Make available new technologies, especially information and communications.							
47. Fixed line and mobile telephones (per 1,000 people)	7.5	16.9	...	28.9	...	...	...
48. Personal computers (per 1,000 people)	1.3	3.5	...	4.1	...	...	...

Source: World Development Indicators.

1/ Targets 12–15 and indicators 32–44 are excluded because they can not be measured on a country specific basis. These are related to official development assistance, market access, and the HIPC initiative.

Table 4. Pakistan: Consolidated Government Budget, 2000/01–2004/05

(In billions of Pakistani rupees)

	2000/01	2001/02	2002/03	2003/04		2004/05	
	FY	FY	FY	FY		FY	
	Prov. Act.	Prov. Act.	Prov. Act.	Prog. 1/	Prov. Act.	Prog 1/	Proj.
Revenue and grants	593.5	707.2	838.2	812.0	824.7	857.7	906.0
Revenue	553.0	624.1	719.3	780.3	794.1	833.5	851.2
Tax revenue	441.5	478.1	554.2	600.9	611.5	677.2	662.7
Federal	422.5	459.3	532.3	574.7	583.4	647.8	630.1
CBR revenue	392.1	403.9	460.0	510.1	521.9	576.0	590.0
Direct tax	124.6	142.6	152.0	161.1	164.5	180.0	185.1
Federal excise duty	49.0	46.9	44.0	43.8	45.8	45.5	46.5
Sales tax	153.5	166.3	195.1	218.1	220.6	248.6	252.9
Customs duties	65.0	48.1	68.8	87.1	90.9	102.0	105.5
Petroleum surcharge	17.9	36.6	46.9	46.1	44.6	49.0	18.0
Gas surcharge	12.3	17.7	21.3	16.0	16.8	17.8	17.8
Other	0.2	1.1	4.1	2.5	0.1	5.0	4.2
Provincial	19.0	18.8	21.9	26.2	28.1	29.4	32.6
Nontax revenue	111.4	146.0	165.1	179.4	182.7	156.3	188.6
Federal	91.5	124.7	139.7	152.2	160.6	126.7	149.6
Provincial	19.9	21.3	25.4	27.2	22.0	29.6	38.9
Grants	40.5	83.1	118.9	31.7	30.5	24.2	54.8
Expenditure	717.9	826.2	890.9	957.7	955.9	1,032.7	1,050.4
Current expenditure	645.7	700.2	802.4	793.6	774.9	844.6	866.0
Federal	479.0	524.6	608.0	589.2	556.5	614.6	623.3
Interest payments	234.5	245.3	207.2	202.5	196.3	210.8	214.0
Domestic	183.5	184.6	166.9	161.5	154.8	169.6	170.4
Foreign 2/	51.0	60.6	40.2	41.0	41.4	41.2	43.6
Defense	104.7	149.0	159.9	180.0	180.4	194.0	194.0
Running of the civil government	70.7	56.3	67.4	70.5	75.5	75.0	81.5
Pensions for defense and civil government	30.9	27.2	40.6	42.6	32.5	44.0	48.9
Subsidies 3/	19.9	23.7	51.5	62.5	37.0	59.5	53.0
Grants	18.1	22.8	23.5	29.2	34.3	29.2	29.5
Other	0.3	0.3	57.9	1.9	0.6	2.1	2.4
Provincial	166.7	175.6	194.4	204.4	218.4	230.0	242.7
Development expenditure and net lending	72.2	125.9	88.5	164.1	181.0	188.1	184.4
Public Sector Development Program	89.8	126.2	130.0	152.0	160.5	180.0	188.0
Federal	66.9	98.4	90.8	107.5	102.3	126.0	134.0
Provincial	22.9	27.8	39.2	44.5	58.2	54.0	54.0
Net lending	-17.6	-0.2	-41.5	12.1	20.4	8.1	-3.6
Statistical discrepancy ("+" = additional expenditure)	14.8	-11.7	13.0	...	-32.4	...	...
Federal government	29.8	15.3	5.8	...	9.3	...	...
Provinces	-15.0	-26.9	7.2	...	-41.6	...	...
Underlying budget balance (excluding grants)	-179.7	-190.5	-184.6	-177.4	-129.4	-199.2	-199.2
One-off expenditure items 4/	...	52.0	...	...	...	...	...
Budget balance (excluding grants)	-179.7	-242.5	-184.6	-177.4	-129.4	-199.2	-199.2
Budget balance (including grants)	-139.2	-159.3	-65.7	-145.7	-98.9	-175.0	-144.4
Financing	139.2	159.3	65.7	145.7	98.9	175.0	144.4
External	80.2	51.7	-23.8	-17.3	-37.1	-17.1	38.7
Of which: privatization receipts	...	...	7.6	0.0	0.0	0.0	0.0
Domestic	59.0	107.6	89.4	163.0	136.0	192.0	105.7
Bank	-33.0	14.3	-55.9	82.0	63.7	90.0	60.0
Nonbank	92.0	85.0	141.6	70.0	61.0	87.0	30.7
Privatization receipts	0.0	8.4	3.7	11.0	11.2	15.0	15.0
Memorandum items:							
Expenditure incl. statistical discrepancy and one-off	732.7	866.5	903.9	957.7	923.6	1,032.7	1,050.4
Primary balance (excluding grants and one-offs)	54.8	2.8	22.6	25.1	66.8	11.6	14.8
Primary balance (including grants and one-offs)	95.3	86.0	141.5	56.8	97.4	35.8	69.6
Social and poverty-related expenditure 5/	122.3	133.5	169.7	185.1	208.7	278.0	278.0
Total government debt	3,698	3,528	3,584	3,748	3,751	3,899	3,923
Domestic debt	1,802	1,777	1,896	1,991	2,009	2,153	2,084
External debt	1,896	1,751	1,687	1,757	1,743	1,746	1,838
Nominal GDP at market prices	4,163	4,402	4,821	5,458	5,458	6,164	6,164

Sources: Pakistani authorities; and Fund staff estimates and projections.

1/ Program as agreed during the eighth review (IMF Country Report No. 04/211).
2/ Accrued payments. Excludes interest expenditure by the military which is included in the defense allocation.
3/ In 2002/03, subsidies include arrears settlement on behalf of KESC amouting to PRs 11 billion in the initial program and PRs 8 billion in the revised projections.
4/ 2001/02: KESC recapitalization (PRs 32 billion) and CBR bonds (PRs 20 billion).
5/ Figures for 2004/05 incorporate an expanded definition, in line with the full PRSP, including items such as law and order, justice, low cost housing, and village electrification, adding nearly 1 percent of GDP.

Table 5. Pakistan: Consolidated Government Budget, 2000/01–2004/05

(In percent of GDP; unless otherwise indicated)

	2000/01	2001/02	2002/03	2003/04		2004/05	
	FY	FY	FY	FY		FY	
	Prov. Act.	Prov. Act.	Prov. Act.	Prog. 1/	Prel. Est.	Prog 1/	Proj.
Revenue and grants	14.3	16.1	17.4	14.9	15.1	13.9	14.7
Revenue	13.3	14.2	14.9	14.3	14.5	13.5	13.8
Tax revenue	10.6	10.9	11.5	11.0	11.2	11.0	10.8
Federal	10.2	10.4	11.0	10.5	10.7	10.5	10.2
CBR revenue	9.4	9.2	9.5	9.3	9.6	9.3	9.6
Direct tax	3.0	3.2	3.2	3.0	3.0	2.9	3.0
Federal excise duty	1.2	1.1	0.9	0.8	0.8	0.7	0.8
Sales tax	3.7	3.8	4.0	4.0	4.0	4.0	4.1
Customs duties	1.6	1.1	1.4	1.6	1.7	1.7	1.7
Petroleum surcharge	0.4	0.8	1.0	0.8	0.8	0.8	0.3
Gas surcharge	0.3	0.4	0.4	0.3	0.3	0.3	0.3
Other	0.0	0.0	0.1	0.0	0.0	0.1	0.1
Provincial	0.5	0.4	0.5	0.5	0.5	0.5	0.5
Nontax revenue	2.7	3.3	3.4	3.3	3.3	2.5	3.1
Federal	2.2	2.8	2.9	2.8	2.9	2.1	2.4
Provincial	0.5	0.5	0.5	0.5	0.4	0.5	0.6
Grants	1.0	1.9	2.5	0.6	0.6	0.4	0.9
Expenditure	17.2	18.8	18.5	17.5	17.5	16.8	17.0
Current expenditure	15.5	15.9	16.6	14.5	14.2	13.7	14.0
Federal	11.5	11.9	12.6	10.8	10.2	10.0	10.1
Interest payments	5.6	5.6	4.3	3.7	3.6	3.4	3.5
Domestic	4.4	4.2	3.5	3.0	2.8	2.8	2.8
Foreign 2/	1.2	1.4	0.8	0.8	0.8	0.7	0.7
Defense	2.5	3.4	3.3	3.3	3.3	3.1	3.1
Running of the civil government	1.7	1.3	1.4	1.3	1.4	1.2	1.3
Pensions for defense and civil government	0.7	0.6	0.8	0.8	0.6	0.7	0.8
Subsidies 3/	0.5	0.5	1.1	1.1	0.7	1.0	0.9
Grants	0.4	0.5	0.5	0.5	0.6	0.5	0.5
Other	0.0	0.0	1.2	0.0	0.0	0.0	0.0
Provincial	4.0	4.0	4.0	3.7	4.0	3.7	3.9
Development expenditure and net lending	1.7	2.9	1.8	3.0	3.3	3.1	3.0
Public Sector Development Program	2.2	2.9	2.7	2.8	2.9	2.9	3.0
Federal	1.6	2.2	1.9	2.0	1.9	2.0	2.2
Provincial	0.6	0.6	0.8	0.8	1.1	0.9	0.9
Net lending	-0.4	0.0	-0.9	0.2	0.4	0.1	-0.1
Statistical discrepancy (“+” = additional expenditure)	0.4	-0.3	0.3	...	-0.6	...	...
Federal government	0.7	0.3	0.1	...	0.2	...	...
Provinces	-0.4	-0.6	0.1	...	-0.8	...	...
Underlying budget balance (excluding grants)	-4.3	-4.3	-3.8	-3.2	-2.4	-3.2	-3.2
One-off expenditure items 4/	...	1.2	...	...	...	...	...
Budget balance (excluding grants)	-4.3	-5.5	-3.8	-3.2	-2.4	-3.2	-3.2
Budget balance (including grants)	-3.3	-3.6	-1.4	-2.7	-1.8	-2.8	-2.3
Financing	3.3	3.6	1.4	2.7	1.8	2.8	2.3
External	1.9	1.2	-0.5	-0.3	-0.7	-0.3	0.6
Of which: privatization receipts	...	...	0.2	0.0	0.0	0.0	0.0
Domestic	1.4	2.4	1.9	3.0	2.5	3.1	1.7
Bank	-0.8	0.3	-1.2	1.5	1.2	1.5	1.0
Nonbank	2.2	1.9	2.9	1.3	1.1	1.4	0.5
Privatization receipts	0.0	0.2	0.1	0.2	0.2	0.2	0.2
Memorandum items:							
Expenditure incl. statistical discrepancy and one-off	17.6	19.7	18.7	17.5	16.9	16.8	17.0
Primary balance (excluding grants and one-offs)	1.3	0.1	0.5	0.5	1.2	0.2	0.2
Primary balance (including grants and one-offs)	2.3	2.0	2.9	1.0	1.8	0.6	1.1
Social and poverty-related expenditure 5/	2.9	3.0	3.5	3.4	3.8	4.5	4.5
Total government debt	88.8	80.2	74.3	68.7	68.7	63.3	63.6
Domestic debt	43.3	40.4	39.3	36.5	36.8	34.9	33.8
External debt	45.6	39.8	35.0	32.2	31.9	28.3	29.8
Nominal GDP (market prices, billions of Pakistani rupees)	4,163	4,402	4,821	5,458	5,458	6,164	6,164

Sources: Pakistani authorities; and Fund staff estimates and projections.

1/ Program as agreed during the eighth review (IMF Country Report No. 04/211).
2/ Accrued payments. Excludes interest expenditure by the military which is included in the defense allocation.
3/ In 2002/03, subsidies include arrears settlement on behalf of KESC amouting to PRs 11 billion in the initial program and PRs 8 billion in the revised projections.
4/ 2001/02: KESC recapitalization (PRs 32 billion) and CBR bonds (PRs 20 billion).
5/ Figures for 2004/05 incorporate an expanded definition, in line with the full PRSP, including items such as law and order, justice, low cost housing, and village electrification, adding nearly 1 percent of GDP.

Table 6. Social- and Poverty-Related Expenditure (PRSP Expenditure), Cumulative 1/
2000/01–2003/04

	2000/01	2001/02	2002/03	2003/04	
	FY	FY	FY	FY	
	Prel. Act.	Prel. Act.	Prel. Act.	Proj.	Prel. Act.
	(In billions of Pakistani rupees)				
Total	122.3	167.3	208.8	229.5	253.6
Current	99.2	140.0	165.4	165.8	192.0
Development	23.2	27.3	43.5	63.7	61.6
Total, program definition	122.3	133.5	169.7	185.6	208.7
By functional area					
Education	56.5	66.3	78.6	79.0	98.0
Health	17.5	19.2	22.4	29.1	26.6
Population planning	1.6	1.3	3.1	4.6	4.9
Social security and social welfare	1.6	3.7	1.3	3.7	4.1
Food subsidies	9.4	5.5	10.9	14.1	7.8
Food support program	1.1	2.0	2.2	2.4	2.8
Natural calamities and other disasters	0.9	0.2	0.4	0.5	0.5
Rural development	11.4	12.3	16.9	4.7	18.4
Roads, highways and bridges	8.3	6.3	13.1	13.6	16.5
Water supply and sanitation	4.5	4.6	3.4	4.7	4.2
Irrigation	8.2	10.1	15.5	27.1	22.9
Land reclamation	1.4	1.8	1.8	2.3	2.0
Law and order	...	31.0	36.3	39.5	40.0
Justice	...	2.0	2.2	2.5	2.4
Low cost housing	...	0.0	0.1	0.2	0.4
Village electrification	...	0.8	0.6	1.0	1.4
Tawana Pakistan	...	0.0	0.0	0.7	0.6
	(In percent of GDP)				
Total	2.9	3.8	4.3	4.2	4.6
Current	2.4	3.2	3.4	3.0	3.5
Development	0.6	0.6	0.9	1.2	1.1
Total, program definition	2.9	3.0	3.5	3.4	3.8
By functional area					
Education	1.4	1.5	1.6	1.4	1.8
Health	0.4	0.4	0.5	0.5	0.5
Roads, highways and bridges	0.2	0.1	0.3	0.2	0.3
Irrigation	0.2	0.2	0.3	0.5	0.4
Law and order	...	0.7	0.8	0.7	0.7
	(Year-on-year growth in percent)				
Total	7.0	36.7	24.8	9.9	21.4
Current	9.8	41.1	18.1	0.2	16.1
Development	-3.6	17.8	59.3	46.7	41.7
Total, program definition	7.0	9.1	27.1	9.4	23.0
By functional area					
Education	4.7	17.3	18.6	0.5	24.6
Health	1.0	9.7	16.4	30.0	18.8
Population planning	-53.8	-16.2	134.4	47.5	57.5
Social security and social welfare	-23.8	132.5	-64.5	183.0	218.4
Food subsidies	-4.7	-41.3	97.0	29.4	-27.8
Food support program	...	90.1	10.9	8.5	25.4
Natural calamities and other disasters	-26.6	-79.3	116.9	22.4	32.4
Rural development	75.3	8.0	37.0	-72.2	8.9
Roads, highways and bridges	62.3	-23.9	107.3	3.1	25.2
Water supply and sanitation	-19.0	3.3	-26.3	36.0	22.1
Irrigation	-1.5	24.3	53.3	74.4	47.7
Land reclamation	47.0	33.2	-4.3	29.4	13.5
Law and order	...	...	17.1	8.9	10.2
Justice	...	...	13.4	12.1	8.8
Low cost housing	...	...	...	175.0	605.0
Village electification	...	...	-26.3	69.5	141.0
Tawana Pakistan	...	...	...	...	...
Memorandum items:	(In billions of Pakistani rupees)				
Indicative program target	...	136.4	161.0	185.1	185.1
Shortfall relative to program target	...	2.9	-8.7	...	-23.6
Kushal Pakistan Program	5.0	15.0	...	...	
Nominal GDP	4,163	4,402	4,821	5,458	5,458

Source: Pakistani authorities; World Bank; and Fund staff estimates and calculations.

1/ In 2003/04, the authorities have extended their definition of social- and poverty-related expenditure by law and order, justice, low cost housing, village electrification, and Tawana Pakistan. Data revisions have been made as of 2001/02.

Table 7. Pakistan: Monetary Survey, 2000/01–2004/05

	2000/01	2001/02	2002/03				2003/04 1/					2004/05 1/	
	FY	FY	Sep.	Dec.	Mar.	Jun.	Sep.	Dec.	Mar.	Jun.		FY	
	Act.	Act.	Act.	Act.	Act.	Act.	Act.	Act.	Act.	Prog 2/	Act.	Prog. 2/	Rev. Proj.
	(End-of-period stocks; in billions of Pakistani rupees)												
Net foreign assets	26.3	230.8	348.2	414.8	512.7	569.1	588.4	601.1	602.6	649.3	590.5	665.8	621.2
Net domestic assets	1,499.7	1,530.5	1,453.2	1,502.4	1,464.6	1,514.5	1,534.0	1,668.1	1,732.4	1,793.9	1,895.9	2,090.2	2,196.9
Net claims on government	569.7	644.9	628.9	589.8	555.6	566.5	572.2	536.2	583.9	632.6	624.5	732.6	699.8
Of which:													
Net bank borrowing	499.9	567.2	554.5	533.2	514.7	511.2	521.1	501.5	564.8	593.2	574.9	683.2	634.9
Commodity operations	95.3	100.6	95.9	79.6	61.2	74.0	66.6	52.8	37.2	57.2	65.9	67.2	80.9
Claims on nongovernment	902.4	921.6	885.6	990.0	1,017.0	1,069.0	1,075.2	1,221.8	1,255.7	1,268.5	1,364.2	1,464.8	1,590.0
Private sector	802.1	840.9	811.3	916.8	942.2	999.9	1,023.3	1,177.6	1,219.4	1,232.2	1,298.0	1,424.5	1,505.8
Public sector enterprises	100.2	80.7	74.4	73.3	74.8	69.1	51.9	44.2	36.3	36.3	66.2	40.3	84.2
Privatization account	-2.9	-2.9	-2.9	-2.9	-2.9	-2.9	-2.9	-2.9	-2.9	-2.9	-2.9	-2.9	-2.9
Other items, net	30.6	-33.0	-58.4	-74.4	-105.1	-118.1	-110.4	-87.0	-104.2	-104.2	-90.0	-104.2	-90.0
Total liquidity (broad money)	1,526.0	1,761.4	1,801.4	1,917.2	1,977.3	2,083.6	2,122.3	2,269.1	2,335.0	2,443.2	2,486.4	2,756.0	2,818.1
Of which:													
Pakistani rupee liquidity	1,371.9	1,603.9	1,636.3	1,782.8	1,848.8	1,952.6	1,994.4	2,132.6	2,195.0	2,298.0	2,340.9	2,589.8	2,651.6
	(Changes in percent of stock of broad money at the beginning of the fiscal year)												
Net foreign assets	5.1	13.4	6.3	10.1	15.7	18.9	2.0	2.6	2.7	4.9	2.1	0.7	1.2
Net domestic assets	3.9	2.0	-3.9	-1.1	-3.3	-0.4	0.1	6.5	9.6	12.6	17.5	12.1	12.1
Of which:													
Net claims on the government	-3.3	1.5	2.1	-0.1	-2.1	-1.4	0.3	-1.5	0.8	3.2	2.8	4.1	3.0
Net claims on private sector	3.5	2.5	-1.6	4.4	5.8	9.1	1.1	8.5	10.6	11.2	14.3	7.9	8.4
	(Changes over 12 months; in percent)												
Broad money	9.0	15.4	18.6	16.2	18.5	18.3	17.8	18.4	18.1	17.5	19.6	12.8	13.3
Net claims on private sector	6.5	4.8	4.0	7.6	12.4	19.1	26.1	28.5	29.4	23.2	29.8	15.6	16.0

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

1/ At indicative program exchange rate.
2/ Program column is the revised projection published in IMF Country Report No. 04/211.

Table 8. Pakistan: Accounts of the State Bank of Pakistan, 2000/01–2004/05

	2000/01	2001/02	2002/03				2003/04 1/					2004/05 1/	
	Act.	Act.	Sep.	Dec.	Mar.	Jun.	Sep.	Dec.	Mar.	Jun.		FY	
			Act.	Act.	Act.	Act.	Act.	Act.	Act.	Prog. 2/	Act.	Prog. 2/	Rev. Proj.
	(End-of-period stocks; in billions of Pakistani rupees)												
Net foreign assets	-19.1	133.5	271.8	357.4	451.6	492.0	509.9	538.0	529.7	572.9	519.4	569.9	540.2
Net domestic assets	552.3	451.1	311.5	283.8	198.7	178.0	148.9	208.5	243.0	204.8	253.4	280.2	306.7
Net claims on government	335.6	279.2	152.6	117.3	57.5	34.1	-14.4	11.8	89.2	51.0	96.7	126.4	124.9
Of which:													
Budgetary support	361.1	302.2	174.1	140.3	77.9	52.9	1.1	29.9	107.3	68.8	112.9	144.3	140.9
Claims on nongovernment	40.1	22.7	17.4	14.7	14.2	11.5	10.1	6.7	5.4	5.4	1.8	5.4	1.8
Claims on scheduled banks	198.0	195.8	175.8	222.8	177.1	180.6	181.1	194.7	184.9	184.9	195.6	184.9	220.6
Privatization account	-2.9	-2.9	-2.9	-2.9	-2.9	-2.9	-2.9	-2.9	-2.9	-2.9	-2.9	-2.9	-2.9
Other items, net	-18.4	-43.7	-31.4	-68.1	-47.1	-45.3	-24.9	-1.7	-33.5	-33.5	-37.7	-33.5	-37.7
Reserve money 3/	533.2	584.6	583.3	641.2	650.4	670.0	658.9	746.5	772.7	777.7	772.9	850.1	846.9
Of which:													
Banks' reserves	127.3	110.5	127.3	125.8	128.6	141.5	128.1	145.2	161.1	150.4	156.2	172.1	160.2
Currency	394.6	460.2	454.3	513.3	518.3	525.0	527.3	597.8	609.4	625.3	614.5	675.9	684.6
	(Changes in percent of stock of reserve money at the beginning of the fiscal year)												
Net foreign assets	7.3	28.6	22.6	37.3	53.4	60.3	6.1	10.3	9.1	15.5	7.6	-0.4	2.7
Net domestic assets	-0.2	-19.0	-22.9	-27.6	-42.2	-45.7	-7.7	1.2	6.3	0.5	7.9	9.7	6.9
Of which:													
Budgetary support	-6.3	-21.0	-12.6	-18.6	-28.8	-32.8	-7.7	-3.4	8.1	2.4	9.0	9.7	3.6
	(Changes over 12 months; in percent)												
Reserve money 4/	-3.7	9.6	9.7	8.7	14.4	14.6	13.0	16.4	18.8	16.1	15.4	9.3	9.6
Currency	5.2	16.6	13.8	13.6	13.8	13.5	16.1	16.5	17.6	19.1	17.1	8.1	11.4

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

1/ At indicative program exchange rates.
2/ Program column is the revised projection published in IMF Country Report No. 04/211.
3/ Reserve money includes special reserves on foreign currency deposits.
4/ For the purpose of calculating the 12-month growth rate, reserve money is considered net of the special reserves and corrected for the transformation of the special deposits accounts into treasury bills in December 2000 and March 2001.

Table 9. Pakistan: Balance of Payments, 2001/02–2004/05

	2001/02	2002/03	2003/04 FY		2004/05 FY	
			Prog. 1/	Prel Act.	Prog. 1/	Rev. Proj.
	(In millions of U.S. dollars)					
Current account (excluding official transfers)	96	3,166	1,613	1,312	-70	-1,127
Current account balance (including official transfers)	1,591	4,204	2,213	1,886	384	-717
Trade balance	-292	-444	-755	-1,212	-1,332	-2,974
Exports f.o.b.	9,140	10,889	12,158	12,395	13,130	13,635
Of which: cotton manufactures	5,368	6,650	7,410	7,568	7,976	8,208
Imports f.o.b.	-9,432	-11,333	-12,913	-13,607	-14,462	-16,609
Services (net)	-2,617	-2,127	-3,179	-3,586	-3,806	-4,393
Of which: interest payments	-1,579	-1,276	-1,111	-1,050	-1,076	-1,079
Private transfers (net)	3,005	5,737	5,547	6,110	5,069	6,240
Official transfers (net)	1,495	1,038	600	574	453	410
Of which: Saudi Oil Facility	579	637	302	302	0	0
Of which: additional grant pledges	742	209	203	202	330	343
Capital account	-2,322	-1,709	-2,521	-3,089	-2,475	-1,531
Public medium- and long-term capital	-1,613	-1,656	-1,372	-2,092	-1,796	-531
Project and nonproject loans	-983	-1,840	-1,297	-1,986	-1,291	-521
Disbursements	531	581	727	434	742	903
Amortization 2/	-1,514	-2,421	-2,024	-2,420	-2,033	-1,424
Commercial banks and IDB (net)	-224	-158	-33	-33	-16	-16
Other 3/	-407	342	-42	-73	-489	6
Public sector short-term (net)	-1,064	-268	-707	-856	-469	-569
Private medium- and long-term	-80	164	466	493	315	264
Of which: FDI	368	612	778	752	500	550
Private short-term (including errors & omissions) 4/	435	51	-908	-634	-525	-695
Overall balance (before debt relief)	-731	2,495	-308	-1,203	-2,091	-2,248
Financing	731	-2,495	308	1,203	2,091	2,248
Reserve assets (increase -)	-3,082	-5,261	-1,402	-404	-460	-398
State Bank of Pakistan (including FE-25s)	-2,717	-5,911	-1,455	-427	-160	-233
Deposit money banks	-365	650	53	23	-300	-165
Fund repurchases	-194	-418	-578	-673	-294	-380
Net exceptional financing	4,007	3,185	2,288	2,280	2,845	3,026
Arrears (increase +)	0	0	0	0	0	0
Rescheduling	1,210	1,009	100	100	100	100
Of which: Private Sector Involvement	0	100	100	100	100	100
Rollover of foreign deposits with banking system 5/	1,314	900	1,200	1,200	1,200	1,200
Program financing from IFIs	1,367	1,090	789	781	1,446	1,630
World Bank	698	213	100	192	540	640
AsDB	185	408	444	344	400	735
IMF	484	469	245	245	506	255
Privatization receipts	117	186	199	199	99	96
Financing gap	0	0	0	0	0	0
	(In percent of GDP, unless otherwise indicated)					
Memorandum items:						
Current account (excluding official transfers)	0.1	3.8	1.7	1.4	-0.1	-1.1
Current account balance (including official transfers)	2.2	5.1	2.3	2.0	0.4	-0.7
Exports f.o.b. (growth rate, percent)	2.3	19.1	11.7	13.8	8.0	10.0
Imports f.o.b. (growth rate, percent)	-7.5	20.2	13.9	20.1	12.0	22.1
Terms of trade (growth rate, percent)	-0.5	-0.9	4.1	2.3	-0.6	-4.7
End-period gross official reserves 6/						
Including Sinking Fund (in millions of U.S. dollars)	4,330	10,251	11,657	10,621	11,745	10,789
Excluding Sinking Fund (in millions f U.S. dollars)	4,330	9,521	11,657	10,556	11,745	10,789
(In months of next year imports of goods and nonfactor services)	3.7	6.4	7.6	6.0	7.4	5.9

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

1/ Program as agreed during the eighth review (IMF Country Report No. 04/211). Ratios to GDP reflect the recently revised GDP statistics.
2/ Includes accelerated repayments. To U.S.: $1 billion in 2002/03 and $495 million in 2004/05; to AsDB: $1.1 billion in 2003/04.
3/ Includes U.S. capital grants to finance accelerated repayment of U.S. debt. In 2002/03: $1 billion; in 2004/05: $495 million.
4/ Includes repayment of foreign currency deposits held in NBFIs and banks (reschedulings shown as exceptional financing).
5/ Includes rollover of FE-45 deposits with the banking system, of Kuwait's and U.A.E.'s deposits with the SBP, and Bank of China's deposits with the NBP.
6/ Excluding gold, foreign currency deposits held with the SBP, cash reserve requirement, and net of and outstanding short-term swap and forward contracts.

Table 10. Pakistan: Financial and Operational Targets for WAPDA, 2001/02–2003/04

(In millions of Pakistani rupees, unless otherwise indicated)

	2001/02	2002/03	2003/04									
			Q1		Q2		Q3		Q4		Year	
	Act.	Act.	FIP	Prel. Est.	FIP	Prel. Est.	FIP	Prel. Est.	FIP	Prel. Est.	FIP	Prel. Est.
Main assumptions												
Average revenue (PRs/kWh) 1/	3.93	4.40	4.21	4.35	4.47	4.61	4.13	4.22	4.58	4.21	4.35	4.33
Units generated and purchased (in GWh)	60,849	64,038	18,455	19,668	15,198	14,840	14,079	15,121	17,842	19,462	65,574	69,091
Of which: thermal units (in percent of units generated)	68.7	65.1	51.1	46.0	72.5	52.0	82.4	80.0	68.2	66.0	67.3	58.9
purchased units (in GWh)	23,242	22,106	5,177	3,885	5,839	3,665	6,624	6,080	7,045	7,038	24,685	20,668
Main operational and financial targets												
Technical and nontechnical losses 2/ 3/	25.8	25.9	23.4	25.6	22.7	21.0	25.0	27.0	25.8	27.6	24.0	25.5
Total receivables	50,969	58,842	60,087	68,503	65,743	70,030	65,743	75,825	68,591	69,330	68,591	69,330
Of which: public sector and FATA receivables	29,182	33,986	38,586	40,835	44,231	45,408	44,231	49,174	47,089	41,684	47,089	41,684
Stock of payables to fuel suppliers and IPPs 2/	25,565	6,406	5,959	5,772	5,512	5,526	5,065	4,878	4,618	4,481	4,618	4,481
Summary cash flow statement												
Total cash receipts (excluding GST, ED, & W/Tax)	177,409	201,016	56,506	53,404	46,866	52,481	43,648	40,770	57,864	65,795	204,884	212,450
Total cash outflows	178,649	207,879	48,612	39,469	53,537	47,202	56,792	39,262	54,976	56,372	213,918	182,305
Purchase of power from IPPs	109,101	116,133	23,587	21,021	25,286	22,051	28,437	21,994	28,739	29,829	106,049	94,895
Cost of fuel	37,365	47,978	8,765	10,519	11,778	8,786	11,454	8,786	8,695	11,918	40,692	40,009
Debt service to GOP (interest and amortization) 4/	3,423	46	5,726	0	5,726	0	5,725	0	5,725	0	22,902	0
Debt service other than to GOP (interest and amortization)	11,684	15,944	3,067	1,712	3,067	7,684	3,067	1,331	3,068	5,415	12,269	16,142
Hydel profit payment	6,000	6,000	1,500	1,000	1,500	2,237	1,500	750	1,500	2,250	6,000	6,237
Operations and maintenance	17,261	19,411	4,807	4,357	5,021	5,739	5,449	5,479	6,089	5,991	21,366	21,566
Other cash outflows 5/	-6,185	2,367	1,160	860	1,160	705	1,160	922	1,160	969	4,640	3,456
Net cash available before investment program	-1,240	-6,863	7,894	13,935	-6,672	5,279	-13,144	1,508	2,888	9,423	-9,034	30,145
Investment expenditure	20,618	11,630	7,732	4,801	7,732	2,531	7,732	2,699	7,732	2,600	30,928	12,631
Foreign-financed component	13,034	0	4,732	1,482	4,732	0	4,732	0	4,732	0	18,928	1,482
Locally-financed component	7,584	11,630	3,000	3,319	3,000	2,531	3,000	2,699	3,000	2,600	12,000	11,149
Cash surplus (+)/deficit(-)	-21,858	-18,493	162	9,134	-14,404	2,748	-20,876	-1,191	-4,844	6,823	-39,962	17,514
Memorandum items:												
Net change in payment arrears 6/	...	1,523	-447	5,592	-447	4,743	-447	5,827	-447	4,578	-1,788	20,740
Of which: arrears to the government 4/	...	20,682	0	6,226	0	4,989	0	6,475	0	4,975	0	22,665
Of which: arrears to IPPs and suppliers	...	-19,159	-447	-634	-447	-246	-447	-648	-447	-397	-1,788	-1,925
Accrual balance 7/	...	-20,016	5,341	5,024	-9,225	-1,995	-15,697	-7,018	335	2,245	-19,246	-1,744
Accrual balance, cumulative since start of fiscal year 7/		-20,016	5,341	5,024	-3,884	3,029	-19,581	-3,989	-19,246	-1,744	-19,246	-1,744

Source: Pakistani authorities (WAPDA), see www.finance.gov.pk/other/financial.pdf.

1/ Defined as the billing (equal to total cash receipts plus increase in receivables) divided by the number of units sold.
2/ Ceiling under FIP.
3/ Defined as units generated and purchased minus units sold, as a percentage of units generated and purchased.
4/ In 2003/04, the Ministry of Finance (MoF) and WAPDA agreed that WAPDA would not pay the interest due and instead receive an equally smaller transfer from the MoF.
5/ Negative "other cash outflows" in 2001/02 appears to reflect bond financing and government support, including through debt-equity swaps in the past, and is not strictly comparable with the 2002/03 presentation.
6/ Change in the stock of arrears vis-à-vis IPPs, fuel suppliers and the government (including debt service).
7/ For monitoring purposes, defined as the cash balance minus any net change in the stock of arrears to suppliers and to the government plus foreign-financed investment.

Table 11. Pakistan: Financial and Operational Targets for KESC, 2001/02–2003/04

(In millions of Pakistani rupees, unless otherwise indicated)

	2001/02	2002/03	2003/04									
			Q1		Q2		Q3		Q4		Year	
	Act.	Act.	FIP	Prel. Est.	FIP	Prel. Est.	FIP	Prel. Est.	FIP	Prel. Est.	FIP	Prel. Est.
Main assumptions												
Average tariff (PRs per kWh)	4.5	4.6	4.6	4.8	4.6	4.8	4.6	...	4.6	...	4.6	...
Units generated and purchased (in GWh)	11,548	12,036	3,240	3,469	2,906	2,921	2,605	2,733	3,468	3,604	12,219	12,727
Of which: purchased units (in GWh)	3,406	3,809	836	1,081	799	710	563	...	1,063	...	3,261	3,664
Main operational and financial targets												
Technical and nontechnical losses 1/	41.1	40.8	39.9	41.7	36.7	33.9	38.4	36.4	37.0	38.5	38.0	37.9
Total receivables	21,130	19,842	20,334	20,459	20,334	20,739	20,334	21,325	20,334	21,842	20,334	21,842
Of which: public sector receivables	2,366	1,913	2,316	2,301	2,316	2,214	2,316	2,716	2,316	2,854	2,316	2,854
Stock of payables to fuel suppliers and IPPs 2/	11,198	928	923	4,536	923	4,000	923	899	923	0	923	0
Summary cash flow statement												
Receipts	34,649	38,848	10,505	10,659	9,918	10,405	8,654	9,196	11,770	12,352	40,846	42,611
Collection of dues	32,452	36,183	9,889	10,141	9,330	9,984	8,127	8,669	11,094	11,161	38,439	39,954
GST	1,436	1,656	496	340	468	260	407	375	556	1,025	1,927	2,000
Other receipts	761	1,008	120	178	120	161	120	152	120	166	480	657
Payments	49,807	60,536	13,601	10,323	12,348	13,152	11,155	13,218	13,199	13,880	50,304	50,572
Purchase of power	14,147	25,293	3,761	3,231	3,618	4,748	2,746	3,806	4,738	4,890	14,864	16,675
Cost of fuel	21,721	23,930	6,378	4,411	5,315	5,811	4,998	6,745	6,409	6,388	23,100	23,355
Debt service (interest and amortization)	9,587	6,883	2,226	1,659	2,072	1,450	2,066	1,529	645	639	7,008	5,276
Taxes	837	987	356	196	425	290	391	318	415	484	1,587	1,288
Operations and maintenance	3,515	3,443	880	826	917	853	955	820	992	1,479	3,744	3,978
Net cash available before investment program	-15,158	-21,689	-3,096	336	-2,430	-2,747	-2,502	-4,022	-1,429	-1,528	-9,458	-7,961
Investment program	1,560	1,881	1,293	551	1,407	569	1,621	697	1,563	316	5,884	2,133
Regular component	1,560	1,614	514	382	550	331	566	441	582	132	2,212	1,286
Additional component 3/	0	267	779	169	857	238	1,055	256	981	184	3,672	847
Cash surplus (+)/deficit(-)	-16,718	-23,570	-4,389	-215	-3,837	-3,316	-4,123	-4,719	-2,992	-1,844	-15,342	-10,094
Memorandum items:												
Net change in payment arrears 4/	...	-10,270	0	3,608	0	-536	0	-3,101	0	-899	0	-928
Accrual balance 5/	...	-13,300	-4,389	-3,823	-3,837	-2,780	-4,123	-1,618	-2,992	-945	-15,342	-9,166
Accrual balance, cumulative since start of fiscal year 5/		-13,300	-4,389	-3,823	-8,226	-6,603	-12,349	-8,221	-15,342	-9,166	-15,342	-9,166

Source: Pakistani authorities (KESC), see www.finance.gov.pk/other/financial.pdf.

1/ Defined as units generated minus units sold, as a percentage of units generated.
2/ Ceiling under FIP.
3/ The additional component of the investment program was introduced in KESC's FIP. It is financed by the government and aims at improving KESC's financial situation through technical and administrative improvements.
4/ Change in the stock of arrears vis-à-vis IPPs, WAPDA, fuel suppliers and the government (including debt service).
5/ For monitoring purposes, defined as the cash balance minus any net change in the stock of arrears to suppliers and to the government plus foreign-financed investment.

Table 12. Pakistan: Gross Financing Requirements, 2001/02–2004/05

(In millions of U.S. dollars)

	2001/02	2002/03	2003/04	2004/05 Proj.
Gross financing requirements	-7,889	-5,472	-4,897	-5,473
External current account deficit	1,591	4,204	1,886	-717
Debt amortization	-6,204	-3,996	-5,706	-3,978
Medium- and long-term debt	-2,657	-2,813	-3,671	-2,414
Public sector	-2,261	-2,130	-2,976	-1,929
Multilateral (excluding IMF)	-604	-612	-1,766	-631
Bilateral	-817	-658	-570	-703
Bonds (net)	-35	-193	-181	-181
Other (including SBP liabilities)	-805	-667	-459	-415
Private sector	-396	-683	-695	-485
Short-term debt	-3,547	-1,183	-2,035	-1,564
Public sector	-2,188	-976	-1,367	-1,419
Private sector	-1,359	-207	-668	-145
Repayment of arrears	0	0	0	0
Gross reserves accumulation	-3,082	-5,261	-404	-398
Of which: official reserves	-2,717	-5,911	-427	-233
IMF repurchases and repayments	-194	-418	-673	-380
Available financing	7,889	5,472	4,897	4,979
FDI and portfolio investment (net, excluding public securities) 1/	475	793	884	696
Debt financing from private creditors	2,988	1,949	2,517	1,649
Medium- and long-term financing	487	354	1,003	150
To private sector	185	350	503	150
To public sector	302	4	500	0
Short-term financing	2,501	1,595	1,514	1,499
To public sector	1,378	1,108	1,211	1,550
To private sector	1,123	487	303	-51
Official creditors	2,623	2,111	970	2,278
Project lending	531	581	434	408
Balance of payments support	2,092	1,530	536	1,870
AsDB and World Bank	883	621	536	1,375
Debt relief from bilateral creditors 2/	1,210	909	0	495
Private sector involvement	0	100	100	100
IMF	484	469	245	255
Other net capital flows 3/	1,319	50	181	1
Financing gap	0	0	0	0

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

1/ Includes privatization receipts.
2/ Debt relief agreed in January 2001 and in December 2001.
3/ Including errors and omissions; for 2001/02, also including SBP purchases in the kerb market.

Table 13. Pakistan: Proposed Milestones of Fiscal Reform Agenda

Reform Project	Timing
CBR reform	
Customs administration pilot project	Short term
Extending GST to remaining services	Short term
Opening of additional LTUs and MTUs	Short term
Functional specialization of sales tax administration	Medium term
Functional integration of income tax and sales tax	Long term
Social service delivery	
Conduct ‘core welfare indicator questionnaire’ survey	Short term
Budget process	
Costed three-year projections for the health and population welfare ministries	Medium term
Medium-term budget framework	Medium term
Fiscal reporting	
Adopting the new accounting model for the federal government	Short term
Adopting the new chart of accounts for the provincial governments	Medium term
Public sector enterprises/power utilities	
Announcement of transparent tariff framework	Short term
Corporatization and splitting up of WAPDA’s into regional entities	Short term
Privatization of KESC	Medium term

Table 14. Pakistan: Financial Soundness Indicators for the Banking Sector, 1999–2004

	1999	2000	2001	2002	2003	2004	
	Dec.	Dec.	Dec.	Dec.	Dec.	Mar.	Jun.
All banks 1/							
Capital adequacy							
Regulatory capital to risk-weighted assets	10.9	9.7	8.8	8.8	8.5	9.8	9.8
Tier I capital to risk -weighted assets	9.2	8.3	7.3	6.2	6.5	7.5	7.4
Capital to total assets	4.8	4.5	3.8	4.8	5.4	5.8	5.1
Asset composition and quality							
NPLs to gross loans	25.9	23.5	23.4	21.8	17.0	16.1	14.5
Provisions to NPLs	48.6	55.0	54.7	60.6	63.7	66.1	66.8
NPLs net of provisions to capital	149.8	131.3	150.5	85.5	55.4	47.4	48.1
Earnings and profitability							
ROA (after tax)	-0.2	-0.2	-0.5	0.1	1.1	0.6	1.0
ROE (after tax)	-3.9	-3.5	-12.6	3.2	20.5	11.5	18.3
Net interest income to gross income	55.6	62.3	70.4	67.1	60.5	61.2	60.2
Noninterest expenses to gross income	75.8	71.6	62.4	59.1	49.1	56.0	54.0
Liquidity							
Liquid assets to total assets	36.8	36.0	38.5	49.7	45.1	43.6	42.4
Liquid assets to total deposits	48.6	48.5	50.7	61.8	58.5	55.2	54.0
Commercial banks							
Capital adequacy							
Regulatory capital to risk-weighted assets	12.2	11.4	11.3	12.6	11.1	11.1	10.9
Tier I capital to risk -weighted assets	10.3	9.8	9.7	9.7	9.1	9.0	8.7
Capital to total assets	5.0	4.9	4.6	6.1	6.0	6.4	5.7
Asset composition and quality							
NPLs to gross loans	22.0	19.5	19.6	17.7	13.7	13.2	11.4
Provisions to NPLs	46.6	53.9	53.2	58.2	64.7	66.1	69.3
NPLs net of provisions to capital	117.4	96.7	100.7	54.2	37.5	33.5	30.6
Earnings and profitability							
ROA (after tax)	-0.3	0.0	0.0	0.8	1.2	1.1	1.1
ROE (after tax)	-6.2	-0.3	-0.3	14.3	20.5	17.4	18.7
Net interest income to gross income	54.3	61.2	68.9	66.1	59.4	60.7	58.7
Noninterest expenses to gross income	76.9	71.6	62.7	56.7	48.6	53.6	53.8
Liquidity							
Liquid assets to total assets	38.7	37.5	39.9	48.1	46.0	44.5	42.4
Liquid assets to total deposits	48.2	48.0	50.3	61.5	57.9	54.7	54.0

Source: State Bank of Pakistan.

1/ Includes commercial banks and specialized banks.

Table 15. Pakistan: Indicators of Fund Credit, 2001/02–2008/09

				Proj.				
	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09
Outstanding Fund credit								
In millions of SDRs	1,524	1,519	1,206	1,256	1,034	927	818	681
In millions of U.S. dollars	1,939	2,092	1,762	1,834	1,514	1,360	1,201	1,000
In percent of:								
Quota	147.5	146.9	116.7	121.5	100.0	89.7	79.1	65.9
GDP	2.7	2.5	1.9	1.8	1.3	1.1	1.0	0.8
Exports of goods and nonfactor services	17.5	15.3	11.7	11.4	8.9	7.5	6.1	4.8
Public and publicly guaranteed debt	5.9	6.4	5.3	5.4	4.5	4.0	3.5	2.9
Debt service to the Fund								
In millions of SDRs	194	333	478	155	233	113	114	142
In millions of U.S. dollars	247	458	699	226	341	166	167	209
In percent of:								
Exports of goods and nonfactor services	2.2	3.3	4.6	1.4	2.0	0.9	0.9	1.0
Gross official reserves	5.7	4.8	6.6	2.1	3.1	1.5	1.4	1.7

Sources: IMF Finance Department; and Fund staff estimates.

Table 16. Pakistan: Indicators of External Vulnerability, 2001/02–2004/05

	2001/02	2002/03	2003/04	Latest available observation	Proj. 2004/05
Financial indicators					
Total government debt (in percent of GDP)	79.7	74.3	68.7	...	63.6
Broad money (12-month percentage change)	15.4	18.3	19.6	19.0 1/	13.2
Private sector credit (12-month percentage change)	4.8	19.1	29.8	31.4 1/	16.0
180-day treasury bill yield (in percent)	7.8	3.7	1.7	2.6 1/	...
180-day treasury bill yield, real (in percent)	5.3	0.6	-2.9	-3.2 1/	...
Karachi Stock Exchange index					
End-of-period	1,770	3,402	5,279	5,218 2/	...
Period average	1,514	2,443	4,594	...	...
External Indicators					
Exports (12-month percentage changes, in U.S. dollars)	2.3	19.1	13.8	...	10.0
Imports (12-month percentage changes, in U.S. dollars)	-7.5	20.2	20.1	...	22.1
Terms of trade (12-month percentage changes)	-0.5	-0.9	2.3	...	-4.7
Current account balance (excluding official transfers in percent of GDP)	0.1	3.8	1.4	...	-1.1
Gross Official Reserves (in millions of U.S. dollars) 3/	4,330	10,251	10,621	10,806 2/	10,789
In months of next year imports of goods and nonfactor services	3.7	6.4	6.0	...	5.9
In percent of broad money	14.7	28.5	23.9	...	23.0
In percent of total short-term debt at remaining maturity	73.1	210.5	169.2	...	258.0
Total external debt (in millions of U.S. dollars)	35,545	35,084	35,149	...	35,202
In percent of exports of goods and nonfactor services	321.5	256.3	232.4	...	219.1
Exchange rate (Pakistani rupees per U.S. dollar, period average)	61.6	58.4	57.5	59.2 2/	...
Real exchange rate (12-month percentage changes)	-2.9	-0.2	-3.6	...	...

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

1/ August 2004.
2/ September 30, 2004.
3/ Including sinking fund.

PAKISTAN: FUND RELATIONS

As of September 30, 2004

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

II. **General Resources Account**:	SDR Million	% Quota
Quota	1,033.70	100.00
Fund Holdings of Currency	1,267.70	122.64
Reserve position in Fund	0.12	0.01

III. **SDR Department**:	SDR Million	% Allocation
Net cumulative allocation	169.99	100.00
Holdings	159.81	94.01

IV. **Outstanding Purchases and Loans**:	SDR Million	% Quota
Stand-by arrangements	150.00	14.51
Extended arrangements	84.12	8.14
PRGF arrangements	1,066.13	103.41

V. **Latest Financial Arrangements**:

Type	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
PRGF	12/06/2001	12/05/2004	1,033.70	861.42
Stand-By	11/29/2000	09/30/2001	465.00	465.00
EFF	10/20/1997	10/19/2000	454.92	113.74

VI. **Projected Payments to the Fund**[1] SDR Million; based on existing use of resources and present holdings of SDRs):

	Overdue	Forthcoming				
	9/30/04	2004	2005	2006	2007	2008
Principal	0.0	92.32	163.91	72.03	97.88	116.16
Charges/Interest	0.0	4.66	9.21	6.61	5.68	4.66
Total	0.0	96.98	173.11	78.64	103.55	120.82

[1] This schedule presents all currently scheduled payments to the IMF, including repayment expectations and repayment obligations. The IMF Executive Board can extend repayment expectations (within predetermined limits) upon request by the member if its external payment position is not strong enough to meet the expectations without undue hardship or risk.

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 $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. 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 July 15, 2004, the FIBR was PRs 58.15 per $1. Pakistan’s exchange regime is classified as managed floating with no predetermined path for the exchange rate. Pakistan maintains a minor exchange restriction on payments for current international transactions subject to Fund approval under Article VIII, Section 2a, resulting from limitations on advance payments for certain imports.

VIII. **Last Article IV Consultation**

The last Article IV consultation discussions were held in Islamabad in August 2002. The staff report (IMF Country Report No. 02/246) was discussed by the Executive Board on November 1, 2002.

IX. **Safeguards Assessments**

In accordance with the Fund’s safeguards assessment policy, the State Bank of Pakistan (SBP) was subject to a full safeguards assessment under the Stand-By Arrangement that expired on September 30, 2001. This assessment, which included a safeguards mission to the SBP, was completed on February 13, 2001. The staff’s findings and recommendations were reported in IMF Country Report No. 01/58, Appendix IV. The authorities have implemented all of the recommended remedial measures that were included under SBA conditionality, and no new critical vulnerabilities have been identified under Pakistan’s current PRGF arrangement, which was approved on December 6, 2001 and is scheduled to expire on December 5, 2004.

X. **ROSCs**

Fiscal Transparency Module	11/28/2000	(refer to www.imf.org)
Financial System Stability Assessment	6/23/2004	IMF Country Report No. 04/215
Data Module and Detailed Assessment Using the Data Quality Assessment Framework	Report under preparation (STA mission December 1–16, 2003)	

XI. **Recent Technical Assistance**

a. **FAD**: 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 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 1993/94–1998/99. In September 2000, a mission provided technical assistance (TA) 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 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. In January 2002, another mission advised the authorities on fiscal data management, quality, and transparency. In January 2003, a mission assisted the authorities in reviewing and preparing tax administration reforms. In March 2003, a mission advised the authorities on customs administration reform. In April 2004, a mission advised the authorities on improving fiscal reporting at the subnational level.

b. **MFD**: In July 2000, a joint MFD/MCD 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 TA 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. In February 2002, a mission reviewed external sector statistics and provided advice on steps to be undertaken to subscribe to the SDDS.

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

XII. **Resident Representative**

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

PAKISTAN: IMF-WORLD BANK RELATIONS

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Partnership in Pakistan's development strategy

1. The government of Pakistan's Poverty Reduction Strategy Paper (PSRP) for 2002/03 to 2007/08,[1] completed in December 2003, constitutes a broad-based strategy for addressing poverty, including human development, governance, and vulnerability, and builds on the economic program first articulated in the fall of 1999 and further elaborated in the I-PRSP of 2001. The Bank-Fund Joint Staff Assessment (JSA), discussed by the Board of the Fund on March 8, 2004 and the Board of the World Bank on March 11, 2004, endorsed the PRSP and indicated it provides a good policy framework for the implementation of a reform program which can accelerate progress toward the Millennium Development Goals.

2. The Fund takes the lead in the policy dialogue with Pakistan on macroeconomic policies including overall fiscal and monetary policy. In addition to macroeconomic targets, the Fund has established structural performance criteria relating to reforms in the areas of tax policy and administration, power sector reform, and public expenditure management. As outlined more fully below, the World Bank has complemented the Fund's work through support to structural reforms in the social sectors and support of the growth agenda through deregulation of key sectors, such as power, oil and gas, and banking reforms whose performance have a strong bearing on growth and public finances.

World Bank Group Strategy

3. The objective of the World Bank Group's assistance strategy is to help Pakistan reduce poverty through support of the government's Poverty Reduction Strategy. The World Bank Group's program priorities are focused on the reforms to (a) strengthen macroeconomic stability and government effectiveness; (b) improve the business environment for growth; and (c) improve equity through support for pro-poor and pro-gender equity policies. The Country Assistance Strategy (CAS) was presented to the World Bank's Board of Executive Directors on June 11, 2002. A CAS Progress Report, which was presented to the Board on April 20, 2004, confirms that the strategy set out in the 2002 CAS remains valid in light of the full PRSP.

4. The World Bank works closely with the Fund and the government on structural reforms underpinning macroeconomic stability. In this context, the World Bank's lending program has featured structural adjustment lending to support the government's actions in the areas of improving public expenditure management and supporting reforms of tax administration, safe and sound banking, efficient public utilities, and structural fiscal and

[1] Government of Pakistan, 2003, *Accelerating Economic Growth and Reducing Poverty: The Road Ahead*.

governance reforms. The World Bank has also approved structural adjustment credits for two provinces (Sindh and North West Frontier Province (NWFP)) supporting provincial reform strategies to improve resource management and strengthen provision of public services by local governments and communities. Further structural adjustment lending is planned, including follow-on provincial adjustment credits and a Poverty Reduction Support Credit.

5. The World Bank Group's support to strengthening the investment climate includes a combination of analytical work and financial assistance targeted to reforms in key sectors. The World Bank Group continues to perform analytical work to support the ongoing liberalization and modernization of trade, industrial, business, and labor regulations.

6. In the social sectors, the World Bank Group's assistance is geared toward support to the implementation of the Education Sector Reform (ESR) Strategy and the government's priority of strengthening public health programs and maternal and child health and family planning. Accordingly, the World Bank is focusing on: (a) programmatic support to the National Education Sector Reform Strategy; (b) support to the National Education Assessment System; (c) a program of analytical work to underpin the policy dialogue during the implementation of the ESR; and (d) province-based support to implementing the ESR within the fiscal and economic reforms of Sindh, NWFP, and an Education Sector Adjustment Credit for Punjab. In FY 2003, World Bank Group assistance to health sector reforms also included the HIV/AIDS Prevention Project and Partnership for Polio Eradication Project.

7. Supporting the rural sector through community-based infrastructure projects (particularly for water supply and sanitation services) and the increased availability of micro-credit have been part of the World Bank Group's strategy to reduce and mitigate risks for Pakistan's poor. The World Bank will continue to pilot new approaches, and also help scale up those which have proven effective such as the Community Infrastructure and Services Project (CIP) and the Pakistan Poverty Alleviation Fund (PPAF). Follow-on PPAF and CIP projects were approved in FY 2004.

8. IBRD and IDA have approved 85 loans and 122 credits to Pakistan since 1952, totaling $7,025.3 million and $7,891.9 million, respectively. Since 1999, Bank lending has totaled $2,992.8 million (see Table 1), with $800 million approved in fiscal year 2002, $297.2 million in 2003, and $781.2 million in 2004. As of September 30, 2004, there were 170 outstanding IBRD and IDA loans and credits representing a total obligation of 8,465.1 million. The World Bank active portfolio in Pakistan consisted of 18 lending operations with a total commitment of $1,450 million of which $898 million is undisbursed.

Table 1. Pakistan: World Bank Lending FY1999–2005
(as of September 30, 2004)

Project Name	Fiscal year Approved	Amount	Disbursed
Structural Adjustment Loan	1999	350.0	350.0
Poverty Alleviation Fund	1999	90.0	90.0
Trade & Transport	2001	3.0	2.3
NWFP On-Farm Water Management Project	2001	21.4	3.7
Structural Adjustment Credit	2001	350.0	343.9
Banking Sector Restructuring and Privatization Project	2002	300.0	211.2
Structural Adjustment Credit II	2002	500.0	510.3
Community Infrastructure & Services	2003	20.0	4.1
Banking Sector Technical Assistance	2003	26.5	6.6
Sindh Structural Adjustment Credit	2003	100.0	106.4
NWFP Structural Adjustment Credit	2003	90.0	95.8
Partnership for Polio Eradication	2003	20.0	20.0
HIV/AIDS Prevention Project	2003	37.1	1.6
National Education Assessment System	2003	3.6	0.2
Highways Rehabilitation	2004	200.0	16.4
Poverty Alleviation Fund II	2004	238.0	0.0
Punjab Education Reform Program	2004	100.0	100.6
Sindh On-Farm Water Management Project	2004	61.1	0.0
NWFP Community Infrastructure II (CIP2)	2004	37.1	0.0
PK Public Sector Capacity Building Project	2004	55.0	3.0
NWFP SAC II	2004	90.0	90.0
Poverty Reduction Support Credit I	2005	300.0	300.0

Bank-Fund collaboration in specific areas

9. As part of its overall assistance to Pakistan—through lending, country analytic work, and technical assistance—the World Bank supports policy reforms in the following areas in collaboration with the Fund:

a. **Financial sector reforms**. A major achievement of the reform process has been the transformation of a predominantly state-owned and weak banking system into a healthier, market-based system, owned primarily by the private sector. This has been supported by considerable strengthening of the legal and regulatory environment, and significant improvements in transparency, corporate governance, and credit culture. World Bank support is being provided through implementation of two ongoing projects: the Banking Sector Restructuring and Privatization Project and the Banking Sector Technical Assistance. A Banking Sector Adjustment Credit is planned in FY 2005. A joint World Bank/Fund Financial Sector Assessment Program (FSAP) was completed in FY 2004.

b. **Power sector reforms**. The Fund PRGF arrangement includes conditionality related to energy tariff adjustments and other power sector reforms with the aim of reducing the sector's fiscal burden. In the context of the structural adjustment operations approved in FY 2001 and FY 2002, the World Bank has continued to take the lead in working with the government of Pakistan to unbundle and corporatize the state-owned Water and Power Development Authority (WAPDA) with the eventual aim for privatizing the generation and distribution of electricity. The World Bank is currently working with the government on the finalization of a comprehensive medium-term adjustment program to improve the electric services to Pakistan's industry and households at lower cost and higher reliability.

c. **Public expenditure management**. Under a policy framework agreed with the government and the Fund, the World Bank is taking the lead in supporting implementation of the reform program while the Fund is providing related technical assistance. World Bank support is being provided in the context of the ongoing Pakistan Improvement of Financial Reporting and Accounting (PIFRA) project through which the national accounting and audit systems are being modernized. A follow-on PIFRA II project will further these efforts. Analytical and diagnostic support is being provided in the form of a Country Financial Accountability Assessment, which was completed in FY 2003, as well as provincial financial accountability assessments, as appropriate. Policy measures relating to financial management have been included as prior actions for World Bank structural adjustment lending at both the national and provincial level.

d. **Tax policy and administration reforms**. The Fund has taken the lead in supporting tax policy reforms, providing technical assistance leading, inter alia, to the formulation of an income tax reform package which became effective July 1, 2002. In consultation with the Fund and the World Bank, Pakistan has also launched a program for the fundamental restructuring of the Central Board of Revenues (CBR) in order to improve the efficiency of tax administration. The CBR reform effort is being supported by both the World Bank and the Fund. The structural performance criteria of the PRGF include adoption of tax policy changes and implementation of CBR reform. A planned World Bank tax administration reform project will support CBR reforms and is expected to be approved in FY 2005.

PAKISTAN: STATISTICAL ISSUES

1. The staff believes that data reporting and accounting procedures are broadly adequate for effective surveillance and program monitoring purposes. The authorities are responsive to data requests and report to the Fund, on a routine and timely basis, monthly data on external trade, prices, federal government expenditures and tax revenues, government bank borrowing, and money. Moreover, the authorities provide daily data through the resident representative's office on international reserves, exchange rates, and the Karachi Stock Exchange index.

2. The Pakistani authorities are strongly committed to adhering to internationally accepted standards and good practices, as demonstrated by their participation in 2003 in the General Data Dissemination System (GDDS). Pakistan meets the recommendations for the coverage, periodicity, and timeliness of most GDDS data categories. The only exceptions are the timeliness of the GDP and the lack of annual data on wages/earnings. For subscription to the Special Data Dissemination Standard (SDDS), Pakistan will need to disseminate (a) biweekly data on the analytical accounts of the SBP; (b) monthly transaction data on central government operations; (c) quarterly data on the GDP, employment, unemployment, and wages/earnings; (d) more detailed breakdown of data on central government debt; (e) annual data on its international investment position; and (f) update and expand the metadata on compilation and dissemination practices.

3. The Federal Bureau of Statistics (FBS) recently completed a revision of the national accounts, to bring them in line with the concepts and definitions of the *1993 System of National Accounts (1993 SNA)*. As part of this exercise, the base year was moved from 1980/81 to 1999/2000. There remains room for further improvement. Notably, informal economic activities need to be better captured, while newly emerging activities, such as in the information technology sector, continue to pose challenges. Some of these gaps will be identified when the results of the 1999/2000 Economic Census become available in 2004/05. The FBS intends to carry out another rebasing for 2004/05. Meanwhile, the FBS is also preparing the compilation of quarterly GDP data. With respect to labor market statistics, the FBS is investigating the feasibility of compiling quarterly employment/unemployment data and of disseminating data on wages/salaries.

4. The FBS produces three price indices: the consumer price index (CPI), wholesale price index (WPI), and the sensitive price indicator (SPI). The CPI and WPI are compiled on a monthly basis. The SPI is compiled on a weekly basis and consists of 46 essential commodities that are consumed by the lowest income group. The concepts and definitions of the CPI and WPI follow international guidelines. For prices, plans are to introduce classification of individual consumption by purpose (COICOP) and complete work on development of a Producer Price Index (PPI), with base year 1999/2000.

5. Government Finance Statistics (GFS) suffered from a lack of information on economic and functional classification of government outlays; and inadequate reporting by provinces on their fiscal operations. The concepts and definitions used in compiling GFS are broadly based on the methodology prescribed in *A Manual on Government Finance*

Statistics, 1986 (*GFSM 1986*), except that the treatment of privatization proceeds resembles the methodology of the *Government Finance Statistics Manual, 2001* (*GFSM 2001*). There are no specific plans to migrate to the *GFSM 2001* standard. The scope of GFS is budgetary general government, which covers the bulk of general government activity, but does not cover the activity of extra-budgetary units in central government. Classification and sectorization systems only follow *GFSM 1986* standards to a limited extent. Institutional sectors are not explicitly defined, since only budgetary data are covered in GFS. Central and provincial governments are distinguished, but local governments are included with the provincial governments. The classification of expenditure departs substantially from *GFSM 1986* methodology, both because the economic and functional classifications are not clearly distinguished, and because the level of detail falls far short of what is required. The basis of recording GFS is on, or close to, a cash basis, as required by the *GFSM 1986* standard. Transactions are recorded on a gross basis. Corrective transactions are not necessarily made in the original period, as required by *GFSM 1986*. Plans for improvement of GFS are taking place within the context of the Project for the Improvement of Financial Reporting and Auditing (PIFRA). In the longer term, the Ministry of Finance and Economic Affairs intends to adopt the *Government Finance Statistics Manual 2001 (GFSM 2001)*.

6. The analytical framework for monetary statistics reflects concepts and definitions that are based on the IMF's *Guide to Money and Banking Statistics in International Finance Statistics* of December 1984. The scope of the monetary statistics is comprehensive. The classification and sectorization of the monetary survey compiled by SBP's Statistics Department for reporting to the IMF and for internal use are broadly in line with the *Monetary and Financial Statistics Manual (MFSM)*. The basis for recording flows and stocks is largely consistent with *MFSM* and the SBP will continue to adopt the *MFSM* in order to further improve monetary statistics. In particular, the SBP plans to (a) disaggregate data on nonfinancial corporations and households within the private sector; (b) collect data on nonbank financial institutions to expand the coverage of the monetary aggregates; and (c) disseminate the analytical accounts of the SBP within two weeks after the end of the reference month.

7. Pakistan's balance of payments statistics are compiled broadly in accordance with the concepts and definitions of the *Balance of Payments Manual, Fifth Edition (BPM5)*. However, the presentation of the balance of payments on the web and in the publications of the SBP is still based on the *BPM4*. In general, the scope of the balance of payments pertaining to residency conforms to *BPM5*. The exceptions include the enterprises operating in the export processing zones and offshore banks, which are regarded as nonresidents, and Pakistani nationals residing abroad but owning a dwelling in Pakistan, who are considered residents. Classification and sectorization systems also follow *BPM5* to some extent, while the basis for recording transactions follows best international practices. Regarding the external sector, the SBP plans to (a) continue the implementation of the *BPM5*; (b) initiate plans to compile and publish data on the international investment position; and (c) disseminate the metadata for the template on International Reserves and Foreign Currency Liquidity on the SBP website.

Pakistan: Core Statistical Indicators
(As of October 15, 2004)

	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	October 15, 2004	October 15, 2004	August 31, 2004	August 31, 2004	August 31, 2004	September 2004	September 2004	September 2004	Q4 2003/04	Q4 2003/04	2003/ 2004	Q4 2003/04
Date Received	10/15/04	10/15/02	10/12/04	10/12/04	10/12/04	10/12/04	10/12/04	10/12/04	8/27/04	8/27/04	8/27/04	8/27/04
Frequency of Data 1/	D	D	M	M	M	M	M	M	Q	Q	A	Q
Frequency of Reporting 1/	D	D	M	M	M	M	M	M	Q	Q	A	Q
Source of Update 2/	A	A	A	A	A	A	A	A	A	A	A	A
Mode of Reporting 3/	C	C	C	C	C	C	C	C	V	V	C	V
Confidentiality 4/	C	B	C	C	C	C	C	C	C	C	C	C
Frequency of Publication 1/	D	W	M	M	M	M	M	M	Q	Q	A	Q

1/ A = annually; Q=quarterly; M=monthly; W=weekly; and D=daily.
2/ A = direct reporting by central bank, Ministry of Finance, or other official agency.
3/ C = cable, e-mail, or facsimile; and V=staff visits.
4/ B = for use by the staff and the Executive Board; C=unrestricted use.

PAKISTAN

MEDIUM-TERM SCENARIOS

1. **Pakistan has undergone substantial adjustment in recent years, improving economic performance and reducing vulnerabilities**. A combination of a pickup in economic growth, large primary surpluses, debt restructuring (through the Paris Club rescheduling in 2001, additional bilateral debt cancellation, and recent prepayments of high interest debts), declining domestic interest rates, and a number of structural reforms have contributed to the favorable outcome.

2. **Looking ahead, the authorities are pursuing an ambitious reform agenda aimed at accelerating economic growth**. This annex examines some macroeconomic scenarios and their implications for the sustainability of public and external debt.

Baseline Medium-Growth Scenario

3. **The baseline scenario assumes that the economy largely maintains its current momentum in the medium term (**Table 1). Economic growth slows only marginally to 6 percent per annum from 2004/05, driven by robust exports growth and consumption driven domestic demand, with a modest increase in the investment ratio. The current account (excluding grants) remains in a small deficit (nearly 1 percent of GDP), and external grants continue at around ½ percent of GDP. Reserves remain at about 5½ months of imports (Table 2).

4. **The government is assumed to support growth by prudent fiscal management**. The fiscal space created by generating modestly higher revenues, interest savings, and lower subsidies is used to substantially increase expenditure on social and development sectors. Thus, the overall deficit (excluding grants) is lowered to about 3 percent of GDP by 2008/09. The reduced borrowing need and a favorable growth-interest differential lower the stock of debt to around 53 percent of GDP by 2008/09.[17]

Alternative High-Growth Scenario

5. Under the ambitious high-growth scenario envisaged by the Pakistani government, growth accelerates, owing to a combination of structural reform and further improvements in external and domestic factors. South Asian trade integration and more liberal trade in clothing and textiles could provide strong growth impulses if external competitiveness continues to improve. Substantially higher public and private investment complement strong

[17] Due to the rebasing of GDP, most of the ratios presented in this analysis now appear significantly lower than projected in the previous staff report (IMF Country Report No. 04/211), which had been based on the old national accounts data. The estimated nominal rebased GDP is about 20 percent higher than previously reported.

consumption demand and exports. As a result, real GDP growth picks up to 8 percent per annum by 2007/08. Accelerated privatization of public enterprises and an overall improvement in the business climate buoys foreign direct investment (FDI). Strong import demand is generated by the strengthening economy, resulting in a larger current account deficit than in the baseline (reaching 2½ percent of GDP in 2008/09). In addition to FDI, increased official external borrowing closes the financing gap (Table 3).

6. **Successful implementation of tax reforms and increased momentum in the economy benefit the fiscal sector**. Revenues display greater buoyancy, rising by nearly 1½ percent of GDP between 2004/05 and 2008/09.[18] The improved revenue performance allows the authorities to devote additional resources to social and development spending, which rise by more than 1½ percent of GDP, while still allowing the fiscal deficit to continue to decline in line with the baseline projections. Although external borrowing is higher than in the baseline, total public debt falls as a share of the higher GDP.

Alternative Low-Growth Scenario

7. Under an alternative low-growth scenario, keeping key variables at their historical levels over the last 10 years, GDP growth would fall back to 3.5 percent. Such performance would mirror situations of major economic and political problems, similar to those that were underlying causes for the subdued growth rates during the 1990s (in the 15 years before 1990, growth averaged 6 percent). In spite of the much slower growth, public and external debt ratios would decline moderately, although more slowly than in the previous scenarios.

Sensitivity Analysis of Debt Sustainability

8. Public debt declines substantially in all three scenarios, contingent upon a positive growth-interest differential and continued primary surplus of about ½ percent of GDP. Under both the baseline and alternative scenarios, gross public debt declines to around 50 percent of GDP by 2008/09, compared to the peak of 89 percent in 2000/01 (Tables 4 and 5, Figure 1). By contrast, the low-growth scenario would imply a slower decline in the debt-to-GDP ratio to 60 percent in 2008/09.

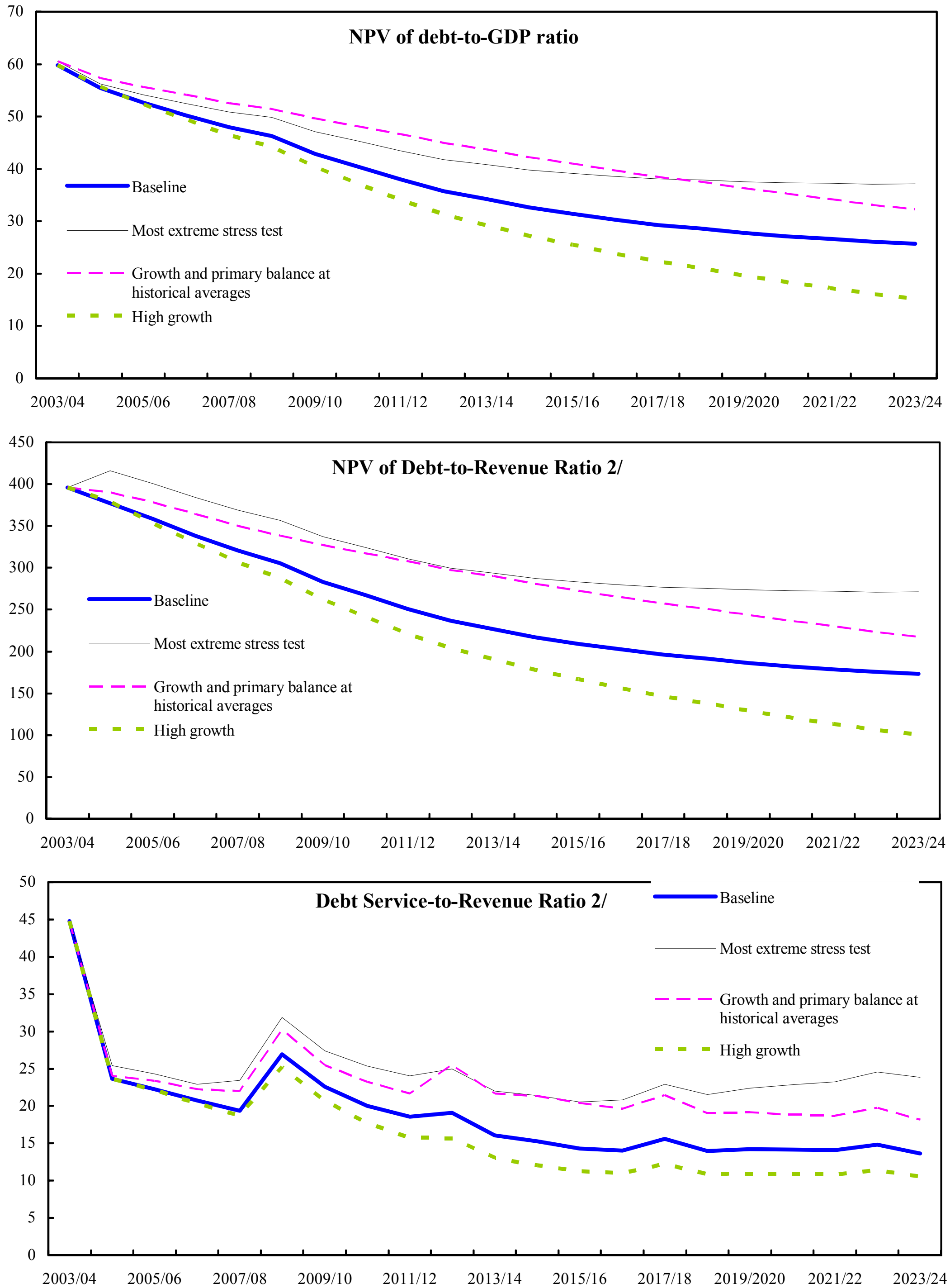
9. Bound tests indicate that the public debt path would remain on a downward trend, even if a number of downside risks were to materialize. A lower primary balance, lower growth, and a sharp exchange rate depreciation would affect the debt path, but the key ratios would continue to decline over the forecast horizon.

[18] World Bank and Fund staff agree that there is additional upside potential to the revenue outlook. Indeed, an ambitious administrative reform project of the CBR will commence in 2005 with World Bank support. Successful implementation of the project and acceleration of GDP growth could well lead to revenue ratios higher than envisaged in the alternative scenario.

10. **Despite the improvement to the outlook, a number of vulnerabilities remain**. The ratio of the net present value of external debt to exports (as well as revenues), while falling, remains in a range that signals exposure to risks (Tables 6 and 7, Figure 2). Under the baseline, the ratio of the net present value of public and publicly guaranteed external debt to exports is projected to decline from 172 percent in 2003/04 to 128 percent by 2008/09. Under the scenario assuming key variables at their historical averages, this ratio would decline only marginally, to 164 percent in 2008/09. Similarly, the bound tests point to continued vulnerabilities: while the majority of tests point to a continued reduction of the debt to exports ratio, under two tests the ratio would exceed 200 percent in 2005/06 before declining somewhat over the medium term.

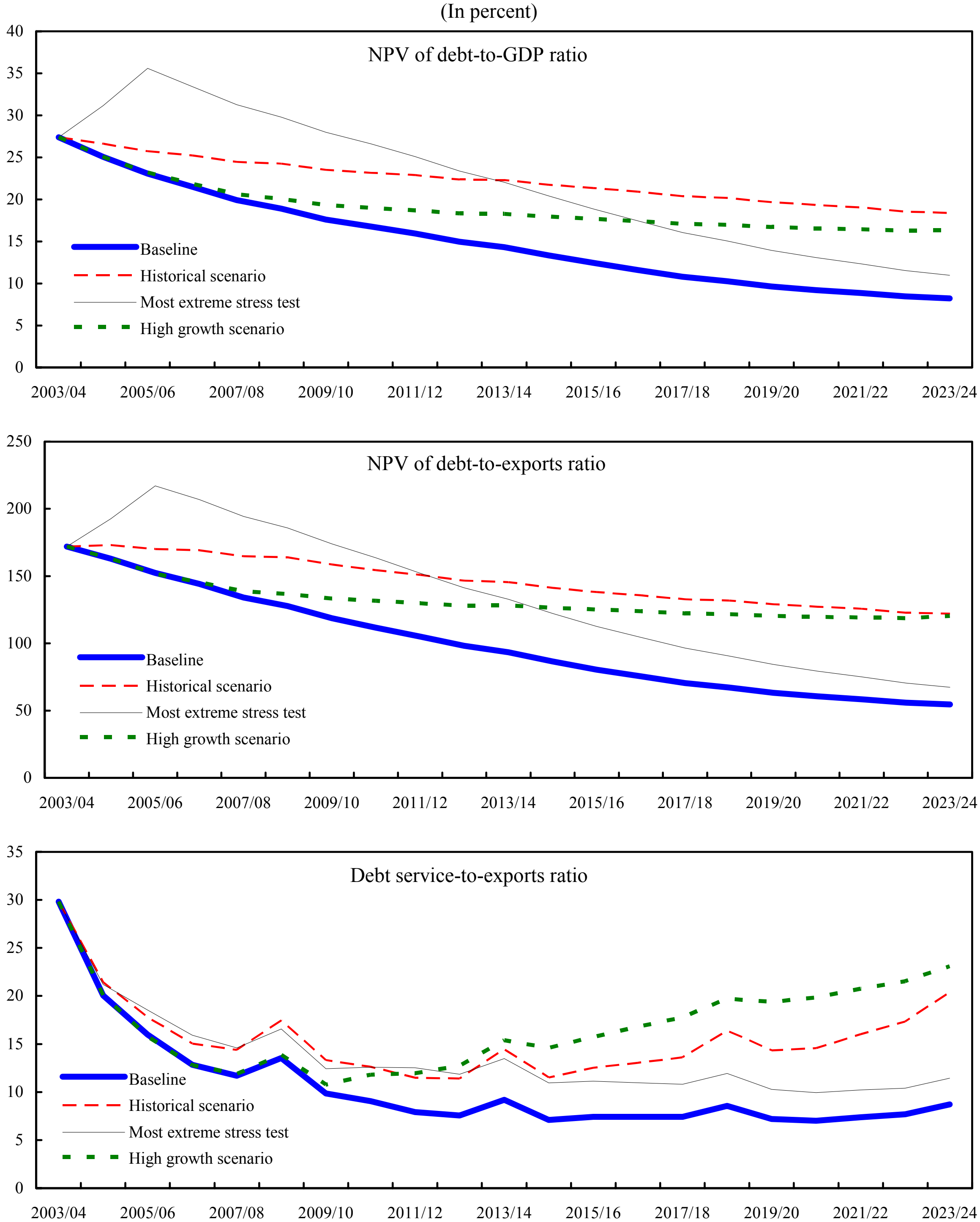
Figure 1. Pakistan: Indicators of Public Debt Under Alternative Scenarios, 2003/04–2023/24 1/

(In percent)



Source: Staff projections and simulations.
1/ Most extreme stress test is test that yields highest ratio in 2012/13.
2/ Revenue including grants.

Figure 2. Pakistan: Indicators of Public and Publicly Guaranteed External Debt Under Alternative Scenarios, 2003/04–2023/24
(In percent)



Source: Staff projections and simulations.

Table 1. Pakistan: Growth Scenarios, Selected Indicators, 2002/03–2008/09

			Projections				
	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09
			(In percent of GDP, unless indicated otherwise)				
A. Medium-growth scenario							
Output and prices							
Real GDP at factor costs (percent change)	5.1	6.4	6.5	6.0	6.0	6.0	6.0
Consumer prices (period average percent change)	3.1	4.6	7.0	5.0	4.0	4.0	4.0
GDP at market prices (in billions of Pakistani rupees)	4,821	5,458	6,164	6,863	7,568	8,344	9,199
GDP at market prices (in billions of U.S. dollars)	82.6	94.9	104.5	112.5	121.6	131.5	142.2
Per capita GDP (in U.S. dollars)	566	638	690	729	774	823	874
Savings and investment							
Gross national savings	21.8	20.1	19.2	20.1	20.8	21.6	22.3
Government	0.8	0.9	0.7	0.9	1.2	1.5	1.8
Nongovernment	21.0	19.2	18.5	19.2	19.6	20.1	20.5
Gross capital formation	16.7	18.1	19.9	20.5	21.2	22.0	22.8
Government	2.7	2.9	3.0	3.5	3.8	4.1	4.3
Nongovernment	14.1	15.1	16.8	17.0	17.4	18.0	18.4
Public finances							
Revenue (including grants)	17.4	15.1	14.7	14.7	14.9	15.0	15.2
Expenditure	18.8	16.9	17.0	17.3	17.4	17.5	17.7
Budget balance (excluding grants)	-3.8	-2.4	-3.2	-3.2	-3.1	-3.0	-2.9
Budget balance (including grants)	-1.4	-1.8	-2.3	-2.6	-2.5	-2.5	-2.5
Primary balance (including grants)	2.9	1.8	1.1	0.7	0.5	0.5	0.3
Total government debt	74.3	68.7	63.6	60.1	57.2	54.7	52.3
External sector							
Merchandise trade balance	-0.5	-1.3	-2.8	-2.5	-2.3	-2.0	-1.8
Current account excluding official transfers	3.8	1.4	-1.1	-0.9	-0.9	-0.8	-0.8
Current account including official transfers	5.1	2.0	-0.7	-0.4	-0.4	-0.4	-0.4
B. High-growth scenario							
Output and prices							
Real GDP at factor costs (percent change)	5.1	6.4	6.5	7.0	7.5	8.0	8.0
Consumer prices (period average percent change)	3.1	4.6	7.0	5.0	4.0	4.0	4.0
GDP at market prices (in billions of Pakistani rupees)	4,821	5,458	6,164	6,926	7,741	8,691	9,757
GDP at market prices (in billions of U.S. dollars)	82.6	94.9	104.5	113.5	124.4	137.0	150.8
Per capita GDP (in U.S. dollars)	566	638	690	736	792	857	927
Savings and investment							
Gross national savings	21.8	20.1	20.0	21.0	21.3	21.6	22.1
Government	0.8	0.9	0.7	1.0	1.3	1.6	1.8
Nongovernment	21.0	19.2	19.3	20.0	20.0	20.1	20.2
Gross capital formation	16.7	18.1	20.7	22.0	22.7	23.5	24.2
Government	2.7	2.9	3.1	3.5	3.7	3.9	4.1
Nongovernment	14.1	15.1	17.7	18.6	19.0	19.6	20.1
Public finances							
Revenue (including grants)	17.4	15.1	14.7	14.8	15.0	15.1	15.4
Expenditure	18.8	16.9	17.0	17.3	17.6	17.8	17.9
Budget balance (excluding grants)	-3.8	-2.4	-3.2	-3.2	-3.2	-3.1	-2.9
Budget balance (including grants)	-1.4	-1.8	-2.3	-2.6	-2.6	-2.7	-2.6
Primary balance (including grants)	2.9	1.8	1.1	0.7	0.4	0.2	0.2
Total government debt	74.3	68.7	63.6	59.5	56.1	52.9	49.9
External sector							
Merchandise trade balance	-0.5	-1.3	-2.8	-3.1	-3.1	-3.1	-3.1
Current account excluding official transfers	3.8	1.4	-1.1	-1.6	-1.9	-2.2	-2.5
Current account including official transfers	5.1	2.0	-0.7	-1.0	-1.4	-1.8	-2.1

Source: Pakistani authorities; and Fund staff projections.

Table 2. Pakistan: Medium-Term Balance of Payments, Baseline Medium Growth Screnario, 2001/02–2008/09

	2001/02	2002/03	2003/04 Prel Est.	2004/05 Rev. Proj.	2005/06 Proj.	2006/07 Proj.	2007/08 Proj.	2008/09 Proj.
	(In millions of U.S. dollars)							
Current account (excluding official transfers)	96	3,166	1,312	-1,127	-1,057	-1,098	-1,095	-1,156
Current account balance (including official transfers)	1,591	4,204	1,886	-717	-403	-448	-548	-611
Trade balance	-292	-444	-1,212	-2,974	-2,810	-2,791	-2,679	-2,554
Exports f.o.b.	9,140	10,889	12,395	13,635	14,444	15,585	16,909	18,347
Imports f.o.b.	-9,432	-11,333	-13,607	-16,609	-17,254	-18,375	-19,588	-20,900
Services (net)	-2,617	-2,127	-3,586	-4,393	-4,444	-4,574	-4,756	-5,004
Of which: interest payments	-1,579	-1,276	-1,050	-1,079	-1,113	-1,090	-1,056	-1,058
Private transfers (net)	3,005	5,737	6,110	6,240	6,197	6,267	6,339	6,402
Official transfers (net)	1,495	1,038	574	410	654	650	547	544
Capital account	-2,322	-1,709	-3,089	-1,531	-1,344	-945	-876	-634
Public medium- and long-term capital	-1,613	-1,656	-2,092	-531	-921	-698	-684	-447
Public sector short-term (net)	-1,064	-268	-856	-569	-550	-550	-550	-550
Private medium- and long-term	-80	164	493	264	614	752	797	854
Private short-term (including errors & omissions)	435	51	-634	-695	-487	-449	-439	-491
Overall balance (before debt relief)	-731	2,495	-1,203	-2,248	-1,748	-1,393	-1,424	-1,245
Financing	731	-2,495	1,203	2,248	1,748	1,393	1,424	1,245
Reserve assets (increase -)	-3,082	-5,261	-404	-398	-226	-721	-686	-623
State Bank of Pakistan (including FE-25s)	-2,717	-5,911	-427	-233	-99	-588	-546	-476
Deposit money banks	-365	650	23	-165	-127	-133	-140	-147
Fund repurchases	-194	-418	-673	-380	-327	-186	-190	-232
Net exceptional financing	4,007	3,185	2,280	3,026	2,300	2,300	2,300	2,100
Financing gap	0	0	0	0	0	0	0	0
Memorandum items:								
Current account (excluding official transfers, percent of GDP)	0.1	3.8	1.4	-1.1	-0.9	-0.9	-0.8	-0.8
Current account balance (including official transfers, percent of GDP)	2.2	5.1	2.0	-0.7	-0.4	-0.4	-0.4	-0.4
End-period gross official reserves 1/	4,330	9,521	10,556	10,789	10,867	11,370	11,816	12,182
(In months of next year imports of goods and nonfactor services)	3.7	6.4	6.0	5.9	5.6	5.6	5.4	5.3

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

1/ Excluding gold, foreign currency deposits held with the SBP, cash reserve requirement, and net of and outstanding short-term swap and forward contracts and the sinking fund.

Table 3. Pakistan: Medium-Term Balance of Payments, Alternative High Growth Scenario, 2001/02–2008/09

	2001/02	2002/03	2003/04 Prel Est.	2004/05 Rev. Proj.	2005/06 Proj.	2006/07 Proj.	2007/08 Proj.	2008/09 Proj.
	(In millions of U.S. dollars)							
Current account (excluding official transfers)	96	3,166	1,312	-1,127	-1,835	-2,417	-3,041	-3,762
Current account balance (including official transfers)	1,591	4,204	1,886	-717	-1,181	-1,766	-2,493	-3,218
Trade balance	-292	-444	-1,212	-2,974	-3,475	-3,894	-4,279	-4,661
Exports f.o.b.	9,140	10,889	12,395	13,635	14,786	16,154	17,727	19,434
Imports f.o.b.	-9,432	-11,333	-13,607	-16,609	-18,261	-20,048	-22,006	-24,095
Services (net)	-2,617	-2,127	-3,586	-4,393	-4,557	-4,790	-5,101	-5,503
Of which: interest payments	-1,579	-1,276	-1,050	-1,079	-1,138	-1,159	-1,190	-1,279
Private transfers (net)	3,005	5,737	6,110	6,240	6,197	6,267	6,339	6,402
Official transfers (net)	1,495	1,038	574	410	654	650	547	544
Capital account	-2,322	-1,709	-3,089	-1,531	-551	389	1,085	1,989
Public medium- and long-term capital	-1,613	-1,656	-2,092	-531	-548	-39	273	831
Public sector short-term (net)	-1,064	-268	-856	-569	-550	-550	-550	-550
Private medium- and long-term	-80	164	493	264	1,034	1,427	1,802	2,199
Private short-term (including errors & omissions)	435	51	-634	-695	-487	-449	-439	-491
Overall balance (before debt relief)	-731	2,495	-1,203	-2,248	-1,732	-1,377	-1,408	-1,229
Financing	731	-2,495	1,203	2,248	1,732	1,377	1,408	1,229
Reserve assets (increase -)	-3,082	-5,261	-404	-398	-241	-737	-702	-639
State Bank of Pakistan (including FE-25s)	-2,717	-5,911	-427	-233	-114	-604	-562	-492
Deposit money banks	-365	650	23	-165	-127	-133	-140	-147
Fund repurchases	-194	-418	-673	-380	-327	-186	-190	-232
Net exceptional financing	4,007	3,185	2,280	3,026	2,300	2,300	2,300	2,100
Financing gap	0	0	0	0	0	0	0	0
Memorandum items:								
Current account (excluding official transfers, percent of GDP)	0.1	3.8	1.4	-1.1	-1.6	-1.9	-2.2	-2.5
Current account balance (including official transfers, percent of GDP)	2.2	5.1	2.0	-0.7	-1.0	-1.4	-1.8	-2.1
Exports f.o.b. (growth rate, percent)	2.3	19.1	13.8	10.0	8.4	9.3	9.7	9.6
Imports f.o.b. (growth rate, percent)	-7.5	20.2	20.1	22.1	9.9	9.8	9.8	9.5
End-period gross official reserves 1/	4,330	9,521	10,556	10,789	10,883	11,402	11,864	12,246
(In months of next year imports of goods and nonfactor services)	3.7	6.4	6.0	5.6	5.2	5.0	4.8	4.7

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

1/ Excluding gold, foreign currency deposits held with the SBP, cash reserve requirement, and net of and outstanding short-term swap and forward contracts and the sinking fund.

Table 4. Pakistan: Public Sector Debt Sustainability Framework, Baseline Medium Growth Scenario, 1999/2000–2023/24

(In percent of GDP, unless otherwise indicated)

	Actual				Estimate	Historical Average 5/	Standard Deviation 5/	Projections								
	1999/2000	2000/01	2001/02	2002/03	2003/04			2004/05	2005/06	2006/07	2007/08	2008/09	2004/05-2008/09 Average	2013/14	2023/24	2009/10-2023/24 Average
Public sector debt 1/	83.7	88.8	79.7	74.3	68.7			63.6	60.4	57.7	55.2	52.9		39.1	28.0	
Of which: foreign-currency denominated	44.0	49.0	41.7	36.8	33.3			30.6	28.6	26.9	25.3	23.9		18.0	9.9	
Change in public sector debt	2.0	5.1	-9.1	-5.4	-5.6			-5.2	-3.2	-2.7	-2.4	-2.3		-2.1	-0.6	
Identified debt-creating flows	0.8	0.3	-1.7	-6.6	-5.8			-5.4	-2.9	-2.5	-2.3	-2.2		-1.2	0.0	
Primary deficit	-1.9	-2.3	-2.0	-3.0	-1.8	-0.7	1.6	-1.1	-0.6	-0.5	-0.3	-0.2	-0.6	-0.8	0.1	-0.5
Revenue and grants	14.4	14.3	16.1	17.3	15.1			14.7	14.7	14.8	14.9	15.1		15.1	14.8	
Of which: grants	0.9	1.0	1.9	2.4	0.6			0.9	0.6	0.6	0.4	0.4		0.0	0.0	
Primary (noninterest) expenditure	12.5	12.0	14.1	14.3	13.3			13.6	14.0	14.3	14.6	14.9		14.3	15.0	
Automatic debt dynamics	2.7	2.6	0.4	-3.5	-3.8			-4.0	-2.1	-1.9	-1.9	-1.8		-0.4	-0.2	
Contribution from interest rate/growth differential	2.4	4.7	2.0	-3.6	-5.1			-4.0	-2.1	-1.9	-1.9	-1.8		-0.7	-0.4	
Of which: contribution from average real interest rate	5.8	6.2	4.7	0.3	-0.9			0.2	1.5	1.5	1.4	1.3		1.2	1.0	
Of which: contribution from real GDP growth	-3.3	-1.5	-2.8	-3.9	-4.2			-4.2	-3.6	-3.4	-3.3	-3.1		-2.0	-1.4	
Contribution from real exchange rate depreciation	0.2	-2.1	-1.5	0.1	1.3			0.0	0.0	0.0	0.0	0.0		0.4	0.2	
Other identified debt-creating flows	0.0	0.0	-0.2	-0.1	-0.2			-0.2	-0.1	-0.1	-0.1	-0.1		0.0	0.0	
Privatization receipts (negative)	0.0	0.0	-0.2	-0.1	-0.2			-0.2	-0.1	-0.1	-0.1	-0.1		0.0	0.0	
Residual, including asset changes	1.2	4.8	-7.4	1.2	0.2			0.2	-0.3	-0.2	-0.2	-0.2		-0.9	-0.6	
NPV of public sector debt	...	...	...	65.5	59.8			55.4	52.6	50.2	47.9	46.3		34.2	25.7	
Of which: foreign-currency denominated	...	...	...	27.9	24.4			22.5	20.9	19.5	18.1	17.3		13.2	7.6	
Of which: external	...	...	...	27.1	23.7			21.9	20.4	19.1	17.8	17.1		13.2	7.6	
NPV of contingent liabilities (not yet officially recognized in public sector debt)	...	...	...	...	...			...	...	...	...	...		...	...	
Gross financing need 2/	4.6	3.3	3.6	1.4	5.0			2.3	2.6	2.6	2.6	3.9		1.6	2.2	
NPV of public sector debt-to-revenue ratio (in percent) 3/	...	...	...	378.2	395.7			377.2	358.4	338.6	320.7	305.6		227.0	173.3	
Of which: external	...	...	...	...	...			149.1	139.1	129.0	119.1	112.7		87.4	51.1	
Debt service-to-revenue ratio (in percent) 3/ 4/	44.9	39.5	34.7	25.1	44.8			23.6	22.3	20.7	19.4	27.0		16.1	13.7	
Primary deficit that stabilizes the debt-to-GDP ratio	-3.9	-7.4	7.1	2.4	3.8			4.0	2.5	2.2	2.1	2.1		1.3	0.7	
Key macroeconomic and fiscal assumptions																
Real GDP growth (in percent)	4.3	1.9	3.2	5.1	6.0	3.5	1.5	6.5	6.0	6.0	6.0	6.0	6.1	5.1	5.0	5.1
Average nominal interest rate on forex debt (in percent)	4.3	4.2	3.4	3.0	3.0	4.7	0.9	3.0	3.0	2.9	2.9	2.8	2.9	2.9	4.0	3.2
Average real interest rate on domestic currency debt (in percent)	11.0	7.4	8.4	6.3	3.8	5.7	4.2	1.7	3.5	4.3	4.1	3.9	3.5	3.4	3.6	3.5
Real exchange rate depreciation (in percent, + indicates depreciation)	0.5	-4.6	-2.9	0.2	3.6	-1.7	2.5	0.0	0.0	0.0	0.0	0.0	0.0	1.9	1.9	1.9
Inflation rate (in percent)	3.6	4.4	2.5	3.1	4.6	6.9	4.0	7.0	5.0	4.0	4.0	4.0	4.8	4.0	4.0	4.0
Growth of real primary spending (deflated by GDP deflator, in percent)	375.0	-2.4	21.7	6.9	-1.5	66.3	151.5	8.5	9.7	8.3	8.1	8.4	8.6	7.1	5.3	5.2
Grant element of new external borrowing (in percent)	...	...	...	...	...	...	...	41.0	46.2	46.2	46.2	27.2	41.4	19.0	5.6	19.9

Sources:Pakistani authorities; and Fund staff estimates and projections.

1/ The public sector is defined to include the the federal, provincial, and district governments (consolidated government). Public debt is gross debt.

2/ Gross financing need is defined as the primary deficit plus debt service plus the stock of short-term debt at the end of the last period.

3/ Revenues including grants.

4/ Debt service is defined as the sum of interest and amortization of medium and long-term debt.

5/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.

Table 5. Pakistan: Sensitivity Analyses for Key Indicators of Public Sector Debt , 2003/04–2023/24

	Estimate	Projections						
	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2013/14	2023/24
NPV of Debt-to-GDP Ratio								
Baseline	60	55	53	50	48	46	34	26
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	60	57	56	54	53	51	44	32
A2. High growth scenario (see text)	60	56	52	49	46	44	29	15
B. Bound tests								
B1. Real GDP growth is at baseline minus one standard deviations in 2004-2005	60	56	53	51	48	47	34	25
B2. Primary balance is at baseline minus one standard deviations in 2004-2005	60	57	53	51	48	46	33	23
B3. Combination of 2-3 using one half standard deviation shocks	60	56	53	51	48	46	33	23
B4. Long-run real GDP growth is at baseline minus one standard deviations	60	55	53	50	48	46	35	30
B5. One time 30 percent real depreciation in 2004	60	55	52	50	47	45	32	22
B6. 10 percent of GDP increase in other debt-creating flows in 2004	60	65	61	58	55	52	37	26
NPV of Debt-to-Revenue Ratio 1/								
Baseline	396	377	358	339	321	306	227	173
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	396	390	378	364	350	338	290	217
A2. High growth scenario (see text)	396	379	353	329	307	287	191	100
B. Bound tests								
B1. Real GDP growth is at baseline minus one standard deviations in 2004-2005	396	382	362	342	323	308	226	168
B2. Primary balance is at baseline minus one standard deviations in 2004-2005	396	385	364	343	323	306	220	153
B3. Combination of 2-3 using one half standard deviation shocks	396	383	363	341	321	305	219	153
B4. Long-run real GDP growth is at baseline minus one standard deviations	396	377	358	339	321	307	233	205
Debt-to-GDP Ratio								
Baseline	69	64	60	58	55	53	39	28
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	69	66	64	62	60	59	50	35
A2. High growth scenario (see text)	69	64	60	57	53	50	34	17
B. Bound tests								
B1. Real GDP growth is at baseline minus one standard deviations in 2004-2005	69	64	61	58	56	53	39	27
B2. Primary balance is at baseline minus one standard deviations in 2004-2005	69	65	61	58	56	53	38	25
B3. Combination of 2-3 using one half standard deviation shocks	69	65	61	58	55	53	38	25
B4. Long-run real GDP growth is at baseline minus one standard deviations	69	63	60	58	55	53	40	34
Debt Service-to-Revenue Ratio 1/								
Baseline	45	24	22	21	19	27	16	14
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	45	24	23	22	22	30	22	18
A2. High growth scenario (see text)	45	24	22	20	19	25	13	11
B. Bound tests								
B1. Real GDP growth is at baseline minus one standard deviations in 2004-2005	45	24	22	21	20	27	16	14
B2. Primary balance is at baseline minus one standard deviations in 2004-2005	45	23	23	21	22	27	16	13
B3. Combination of 2-3 using one half standard deviation shocks	45	24	22	21	21	27	16	13
B4. Long-run real GDP growth is at baseline minus one standard deviations	45	23	22	21	19	27	17	17
Debt Service-to-GDP Ratio								
Baseline	7	3	3	3	3	4	2	2
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	7	4	3	3	3	5	3	3
A2. High growth scenario (see text)	7	4	4	4	3	4	3	3
B. Bound tests								
B1. Real GDP growth is at baseline minus one standard deviations in 2004-2005	7	3	3	3	3	4	2	2
B2. Primary balance is at baseline minus one standard deviations in 2004-2005	7	3	3	3	3	4	2	2
B3. Combination of 2-3 using one half standard deviation shocks	7	3	3	3	3	4	2	2
B4. Long-run real GDP growth is at baseline minus one standard deviations	7	3	3	3	3	4	3	3

Sources: Pakistani authorities; and Fund staff estimates and projections.

1/ Revenues are defined inclusive of grants.

Table 6. Pakistan: External Debt Sustainability Framework, Baseline Medium Growth Scenario, 2000/01–2023/24 1/

(In percent of GDP, unless otherwise indicated)

	Actual			Historical Average 6/	Standard Deviation 6/	Prel. Est.	Projections								
	2000/01	2001/02	2002/03			2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2003/04–2007/08 Average	2013/14	2023/24	2009/10–2023/24 Average
External debt (nominal) 1/	**49.3**	**49.5**	**42.5**			**37.0**	**33.7**	**31.4**	**29.5**	**27.6**	**25.9**		**19.2**	**10.9**	
Of which: public and publicly guaranteed (PPG)	44.6	45.5	39.4			34.8	32.1	30.0	28.0	26.2	24.6		18.1	9.8	
Change in external debt	1.5	0.2	-7.0			-5.5	-3.3	-2.3	-2.0	-1.8	-1.8		-1.2	-0.5	
Identified net debt-creating flows	2.4	-3.0	-12.3			-5.0	-2.0	-2.1	-1.9	-1.7	-1.6		-1.4	-0.6	
Non-interest current account deficit	**-0.6**	**-4.3**	**-6.6**	**-0.3**	**3.1**	**-3.0**	**-0.3**	**-0.6**	**-0.5**	**-0.4**	**-0.3**		**-0.4**	**0.0**	-0.3
Deficit in balance of goods and services	3.2	0.8	0.4			2.7	4.9	4.4	4.1	3.8	3.6		2.4	2.0	
Exports	14.4	15.4	16.6			15.9	15.4	15.1	14.9	14.8	14.8		15.3	15.1	
Imports	17.5	16.2	17.0			18.7	20.3	19.5	19.0	18.7	18.4		17.8	17.1	
Net current transfers (negative = inflow)	-4.6	-6.3	-8.2	-4.7	1.4	-7.0	-6.4	-6.1	-5.7	-5.2	-4.9		-3.8	-2.7	-3.5
Other current account flows (negative = net inflow)	0.9	1.2	1.2			1.3	1.1	1.1	1.1	1.0	1.0		0.9	0.7	
Net FDI (negative = inflow)	**-0.5**	**-0.5**	**-0.7**	**-0.7**	**0.3**	**-0.8**	**-0.5**	**-0.5**	**-0.5**	**-0.5**	**-0.5**		**-0.5**	**-0.5**	-0.5
Endogenous debt dynamics 2/	**3.5**	**1.8**	**-4.9**			**-1.2**	**-1.2**	**-0.9**	**-0.9**	**-0.8**	**-0.8**		**-0.4**	**-0.1**	
Contribution from nominal interest rate	2.1	2.1	1.5			1.0	1.0	1.0	0.9	0.8	0.7		0.5	0.4	
Contribution from real GDP growth	-0.9	-1.6	-2.2			-2.2	-2.2	-1.9	-1.8	-1.6	-1.5		-1.0	-0.5	
Contribution from price and exchange rate changes	2.2	1.3	-4.2			…	…	…	…	…	…	…	…	…	
Residual (3-4) 3/	**-1.0**	**3.2**	**5.3**			**-0.5**	**-1.3**	**-0.2**	**-0.1**	**-0.1**	**-0.1**		**0.1**	**0.1**	
NPV of external debt 4/	...	...	34.1			29.6	26.7	24.5	22.9	21.3	20.2		15.4	9.3	
In percent of exports	...	...	205.5			186.1	173.5	162.1	153.8	143.5	136.7		100.5	61.8	
NPV of PPG external debt	**...**	**...**	**31.0**			**27.4**	**25.1**	**23.1**	**21.5**	**19.9**	**18.9**		**14.3**	**8.2**	
In percent of exports	...	...	187.1			171.9	163.0	152.4	144.2	134.1	127.8		93.4	54.5	
Debt service-to-exports ratio (in percent)	34.6	40.5	31.8			34.8	23.8	18.5	14.8	13.6	15.3		10.5	9.9	
PPG debt service-to-exports ratio (in percent)	27.8	33.8	26.3			29.8	20.1	16.0	12.8	11.7	13.5		9.2	8.7	
Total gross financing need (billions of U.S. dollars)	6.2	4.0	1.8			3.0	5.2	3.6	3.1	3.2	3.8		3.1	6.0	
Non-interest current account deficit that stabilizes debt ratio	-2.0	-4.4	0.4			2.4	3.0	1.6	1.4	1.5	1.4		0.8	0.5	
Key macroeconomic assumptions															
Real GDP at market prices (change in percent)	1.9	3.2	5.1	3.5	1.4	6.0	6.5	6.0	6.0	6.0	6.0	6.1	5.1	5.0	5.1
GDP deflator in U.S. dollar terms (change in percent)	-4.5	-2.6	9.3	-0.5	6.1	8.4	3.3	1.5	2.0	2.0	2.0	3.2	2.0	2.0	2.0
Effective interest rate (percent) 5/	4.3	4.2	3.4	4.8	0.7	2.8	3.0	3.1	3.1	2.9	2.9	3.0	2.9	4.0	3.1
Growth of exports of G&S (U.S. dollar terms, in percent)	7.4	7.5	23.8	5.5	9.4	10.5	6.2	5.9	6.6	7.7	7.7	7.4	7.6	6.8	7.3
Growth of imports of G&S (U.S. dollar terms, in percent)	6.6	-7.1	20.6	1.6	12.7	26.1	19.8	3.4	5.4	6.2	6.3	11.2	6.6	6.7	6.7
Grant element of new public sector borrowing (in percent)	...	...	...	...	...	...	43.0	46.2	46.2	46.2	27.2	41.8	19.0	5.6	19.9
Memorandum item:															
Nominal GDP (billions of U.S. dollars)	71.5	71.9	82.6			94.9	104.5	112.5	121.6	131.5	142.2		202.5	402.7	

Source: Staff simulations.

1/ Includes both public and private sector external debt. Debt-to-GDP ratios are lower than previously reported given the recent revision of GDP figures.
2/ Derived as [r - g - r(1+g)]/(1+g+r+gr) times previous period debt ratio, with r = nominal interest rate; g = real GDP growth rate; and r = growth rate of GDP deflator in U.S. dollar terms.
3/ Includes exceptional financing (i.e., changes in arrears and debt relief); changes in gross foreign assets; and valuation adjustments. For projections also includes contribution from price and exchange rate changes.
4/ Assumes that NPV of private sector debt is equivalent to its face value.
5/ Current year interest payments divided by previous period debt stock.
6/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.

Table 7. Pakistan: Sensitivity Analyses for Key Indicators of Public and Publicly Guaranteed External Debt, 2002/03–2023/24

(In percent)

		Prel. Est.	Projections						
	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	**2013/14**	2023/24
NPV of debt-to-GDP ratio									
Baseline	31	27	25	23	22	20	19	**14**	8
A. Alternative Scenarios									
A1. High growth scenario (see text)	...	27	25	23	22	21	20	**18**	16
A2. Key variables at their historical averages in 2004/05–2023/24 1/	...	27	27	26	25	24	24	**22**	18
A3. New public sector loans on less favorable terms in 2004/05–2023/24 2/	...	27	26	24	23	21	21	**17**	12
B. Bound Tests									
B1. Real GDP growth at historical average minus one standard deviation in 2004/05–2005/06	...	27	26	25	23	22	20	**15**	9
B2. Export value growth at historical average minus one standard deviation in 2004/05–2005/06 3/	...	27	26	27	25	23	22	**17**	9
B3. U.S. dollar GDP deflator at historical average minus one standard deviation in 2004/05–2005/06	...	27	28	28	26	24	23	**17**	10
B4. Net non-debt creating flows at historical average minus one standard deviation in 2004/05–2005/06 4/	...	27	28	28	26	25	23	**17**	9
B5. Combination of B1-B4 using one-half standard deviation shocks	...	27	31	36	33	31	30	**22**	11
B6. One-time 30 percent nominal depreciation relative to the baseline in 2004/05 5/	...	27	35	33	30	28	27	**20**	12
NPV of debt-to-exports ratio									
Baseline	187	172	163	152	144	134	128	**93**	55
A. Alternative Scenarios									
A1. High growth scenario (see text)	...	172	163	152	145	139	137	**128**	120
A2. Key variables at their historical averages in 2004/05–2023/24 1/	...	172	173	170	169	165	164	**146**	122
A3. New public sector loans on less favorable terms in 2004/05–2023/24 2/	...	172	166	158	151	143	139	**110**	79
B. Bound Tests									
B1. Real GDP growth at historical average minus one standard deviation in 2004/05–2005/06	...	172	163	152	144	134	128	**93**	55
B2. Export value growth at historical average minus one standard deviation in 2004/05–2005/06 3/	...	172	190	216	205	192	183	**132**	71
B3. U.S. dollar GDP deflator at historical average minus one standard deviation in 2004/05–2005/06	...	172	163	152	144	134	128	**93**	55
B4. Net non-debt creating flows at historical average minus one standard deviation in 2004/05–2005/06 4/	...	172	180	185	177	165	158	**113**	59
B5. Combination of B1-B4 using one-half standard deviation shocks	...	172	193	217	207	194	186	**133**	67
B6. One-time 30 percent nominal depreciation relative to the baseline in 2004/05 5/	...	172	163	152	144	134	128	**93**	55
Debt service ratio									
Baseline	26	30	20	16	13	12	14	**9**	9
A. Alternative Scenarios									
A1. High growth scenario (see text)	...	30	20	16	13	12	14	**15**	23
A2. Key variables at their historical averages in 2004/05–2023/24 1/	...	30	21	18	15	14	17	**14**	20
A3. New public sector loans on less favorable terms in 2004/05–2023/24 2/	...	30	20	16	13	11	13	**9**	10
B. Bound Tests									
B1. Real GDP growth at historical average minus one standard deviation in 2004/05–2005/06	...	30	20	16	13	12	14	**9**	9
B2. Export value growth at historical average minus one standard deviation in 2004/05–2005/06 3/	...	30	22	20	17	15	18	**13**	12
B3. U.S. dollar GDP deflator at historical average minus one standard deviation in 2004/05–2005/06	...	30	20	16	13	12	14	**9**	9
B4. Net non-debt creating flows at historical average minus one standard deviation in 2004/05–2005/06 4/	...	30	20	17	14	13	15	**11**	10
B5. Combination of B1-B4 using one-half standard deviation shocks	...	30	21	19	16	15	17	**13**	11
B6. One-time 30 percent nominal depreciation relative to the baseline in 2004/05 5/	...	30	20	16	13	12	14	**9**	9
Memorandum item:									
Grant element assumed on residual financing (i.e., financing required above baseline) 6/	...	...	17	17	17	17	17	**17**	17

Source: Staff projections and simulations.

1/ Variables include real GDP growth, growth of GDP deflator (in U.S. dollar terms), non-interest current account in percent of GDP, and nondebt creating flows.
2/ Assumes that the interest rate on new borrowing is by 2 percentage points higher than in the baseline, while grace and maturity periods are the same as in the baseline.
3/ Exports values are assumed to remain permanently at the lower level, but the current account as a share of GDP is assumed to return to its baseline level after the shock (implicitly assuming an offsetting adjustment in import levels).
4/ Includes official and private transfers and FDI.
5/ Depreciation is defined as percentage decline in U.S. dollar/local currency rate, such that it never exceeds 100 percent.
6/ Applies to all stress scenarios except for A2 (less favorable financing) in which the terms on all new financing are as specified in Footnote 2.

November 12, 2004

Mr. Rodrigo de Rato
Managing Director
International Monetary Fund
Washington, D.C. 20431
U.S.A.

Dear Mr. de Rato:

While Pakistan exits from its Poverty Reduction and Growth Facility (PRGF) arrangement, the government remains committed to the economic strategy outlined in the Poverty Reduction Strategy Paper (PRSP), which aims to create an enabling environment for sustained high growth, job creation, and poverty reduction.

We held discussions with Fund staff in August/September 2004 for the ninth review under the PRGF arrangement. The attached Memorandum of Economic and Financial Policies (MEFP) reviews economic developments and policy implementation through August 2004, and discusses our policies for 2004/05 and beyond. It supplements the MEFP dated November 22, 2001, as well as the supplementary MEFPs dated March 12, 2002, June 18, 2002, October 16, 2002, February 8, 2003, May 29, 2003, October 11, 2003, and June 7, 2004.

All quantitative performance criteria for end-June 2004 were met. Moreover, most structural performance criteria were met, except for: (i) the introduction or extension of tax exemptions; (ii) the announcement of a tariff and subsidy policy for regional electricity tariff setting; (iii) the publication of financial recovery plans for the successor companies of the Water and Power Development Authority (WAPDA); and (iv) the performance criterion on not imposing or intensifying restrictions on payments and transfers for current international transactions. The tax exemptions are intended to strengthen our business climate, and the minor negative revenue impact has been more than offset by revenue raising measures taken in the budget. The tariff and subsidy policy was announced in early November. However, the financial recovery plans are further delayed because the regulator has yet to determine tariffs consistent with the cost recovery principle. We temporarily intensified an existing, and imposed one new restriction on advance payments of certain imports, but upon learning that this constituted a breach of a performance criterion, we have taken remedial measures to reinstate the status quo ante.

In light of our improved external situation, which is much better than projected, and despite the temporary pressures in the foreign exchange market, we have decided not to draw the tenth and final tranche under the PRGF so that these resources would become available for other countries in need of concessional support from the Fund.

On this basis, and in view of the policies set out in the attached MEFP, the government requests waivers for the nonobservance of the structural performance criteria listed above, and the completion of the ninth review.

We look forward to our continued cooperation with the Fund, in the context of its normal consultation with member countries on their economic developments and policies. In this regard, the government will, of course, continue to provide the Fund with such information as the Fund may request in connection with Pakistan's progress in implementing its economic and financial policies.

Sincerely yours,

/s/
Salman Shah
Advisor to the Prime Minister on Finance

/s/
Ishrat Husain
Governor
State Bank of Pakistan

Attachment:
Memorandum of Economic and Financial Policies

PAKISTAN

Memorandum of Economic and Financial Policies

I. INTRODUCTION

1. Pakistan's three-year arrangement under the IMF's Poverty Reduction and Growth Facility (PRGF) will come to an end in December 2004. With this, we will also bring to a close a long period of financial support from the IMF. Instead, in the period ahead, Pakistan will primarily rely on domestic and international markets to meet its financing needs, complemented by continued support from official creditors including the World Bank and the Asian Development Bank. Indeed, we have already made a successful re-entry in the international capital markets earlier this year.

2. **The end of IMF-supported programs, however, will not result in a shift in our economic policies.** On the contrary, the prudent fiscal and monetary policies, combined with broad-based structural reforms, implemented in the past few years have served Pakistan well. The country has made an impressive recovery from macroeconomic crisis to stability and a resumption of economic growth. Fiscal and external vulnerabilities have been reduced, through a reduction in fiscal imbalances and supported by debt relief and other assistance provided by the international community.

3. **The task ahead is to maintain stability and further accelerate economic growth.** Strong growth will remain crucial for creating new employment opportunities and reducing poverty. Thus, we will need to continue on the path set out in our Poverty Reduction Strategy Paper (PRSP) "Accelerating Economic Growth and Reducing Poverty." We will continue to implement sound financial policies and will further advance our reform agenda to create a vibrant market-based economy. In addition, our policies will also continue to aim to reduce poverty through greater social inclusion, including through human development and devolution of political and economic power.

4. This Memorandum of Economic and Financial Policies reviews macroeconomic performance and the implementation of structural measures in 2003/04 and sets out our economic policies for the remainder of 2004/05. It provides an update on our policy objectives and prospects for the current fiscal year, as well as on the actions we have already taken or will take to help achieve these objectives.

II. RECENT DEVELOPMENTS

5. **The economy continues to gather steam.** Real GDP growth accelerated to 6.4 percent in 2003/04, exceeding our target of 5.3 percent by a wide margin, and up from 5.1 percent in the preceding year. Growth has been strong across most sectors, but has been most pronounced in the large-scale manufacturing sector. Moreover, growth is broadening from predominantly export-led to being domestic demand-driven as well. Exports and

imports grew by 13.8 percent and 20.1 percent, respectively, in U.S. dollar terms. In U.S. dollar terms, per capita GDP has increased from \$500 in 2001/02 to \$638 in 2003/04.

6. **Inflation has picked up, however.** Annual average inflation in 2003/04 was 4.6 percent, marginally exceeding our 4.1 percent target. The pickup in inflation is more visible in the twelve-month rate of inflation, which has increased from 1.9 percent in June 2003 to 9.0 percent in September 2004. To some extent, this increase in inflation reflects special factors, notably the sharp increase in wheat prices during 2003/04 that resulted from an unanticipated shortage in the supply of wheat, as well as an increase in the support price of wheat. Similarly, the rise in international oil prices contributed to inflation, although the full effect of this has not been passed on to consumer prices. Strong demand and a rapid expansion of credit also contributed to inflation. Notably, house rents, which have a relatively large share in the consumer price index, have increased significantly.

7. **The 2003/04 overall budget deficit remained well within its limits.** The consolidated government deficit (excluding grants) is estimated at PRs 129 billion (2.4 percent of GDP), considerably less than the budget target of PRs 179 billion (3.3 percent of GDP). As a result, the ratio of public debt to GDP fell to under 70 percent, down from its peak of 89 percent in 2000/01. Revenue collection by the Central Board of Revenue (CBR) exceeded the target by a solid margin, reaching PRs 519 billion or 9.5 percent of GDP. Revenue performance benefited from the higher-than-expected rate of economic growth, but also reflected the impact of our ongoing efforts to strengthen revenue administration. Social- and poverty-related expenditures, as well as development expenditures exceeded budget projections, which is a welcome break with past trends of underutilizing resources and attests to improved implementation capacity.

8. **The State Bank of Pakistan (SBP) has started to tighten monetary policy, slowly but steadily, in response to rising inflation and continued strong money growth**. Short-term interest rates (six-month treasury bills) have been increased by 2.07 percentage points since the start of 2004 to 3.73 percent in November. Broad money grew by 19.6 percent in 2003/04, while reserve money grew by 15.4 percent. Credit to the private sector continued to grow rapidly, at almost 30 percent, reflecting the buoyant economy, low interest rates, and ample liquidity in banks.

9. **All quantitative performance criteria under the PRGF arrangement set for end-June 2004 were met (Table 1a).** Similarly, all but two of the indicative targets for end-March and end-June were also met. Exceptions were the end-March target for social- and poverty-related spending—which was missed by a small margin—and the end-March ceiling on the contracting or guaranteeing of nonconsessional medium- and long-term debt. The latter ceiling was breached due to a government guarantee on a larger-than-anticipated loan contracted by Pakistan International Airlines (PIA). Given PIA's improved performance, the IMF's Executive Board augmented the end-June ceiling during the completion of the eighth review under our PRGF arrangement to accommodate this guarantee. The shortfall in social- and poverty-related spending was more than made up by end-June.

10. **Further progress was made in implementing structural reform measures, although some slippages and delays occurred (Table 2)**. In the area of tax policy, the 2004/05 budget removed income and sales tax exemptions and incorporated other base-broadening measures that together will yield a total of PRs 5 billion. However, some new exemptions were introduced with the 2004/05 budget, including exemptions for: (i) income tax on vocational and technical institutions; (ii) import duties on all agricultural machinery; (iii) import duties on raw materials for pesticides; and (iv) import duties on commercial aircraft and engines. In addition, the exemption for capital gains tax was extended. These exemptions aim to remove anomalies and discriminatory practices in the tax system, as well as promote investment. The revenue impact of these measures is estimated to be small: less than 0.1 percent of GDP and, in any event, revenues in 2004/05 are projected to be substantially higher than projected earlier under the program.

11. **Revenue administration** was strengthened further as: (i) a pilot customs office has been opened in the port of Karachi that will allow much faster processing and clearance; (ii) two additional medium-taxpayers units (MTU), organized along functional lines, have been opened; and (iii) a new large-taxpayers unit (LTU) has become operational in Lahore.

12. In the **energy sector**, the Water and Power Development Authority (WAPDA) and the Karachi Electric Supply Company (KESC) met their financial targets for 2003/04. WAPDA benefited from a greater availability of hydro energy, while both WAPDA and KESC realized higher production and sales volumes. The Ministry of Water and Power issued the broad principles for the determination of regional electricity tariffs in June 2004. These principles clarified the respective roles of the government, National Electric Power Regulatory Authority (NEPRA), and the power companies in the setting of tariffs. Following this, NEPRA completed the process of determining the structural tariffs for the individual distribution companies succeeding WAPDA. Subsequently, eight distribution companies filed review motions with NEPRA because the tariff determinations were below cost recovery. NEPRA's revised determination issued in late October also fell short of the cost recovery principle. The determination would have implied much higher-than-budgeted government subsidies to the utilities and would have put our fiscal targets at risk. Therefore, the government rejected the revised determination and has asked NEPRA to review its decision again. The government's electricity subsidy policy was announced in November and aims to ensure that distribution companies achieve cost recovery while protecting consumers from very high tariffs that are not viable on social and economic grounds. The policy also sets a timetable for phasing out electricity subsidies by 2010.

13. With the structural tariffs under review, the Financial Recovery Plans (FRPs) for the distribution companies could not be finalized by end-July as planned. Instead, the companies presented financial scenarios based both on the initially determined tariffs, as well as on the tariffs aimed for in their review motions. We are confident that this will prove to have been a useful exercise that aided the distribution companies in the review process and will allow them to quickly finalize their FRPs once NEPRA had determined new tariffs.

14. In the area of **financial sector** reform, following the sale of Habib Bank Limited (HBL) earlier this year, in August, Allied Bank Limited (ABL) was transferred into private ownership through the sale of additional shares. With this, our agenda for the restructuring and privatization of the banking sector has been almost completed, leaving only the Industrial Development Bank of Pakistan (IDBP) to be divested. National Savings Schemes (NSS) rates were adjusted on July 1, 2004, based on the new formula, to better align them with yields on Pakistan Investment Bonds (PIBs). To help combat money laundering, we have issued several regulations that require inter alia reporting of suspicious transactions and set out minimum record keeping standards to ensure compliance with Financial Task Force recommendations. Discussions among all stakeholders continue on the drafting of the *Benami* law and we expect to submit a first draft to the Cabinet in 2005.

III. Economic and Financial Policies for the Remainder of 2004/05

A. Macroeconomic Framework

15. **Economic growth in 2004/05 is forecast to reach about 6.5 percent,** building on the current momentum and provided that weather conditions remain favorable. Over the medium term, we are aiming to further accelerate the pace of economic growth and reach 8 percent annually. This will require the steadfast implementation of sound financial policies and structural reforms to promote investment, as discussed in our PRSP. Moreover, to achieve such a high rate of economic growth, it will be crucial to substantially increase productivity in the agricultural sector, which accounts for almost one quarter of Pakistan's output. Thus, in our policies we are placing particular emphasis on this sector, with improving the availability of water as one of our key objectives. Furthermore, to achieve and sustain such high economic growth, we will require strong physical infrastructure, for which we are allocating a large sum in the federal budget.

16. **Given recent trends in inflation, annual average inflation in 2004/05 is expected to exceed the 5 percent target.** By further tightening monetary policy, together with measures to regularize conditions in the wheat market, we aim to reduce the twelve-month rate of inflation to 4–5 percent by June 2005, but due to the carry over of price increases in 2003/04, this implies an annual average rate of inflation for 2004/05 of about 7 percent.

B. Fiscal Policy

17. **The budget for 2004/05 adopted in June balances the need for increased social and development spending and a further reduction of the debt burden**. The 2004/05 budget limits the consolidated government overall deficit (excluding grants) to PRs 199 billion (equivalent to 3.2 percent of GDP). Social- and poverty-related expenditures are budgeted to reach PRs 278 billion (4.5 percent of GDP, compared to 3.8 percent of GDP in the previous year), while the Public Sector Development Program was raised to PRs 188 billion (3.0 percent of GDP).

18. **A few measures were taken in the context of the budget that will need to be accommodated within the overall envelope.** This includes an increase in government wages and pensions by 15 percent—estimated to cost PRs 16 billion—and the further reduction in petroleum development levies to insulate domestic petroleum prices from the recent increase in international oil prices. Assuming that international oil prices will gradually decline in line with the IMF's World Economic Outlook projections, this measure is estimated to result in a revenue loss of some PRs 30 billion. Offsetting these measures will be a higher-than-budgeted collection of revenues by the CBR (PRs 10 billion), due to a higher base in 2003/04 and a slightly higher nominal income growth this year; lower-than-budgeted subsidies (PRs 6 billion); and higher-than-budgeted nontax revenues (PRs 30 billion). The latter stems from higher-than-anticipated dividends from public enterprises and other receipts. Once the current spike in oil prices has passed, we will return petroleum development levies to the levels prevailing at the beginning of 2004 and will resume the fortnightly adjustment of domestic petroleum prices in line with import costs.

19. **The 2004/05 budget and current nominal growth projections imply a further reduction in the public debt-to-GDP ratio to about 64 percent**. This is in line with the path set out in the PRSP and the draft Fiscal Responsibility Law (FRL). The draft FRL has already been approved by the Standing Committee on Finance of the National Assembly and we expect parliamentary approval later this year.

C. Monetary and Exchange Rate Policy

20. **Monetary policy will be tightened further to help contain inflationary pressures.** As noted above, our goal is to reduce twelve-month inflation to about 5 percent by the end of 2004/05. An increased supply of wheat will help contain further increases in food prices, but considerable uncertainty remains about the development of oil prices. Moreover, interest rates in international markets have begun to edge upwards and they are expected to continue to rise in the months ahead. Thus, to avoid undue pressure on the exchange rate of the Pakistani rupee, interest rates in Pakistan will have to rise as well. But in determining the appropriate pace of raising interest rates, the SBP will maintain a balance between stemming inflationary pressures, preventing an undue weakening of the exchange rate, and continuing to support economic growth.

21. **Taking into account the lags with which monetary policy affects inflation, the SBP has already acted to raise interest rates since August 2003**. The SBP has raised interest rates more significantly since mid-2004, reducing the gap between twelve-month inflation and short-term interest rates (six-month treasury bills) from almost 7 percent in July to 6 percent in September. Short-term interest rates have been increased by 1.4 percentage points so far since mid-2004, compared to 0.4 percent in the first half of 2004. Monetary expansion is targeted to be in line with nominal income growth. Interest rates can be expected to increase further in the remainder of 2004/05 and the SBP stands ready to tighten further should inflationary pressures not abate. Meanwhile, SBP operations in the foreign exchange market will be limited to smooth short-term fluctuations, and the SBP will make every

attempt to maintain external competitiveness. While the SPB remains committed to a liberal foreign exchange regime, on November 1, 2004, we introduced some new measures in respect of advance payments for imports. These measures were primarily intended to remove certain anomalies and to forestall misuse of some of the facilities by certain market participants. However, upon realizing that parts of our new measures could constitute an intensification of and a new restriction, and thus a breach of a performance criterion, we immediately amended the respective new measures on November 10, 2004, thus reinstating the status quo ante for genuine importers.

22. All (but one) bilateral agreements with the Paris Club creditors have been signed, with the remaining one (with the Russian Federation) expected to be concluded soon. We are seeking comparable treatment from non-Paris Club bilateral creditors and all but three agreements have been signed. Discussions are underway to finalize the remaining agreements with the United Arab Emirates, Libya, and China.

D. Structural Policies

23. **We will continue to build on our efforts to expand the tax base and strengthen revenue administration.** Further steps to broaden the tax base will focus on: (i) expanding the general sales tax to cover more services; (ii) reducing exemptions; (iii) improving compliance of existing taxpayers; and (iv) bringing more taxpayers under the tax net. Revenue administration is being enhanced through the CBR reform project, supported by the World Bank. By setting up LTUs and MTUs, and moving toward a functional organization that relies on self-assessment and risk-based auditing, revenue collection will become more efficient and more taxpayer-friendly. With these measures we aim to gradually increase the share of revenues collected by the CBR by 0.2–0.3 percentage point of GDP annually.

24. **Similarly, we will continue to move ahead with our agenda to improve expenditure management**. We are working to improve our fiscal reporting system through the Project for Improvement of Fiscal Reporting and Accounting, with the help of the World Bank. A new chart of accounts under the New Accounting Model (NAM) has been introduced with the 2004/05 budget for the federal government. The provincial governments are gradually moving toward producing their budgets under the NAM. Work is underway to introduce a medium-term budget framework in two pilot ministries—the Ministry of Health and the Ministry of Population—with the assistance of the U.K.'s Department for International Development.

25. **Two major surveys are underway to assess progress made in improving social indicators.** A Core Welfare Indicators Questionnaire (CWIQ) started in August 2004, and a full Pakistan Integrated Household Survey (PIHS) was launched in the same month. The results of the CWIQ are expected to be available in time to serve as input for the 2005/06 budget discussions, but those of the PIHS—which covers a full year—will only become available in late 2005. The results of these surveys will help us to increase the effectiveness

of social- and poverty-related spending. For the next PRSP progress report we will develop a prioritized action plan for implementing our PRSP agenda.

26. **We will continue with the reform and divestiture of public enterprises, notably in the power sector.** With the unbundling of WAPDA and the establishment of a regional tariff and subsidy policy, crucial steps have been taken on the road to improve efficiency in the power sector. We will finalize the financial recovery plans for the distribution companies as soon as NEPRA has determined tariffs that are consistent with the cost recovery principle. We will also continue to work with the World Bank on a medium-term adjustment program for the sector that aims to eliminate the sector's drain on the budget. Our goal is to increasingly transfer the sector into private ownership. In this regard, in 2004/05 we will offer for sale KESC, the Faisalabad Electric Supply Corporation, the Jamshoro generation company, as well as shares in the Kot Addu Power Company. Outside the power sector, privatization plans for the near future include the sale of majority stakes in Pakistan State Oil and National Refinery Limited.

Table 1a. Pakistan: Quantitative Targets, September 2003–June 2004 1/

(Cumulative flows from July 1, 2003, unless otherwise specified)

	2003	2003						2004					
	End-June	End-September			End-December			End-March			End-June		
	Stock	Prog.	Adj. Prog.	Act.	Prog.	Adj. Prog.	Act.	Prog.	Adj. Prog.	Prel. Est.	Rev. Prog.	Adj. Prog.	Prel. Est.
Net foreign assets of the SBP (floor in millions of U.S. dollars)*	8,068.4	495.0	246.4	708.4	833.0	374.6	1,191.7	996.0	135.0	1,048.2	1,489.0	373.5	872.4
(In billions of Pakistani rupees)													
Net domestic assets of the SBP*	200.7	-12.6	1.8	-52.4	13.4	40.0	7.8	-1.3	48.7	42.3	-10.5	54.3	52.7
Overall budget balance (floor)*	…	-77.0	-77.0	-41.0	-126.3	-126.3	-33.7	-163.7	-163.7	-71.2	-179.2	-179.2	-129.4
Net government bank borrowing*	511.2	43.5	57.5	9.9	53.1	79.8	-9.7	40.9	103.1	53.6	20.2	97.8	63.7
CBR revenue (floor)*	…	92.2	...	95.3	218.1	...	230.9	347.5	...	354.6	510.0	...	521.9
Net banking sector claims on public sector enterprises*	69.1	1.0	...	-17.2	2.7	...	-24.9	4.3	...	-32.8	6.0	...	-2.9
Social- and poverty-related spending ("I-PRSP budgetary expenditure")	…	40.7	...	40.2	81.4	...	80.2	131.4	...	128.6	185.1	...	208.7
WAPDA accrual balance	…	5.3	...	5.0	-3.9	...	3.0	-19.6	...	-4.0	-19.2	...	-1.7
KESC accrual balance	…	-4.4	...	-3.8	-8.2	...	-6.6	-12.4	...	-8.2	-15.3	...	-9.2
(In millions of U.S. dollars)													
Outstanding stock of short-term external debt owed or guaranteed by the government and the SBP*	…	500.0	...	250.9	500.0	...	189.6	500.0	...	138.8	500.0	...	122.2
Contracting or guaranteeing of noncessional medium-term and long-term debt by the government* 2/	…	600.0	...	104.2	600.0	...	454.2	750.0	...	954.2	1,000.0	...	954.2
Accumulation of external payments arrears (continuous performance criterion during the program period)*	…	0.0	...	0.0	0.0	...	0.0	0.0	...	0.0	0.0	...	0.0
SBP's forex reserves held with foreign branches of domestic banks (outstanding stock)		70.0	...	69.8	70.0	...	68.4	70.0	...	69.8	70.0	...	36.2
Of which: other than current account*	0.0	0.0	...	0.0	0.0	...	0.0	0.0	...	0.0	0.0	...	0.0
Stock of outstanding foreign currency swap and forward sales between SBP and residents*	…	400.0	...	45.0	400.0	...	45.0	400.0	...	45.0	400.0	...	45.0
Memorandum items:													
Net external program financing	…	105.9	...	-164.2	59.3	...	-477.3	-239.1	...	-1,129.4	132.7	...	-1,027.1
Of which: privatization proceeds	…	25.0	...	0.0	50.0	...	0.0	75.0	...	199.0	100.0	...	199.0
External cash budget grants	…	22.5	...	44.0	55.6	...	133.8	148.3	...	177.6	148.3	...	192.6
External capital grants	...	0.0	...	0.0	0.0	...	0.0	0.0	...	0.0	0.0	...	0.0
External privatization budget receipts	…	17.2	...	0.0	51.6	...	0.0	86.1	...	0.0	120.5	...	0.0
Daily cash reserve requirements ratio (in percentage points)	4.0	4.0	...	4.0	4.0	...	4.0	4.0	...	4.0	4.0	...	4.0
Special cash reserve requirements ratio on foreign currency deposits (in percentage points)	15.0	15.0	...	15.0	15.0	...	15.0	15.0	...	15.0	15.0	...	15.0

Source: Pakistani authorities.

1/ The relevant variables are defined in the Technical Memorandum of Understanding (TMU) dated May 29, 2003 and are subject to adjustors specified in the TMU. For variables marked "*" the end-December 2003, and end-June 2004 program flows represent ceilings (or floor, if indicated) that constitute performance criteria. All other targets are indicative.

2/ Excluding PRGF loans.

Table 1b. Pakistan: Quantitative Targets, September 2004–June 2005 1/

(Cumulative flows from July 1, 2004, unless otherwise specified)

	2004	2004				2005			
	End-June Stock Prel. Est.	End-Sept.		End-Dec.		End-Mar.		End-Jun.	
		Proj.	Rev. Proj.	Proj.	Rev. Proj.	Proj.	Rev. Proj.	Proj.	Rev. Proj.
Net foreign assets of the SBP									
(floor in millions of U.S. dollars)	8,750.1	208.8	-430.0	-194.5	-385.0	7.5	276.8	-52.5	357.8
	(In billions of Pakistani rupees)								
Net domestic assets of the SBP	314.5	-8.9	61.3	39.3	132.3	61.3	104.3	75.4	53.3
Overall budget balance (floor)	...	-78.5	-89.4	-115.9	-121.1	-160.1	-179.7	-199.2	-199.2
Net government bank borrowing	...	15.0	10.0	30.0	20.0	70.0	40.0	90.0	60.0
CBR revenue (floor)	...	110.0	112.7	255.0	261.2	400.0	409.8	576.0	590.0
Net banking sector claims on public sector enterprises	38.3	1.0	5.0	2.0	10.0	3.0	15.0	4.0	18.0
Social- and poverty-related spending									
(“I-PRSP budgetary expenditure”) 2/	...	59.8	59.8	119.2	119.2	159.2	159.2	278.0	278.0
Memorandum items:	(In millions of U.S. dollars)								
Net external program financing	...	247.7	-342.9	-823.6	-192.4	-809.9	104.5	-926.2	21.2
Of which: privatization proceeds	...	0.0	0.0	0.0	0.0	99.0	96.0	99.0	96.0
External cash budget grants	...	0.0	0.0	315.0	314.0	315.0	328.0	330.0	343.0
External capital grants	...	0.0	495.0	0.0	495.0	0.0	495.0	0.0	495.0
External privatization budget receipts	...	…	…	…	…	…	…	15.0	15.0
Daily cash reserve requirements ratio									
(in percentage points)	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0
Special cash reserve requirements ratio on foreign									
currency deposits (in percentage points)	15.0	15.0	15.0	15.0	15.0	15.0	15.0	15.0	15.0

Source: Pakistani authorities.

1/ The relevant variables are defined in the Technical Memorandum of Understanding (TMU) dated May 29, 2003 and are subject to adjustors specified in the TMU. All program flows are indicative ceilings or floors as indicated.

2/ Expanded definition as described in the December 2003 PRSP.

Table 2. Pakistan: Structural Performance Criteria and Benchmarks
Under the PRGF Arrangement for the Ninth Review

Measures	Timing	Status as of July 31, 2004
I. Structural Performance Criteria		
No new exemptions (as per status of March 1, 2003) 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 commitment.	Continuous	Not observed; 5 new exemptions were introduced with the 2004/05 budget.
KESC or WAPDA downward electricity tariff adjustments determined by NEPRA not to be implemented unless cumulative quarterly deficit targets of KESC, respectively WAPDA, for the preceding quarter were observed.	Continuous	Observed.
Publish quarterly progress reports on implementation of financial improvement plan of WAPDA/successors.	May 31, 2004 for the quarter January–March 2004, and August 31, 2004 for the quarter April–June 2004.	Observed.
Government to notify electricity tariff adjustments determined by NEPRA within 30 days of their determination (effective on day of notification).	Continuous	Observed for KESC; nonapplicable for WAPDA, as WAPDA's successor companies filed review petitions following the initial determination of new individual tariffs in June/July. Revised tariffs were appealed by the government.
Propose to Parliament removing income and sales tax exemptions and adopt other tax-based broadening measures yielding a total of PRs 5 billion in estimated revenues in the context of the 2004/05 budget	June 30, 2004	Observed.
Set up a pilot customs house in Karachi that will involve entry processing on a 24-hour basis, electronic filing of declarations by importers on a self-assessment basis, and parameter and risk-based audits.	June 30, 2004	Observed.
Promulgation of a federal budget for FY 2004/05 consistent with a consolidated overall budget deficit (excluding grants) not exceeding PRs 199.2 billion.	June 30, 2004	Observed: budget was passed by parliament on June 24, 2004.
Adjust NSS rates to reflect PIB yields according to formula set in the amendment of the Technical Memorandum of Understanding (TMU).	July 1, 2004	Observed.

Table 2. Pakistan: Structural Performance Criteria and Benchmarks
Under the PRGF Arrangement for the Ninth Review (concluded)

Measures	Timing	Status as of July 31, 2004
Announce tariff and subsidy policy for regional electricity tariff setting, as further specified in paragraph 12 of the MEFP.	July 31, 2004	Delayed; implemented on November 5 , 2004.
Publish Financial Recovery Plans for WAPDA and its successor entities, prepared in consultation with the World Bank, including financial targets for the power utilities, as specified in paragraph 13 of the MEFP.	July 31, 2004	Delayed.
II. Structural Benchmarks		
Set up two additional medium-taxpayers units.	June 30, 2004	Observed.
Open second large-taxpayers unit in Lahore	August 31, 2004	Observed.

Statement by the IMF Staff Representative
December 1, 2004

1. This statement summarizes information that has become available since the staff report for the 2004 Article IV consultation and the ninth review under Pakistan's arrangement under the Poverty Reduction and Growth Facility was circulated to the Board on November 17, 2004. It does not change the thrust of the staff appraisal.

2. Following the January 2004 summit of the South Asian Association for Regional Cooperation, a series of bilateral talks were held between Pakistani and Indian officials, covering a range of issues, including advancing economic cooperation and fostering regional trade. These talks are expected to continue in the period ahead.

3. Available data indicate that economic activity continues to show strong growth. Provisional data for the large-scale manufacturing industry show an increase in production by 14 percent in the first quarter of 2004/05, compared to the same period in the previous year. In the agricultural sector, the cotton and rice harvests were considerably higher than in the preceding year.

4. Inflation slowed somewhat, with consumer prices increasing by 8.7 percent in the 12 months through October, compared to a peak of 9.3 percent in July. Nonfood, nonenergy (core) inflation, however, continued to increase, to 7.2 percent year-on-year in October. Wholesale price inflation, meanwhile, fell sharply from its peak of 12.8 percent year-on-year in June, to 6.6 percent in October.

5. The budget continues to overperform. Preliminary fiscal data for the consolidated government through September suggest an overall budget deficit (excluding grants) in the first quarter of PRs 25 billion, which would be considerably less than the projected deficit of PRs 89 billion. This reflects a stronger-than-anticipated revenue performance, as well as some underspending. Notably, both revenue collection by the Central Board of Revenue and the receipt of nontax revenues were considerably higher than envisaged. Social- and poverty-related spending in the first quarter of 2004/05 fell somewhat short of projections, though these data are often revised upwards. The improved revenue position—if maintained—mitigates the risk to the budget posed by the higher oil prices and the authorities' decision as yet not to pass these higher prices on to consumers. The staff, however, maintains its recommendation to pass the higher oil prices on to consumers, not only to ensure an efficient resource allocation, but also because higher-than-anticipated revenues could be better used to fund additional social spending or debt reduction.

6. The current account recorded a small surplus in the first quarter of 2004/05 (0.1 percent of GDP). Notably private transfers were higher than projected and exports performed somewhat better as well. Gross official international reserves (including the sinking fund), however, fell from \$10.6 billion at end-June to \$10.3 billion by end-September, and further to \$9.3 billion in late-November, partly reflecting efforts by the

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.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 04/139
FOR IMMEDIATE RELEASE
December 20, 2004

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

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.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

Pakistan: Selected Economic Indicators, 1998/99–2003/04 1/

(In percent of GDP, unless otherwise indicated)

	1998/99	1999/2000	2000/01	2001/02	2002/03	2003/04 Prel. Est.
Domestic economy						
Real GDP growth (at factor costs, percentage change)	4.2	3.9	1.8	3.1	5.1	6.4
CPI inflation (period average, percentage change)	5.7	3.6	4.4	2.5	3.1	4.6
CPI inflation (end-of-period, percentage change)	3.7	5.1	2.5	3.4	1.9	8.5
Gross national savings	9.9	11.7	15.6	19.0	21.8	20.1
Gross capital formation	12.9	13.3	17.2	16.8	16.7	18.1
Fiscal position						
Revenue (including grants)	13.8	14.4	14.3	16.1	17.4	15.1
Expenditure (including statistical discrepancy)	18.1	18.7	17.6	19.7	18.8	16.9
Budget balance (including grants)	-4.3	-4.6	-3.3	-3.6	-1.4	-1.8
Total government debt	81.7	83.7	88.8	80.2	74.3	68.7
External economy						
Merchandise exports	10.7	11.2	12.5	12.7	13.2	13.1
Merchandise imports	13.6	13.1	14.3	13.1	13.7	14.3
Current account including official transfers	-3.0	-1.6	-1.6	2.2	5.1	2.0
External public and publicly guaranteed debt						
(in percent of exports of goods and nonfactor services)	329.4	322.1	309.4	295.8	238.0	218.2
Gross reserves (in millions of U.S. dollars) 2/	1,680	908	1,679	4,330	9,521	10,556
In months of next year imports of goods and services	1.7	0.9	1.7	3.7	6.5	6.0
Pakistani rupees per U.S. dollar (period average, percentage change)	17.0	3.0	12.8	5.2	-4.7	-1.5
Real effective exchange rate (period average, percentage change)	-9.1	-0.6	-2.5	-1.1	-1.5	-3.4
Financial variables						
Broad money (end-period, percentage change)	6.2	9.4	9.0	15.4	18.3	19.6
Net foreign assets (end-of-period, change in percent of broad money)	1.6	2.0	5.1	13.4	18.9	2.1
Net domestic assets (end-of-period, change in percent of broad money)	4.5	7.4	3.9	2.0	-0.4	17.5
O*f which:* credit to the private sector	8.5	1.4	3.5	2.5	9.1	14.3
O*f which:* net claims on the government	-3.8	5.0	-3.3	1.5	-1.4	2.8
Six-month treasury bill rate (period average, in percent)	13.1	8.8	10.4	8.1	4.1	1.7

Sources: Pakistani authorities; and IMF staff.

1/ The fiscal year runs July 1 through June 30.

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

INTERNATIONAL MONETARY FUND
EXTERNAL RELATIONS DEPARTMENT

Press Release No. 04/259
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December 1, 2004

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Completes Final Review Under Pakistan's PRGF Arrangement

The Executive Board of the International Monetary Fund (IMF) completed today the ninth and final review under Pakistan's three-year Poverty Reduction and Growth Facility (PRGF) arrangement. While completion of this review enables the release of the equivalent of SDR 172.3 million (about US$262 million), the Pakistan authorities have already stated that they will not draw the final tranche available under the arrangement, and that they will not seek a successor arrangement once the current PRGF arrangement expires in December 2004.

In completing the final review of the arrangement, the Executive Board also approved Pakistan's request for waivers for the nonobservance of three structural performance criteria and of a continuous performance criterion against the imposition or intensification of exchange restrictions.

Total disbursements under the PRGF arrangement approved on December 6, 2001 (see Press Release No. 01/51) have amounted to the equivalent of SDR 861.4 million (about US$1.31 billion). The PRGF is the IMF's concessional facility for low-income countries. PRGF loans carry an annual interest rate of 0.5 percent, and are payable over 10 years with a 5½-year grace period on principal payments.

Following the Executive Board's discussion of Pakistan's economic performance, Agustín Carstens, Deputy Managing Director and Acting Chair, stated:

"During Pakistan's three-year arrangement under the Poverty Reduction and Growth Facility (PRGF), the country has made a strong recovery from the economic crisis of the late 1990s. Tighter macroeconomic policies and structural reforms have resulted in a stronger external position, a lower public debt burden, renewed access to international capital markets, and a revival in growth, albeit accompanied lately by some increase in inflation. External support has played a part in Pakistan's recovery, but the turnaround has been primarily due to the implementation of strongly owned government policies.

"Executive Directors commended Pakistan on the successful completion of its arrangement under the PRGF. Directors welcomed the authorities' decision not to draw the final tranche, given Pakistan's improved economic situation, so that these resources become available for other countries in need of concessional support from the Fund. The authorities have indicated that they do not wish to seek a successor arrangement following the expiration of the current arrangement. Instead, Pakistan will rely on domestic and international capital markets to meet its financing needs, complemented by continued support from the World Bank, the Asian Development Bank, and bilateral donors. The Fund will maintain a dialogue with the authorities on economic and financial developments and policies in the context of the Fund's normal consultations with member countries.

"Pakistan continues to face major challenges in trying to meet its Millennium Development Goals. Social indicators remain weak. To achieve a significant and lasting reduction in poverty, strong, non-inflationary growth will need to be maintained, but the authorities will also need to ensure that growth will benefit the poor. Maintaining high rates of economic growth will require the continued implementation of sound macroeconomic policies, with monetary policy focusing on maintaining low inflation and avoiding the entrenchment of inflationary expectations, as well as structural reforms. A continued fiscal effort will be needed to reduce the public debt burden further, while increasing funding for social spending, consistent with Pakistan's Poverty Reduction Strategy Paper. The authorities will furthermore need to ensure that provincial and local governments have the administrative and financial means to carry out their increased responsibilities for the delivery of key public services, including health care and education," Mr. Carstens said.

Statement Abbas Mirakhor, Executive Director for Pakistan
December 1, 2004

Key Points:

- *Having achieved macroeconomic stability and respectable expansion largely as a result of "homemade" adjustment and reform efforts, the economy is now poised for accelerated growth rates and poverty reduction;*

- *Potential risks to the program highlighted by staff will be mitigated through steadfast implementation of sound policies and reforms;*

- *The fiscal program aims to balance the need for increased social and development spending with a further reduction in the debt burden, and monetary policy aims at an appropriate balance between controlling inflation, supporting growth, and stemming excessive exchange rate fluctuations;*

- *Poverty and social impact analysis will be deepened to improve the effectiveness of economic and social intervention policies;*

- *Pakistan will not draw the final tranche of the PRGF arrangement in order to free concessional resources for the benefit of more needy countries; and*

- *The authorities will maintain close dialogue with the Fund in the context of the surveillance mechanism.*

Background

As described well by staff, Pakistan has come a long way since the 1998/99 crisis when only moderate rates of growth could be achieved, international reserves had been depleted, and sustained macroeconomic stability was difficult to attain. Prudent economic management in the context of a Fund-supported arrangement has turned the economy around. The country is now positioned to achieve sustained high growth, accelerate poverty reduction, be able to compete with its regional peers, and to exit from Fund financial support.

Since then, progress continues to permeate all areas of the economy. As a priority, macroeconomic situation has been stabilized. While strong external support contributed to this outcome, as illustrated in Box 1 of the staff report, to a large extent, policies that led to stability were "homemade" and the result of a strong domestic commitment and adjustment effort. Fiscal consolidation has taken hold through revenue and expenditure reforms, contributing to entrenched macroeconomic stability. The strengthened fiscal position was also helped by higher grants as well as improved non-tax revenue and lower borrowing costs, resulting from improved macroeconomic policies and financial reforms, thus creating space for private sector activity. Despite two years of severe drought and the September 11 shock, the economy attained growth rates that compare favorably with earlier years. The external position improved significantly with strong donor support and large inflow of remittances—a reflection of enhanced confidence in the economy—while the rupee strengthened and reserves rose substantially.

Wide-ranging reforms have increased resilience of the economy. In the financial sector, reforms allowed the flow of private capital and expertise into the sector, and reinforced supervision enhanced competition and efficiency. The trade and exchange system has been liberalized further to minimize distortions, improve allocative efficiency, and reduce incentives for corruption and rent seeking. State intervention in the economy was reduced to allow the private sector to spearhead growth, while the regulatory framework for parastatals has been reinforced to improve their efficiency and protect consumers. Governance reforms are aimed at strengthening transparency and accountability in public resource management, including at decentralized level of government. Social- and poverty-related spending has increased. The Prime Minister's retention of his erstwhile finance portfolio is evidence of the authorities' commitment to financial discipline as well as to policy and reform continuity.

Recent economic developments

Implementation of the PRGF-supported program remains on course, with quantitative performance criteria and indicative targets for end-June observed. Most structural performance criteria were met, while action has been taken to correct those that were missed, or to mitigate their negative effects, and, on that score, the authorities request their waiver. Real GDP growth accelerated to 6.4 percent in 2003/04. However, propelled by higher wheat and energy prices and rapid expansion of credit to support growth, inflation exceeded the target. The current account surplus was also lower than projected as higher imports more than offset larger private transfers. The increase in imports that has widened the trade deficit and narrowed current account surplus in FY 2004 is primarily due to 45 percent growth in imports of capital goods and 41 percent expansion in imports of raw materials for capital goods. This contributed to 17 percent growth in large scale manufacturing that in turn led to 6.4 percent of GDP growth rate. The authorities believe that this is a virtuous cycle that was needed by Pakistan to get back on the high growth path. Despite a somewhat weaker capital account, reserves increased to $10.6 billion at end-June, equivalent to six months of import cover.

An improving fiscal performance was better than projected, driven by strong revenue collection—reflecting the buoyant economy and improved efficiency—and lower spending. As a result, domestic debt fell below 70 percent of GDP from its peak of 89 percent in 2000/01. Social- and poverty-related spending as well as development expenditure exceeded projections. In response to rising inflation and strong monetary growth, the State Bank of Pakistan has recently tightened policy by increasing short-term interest rates. It is worth noting that, after a long period of stagnation, Pakistan recorded an increase in investment rate by 22 percent. This was possible because of the expansion in private sector credit from the banking system which was broad-based and shared by corporate sector, SMEs, agriculture and household sector for consumer financing. The backward and forward linkages to production and services were quite strong and the growth rate would have been stifled in absence of this domestic demand stimulated by the private sector credit. Inflationary consequences of this rapid private sector credit growth have been contained as the demand for credit by the public sector has been curtailed in the last two years through reduction in fiscal deficit and net retirement of debt by the public sector enterprises. The government borrowing in FY 2004 has risen for a one off prepayment of ADB loan of US$1.17 billion.

Further progress was made in implementing structural reforms. In the important energy sector, the restructuring plan was completed with the unbundling of the Water and Power Development Authority (WAPDA) into separate generation, transmission, and distribution companies. Encouragingly, the two power utilities exceeded their projected financial performance for 2003/04. Broad principles were issued for the determination of regional electricity tariffs in June, although the final cost-recovery structural tariff remains to be completed. The Financial Recovery Plans (FRPs) for the distribution companies were delayed pending determination of the structural tariffs. The government announced an electricity subsidy policy in November aimed at ensuring cost recovery while providing consumer protection. A timetable has been set for phasing out subsidies by 2010.

Significant steps were taken in the 2004/05 Budget to remove income and sales tax exemptions and broaden the tax base, although some new exemptions with minor budgetary impact were introduced aimed at addressing anomalies and discriminatory practices. To further strengthen governance, discussions are held among stakeholders on the drafting of the *Benami* legislation, which is expected to be submitted to Cabinet in 2005. In the financial sector, the restructuring and privatization agenda has been almost completed following the sale of Habbib Bank Limited (HBL) in August and the transfer of Allied Bank Limited (ABL) into private ownership through the sale of additional shares, leaving only the National Bank of Pakistan under major government ownership. The authorities are taking anti-money laundering measures seriously and have issued regulations that require reporting of suspicious transactions and set out minimum records-keeping standards.

Policies going forward

Building on the steady progress made in the past several years, the strategy going forward aims at sustaining macroeconomic stability, further accelerating growth, and reducing poverty. A steadfast implementation of sound financial policies and market-oriented structural reforms is considered critical to fulfilling these tasks. In 2004/05, growth is projected to reach 6.5 percent, building on the current momentum and assuming favorable weather conditions. Over the medium term, it will be necessary to reach growth rates of around 8.0 percent in order to achieve the desired trend in poverty reduction. Average inflation is expected to increase to 7.0 percent mainly reflecting food, particularly wheat price increases in 2004/05, before dropping to 4.0 percent over the medium term as tighter monetary policy and measures to regularize conditions in the wheat market take hold. Available evidence suggests that efforts at containing inflation through government successive importation of wheat and tightening monetary policy have been successful in reducing the momentum of CPI increases.

The analysis in the *Selected Issues* paper (SIP) demonstrates that achieving higher rates of growth that would match the performance of South-East Asian countries would require, as a priority, higher investment, including in human capital. In that regard, the authorities intend to attract higher foreign savings, preferably in the form of FDI, to supplement domestic savings and investment. Spending on education and health will increase in order to enhance human capital and labor productivity. The importance of improving the quality of the country's institutional framework, which the SIP confirms to be an important driver of growth, is well recognized. In that connection, governance and the legal and regulatory framework will be strengthened. A sizable improvement in productivity in the agricultural sector is also crucial to accelerated growth and poverty reduction, given the size of the sector and the higher poverty incidence in the rural areas. On that score, the sector is receiving strong attention, including through improvement of water availability, in order to address a key constraint to agricultural growth. The development of physical infrastructure is also receiving large budgetary allocations, given its importance for growth.

The fiscal strategy for 2004/05 and the medium term aims to balance the need for increased social and development spending with a further reduction in the debt burden in line with the path set out in the PRSP and the draft Fiscal Responsibility Law (FRL). The overall fiscal deficit will be limited to around 3.0 percent of GDP over the medium term, while the public debt-to-GDP ratio will decline to about 50 percent by 2008/09. The Central Board of Revenue (CBR) reform project, supported by the World Bank, aims to move to a functional organization that relies on self-assessment and risk-based auditing in order to render revenue collection more efficient and taxpayer-friendly.

While monetary policy will be directed to achieve the inflation targets in the PRSP, supporting growth and stemming excessive exchange rate fluctuation are important objectives and, as staff suggest, the SBP will strive to achieve an appropriate balance between them. Analysis of the SIP on inflation forecasting and the prospect of inflation targeting in Pakistan provide useful policy guidance. The authorities also take note of and intend to take appropriate action regarding the role of private sector credit growth in inflation trends as well as the potential risks for banks' balance sheets. Financial sector reforms have significantly increased private sector participation and improved efficiency and resilience of the banking system as well as financial intermediation, as confirmed by the recent FSSA. The authorities will ensure that banking supervision remains in compliance with international standards. As noted in the staff report, Pakistan's exchange rate policy has served it well, contributing to strong export growth, high reserves, and increased confidence in the *rupee*. The authorities will limit intervention to smoothing excessive exchange rate fluctuations and will ensure that the exchange rate continues to be market-determined and to safeguard Pakistan's external competitiveness.

Structural reforms aim at fostering growth, long-term macroeconomic sustainability, and accelerated poverty reduction. Building on the strong improvements in the financial performance of major public sector enterprises (PSEs), as confirmed by the SIP study, reform and divestiture of PSEs, particularly in the power sector, will continue. The goal is to gradually transfer the sector into private ownership and, in that connection, major companies will be offered for sale in 2004/05. Furthermore, majority stakes will be sold in Pakistan

State Oil and National Refinery Limited. Work on its medium-term adjustment program, supported by the World Bank, will aim at increasing efficiency and reducing the drain on the budget.

Pakistan continues to liberalize its trade regime—including lowering tariff rates and customs duties and reducing tariff bands—in furtherance of regional trade integration, increased efficiency, larger export markets, and expanding consumer choices. Pakistan needs to position itself to offset possible loss of preferential status for clothing and textiles to the EU in early-2005. The SIP highlights potential benefits of increasing trade with India, which is receiving attention in the context of a prospective South-Asian Free Trade Area.

The authorities recognize the need to deepen the poverty and social impact analysis of their policies. In this context, comprehensive surveys have been launched recently, which are expected to provide greater insight into poverty incidence, geographical distribution, and trends to assist in better targeting and enhancing effectiveness of poverty-related spending and other social interventions. The strategy to continue to reduce poverty with greater social inclusion, notably through devolution of political and economic power. In this regard, provincial and local governments will have the responsibility of provision of key social services. Efforts to strengthen political empowerment will be buttressed by administrative and financial devolution to enable the lower levels of government to carry out their increased responsibilities more effectively.

The authorities acknowledge the potential risks highlighted by staff and consider the best mitigating response is to remain firmly committed to policy continuity and to implement sound policies that sustain stability and achieve high growth, while strengthening the economy's resilience. Staff's analysis confirms that the public debt declines substantially under alternative growth scenarios, while stress tests indicate robustness to a number of downside risks. Nevertheless, the authorities intend to remain vigilant and take whatever steps necessary to stay the course. Noting staff suggestions in the SIP, the authorities intend to pursue a prudent debt management policy, including through balancing the costs of borrowing from domestic and international debt markets. They will also finalize the remaining rescheduling agreements with Paris Club and non-Paris Club bilateral creditors, while continuing to seek grant financing from other official creditors.

Conclusion

Considering Pakistan's improved external position and the need to free concessional resources for the benefit of more needy countries, the authorities have decided not to draw the final tranche of the PRGF arrangement. In the period ahead, they intend to access domestic and international markets, complemented by support from official creditors, to meet Pakistan's financing needs. Already, Pakistan successfully re-entered the international capital markets. While exiting from the PRGF arrangement, the authorities remain committed to implementing sound policies and strong reforms in line with the PRSP to ensure sustained high growth, job creation, and poverty reduction. Close collaboration and dialogue with the Fund will be maintained in the context of the surveillance mechanism, vital to sustaining the quality of policies and programs and in signaling to donors and financial markets. Pakistan continues to count on the international community to support its economic development efforts and progress toward the MDGs.

As always, my authorities look forward to the Board discussion of this review and express their gratitude for the hard work of the staff as well as for the advice and support of management and the Executive Board.