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Pakistan: Second Review Under the Stand-By Arrangement and Request for Waiver of Performance Criteria—Staff Report; Staff Statement; and News Brief

In the context of the first review under the Stand-By Arrangement, the following documents have been released and are included in this package:

- the staff report for the First Review Under the Stand-By Arrangement and Request for Waiver and Modification of Performance Criteria, prepared by a staff team of the IMF, following discussions that ended on **May 25, 2001** with the officials of Pakistan on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on June 28, 2001.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff statement of **July 11, 2001** updating information on recent economic developments.

- a News Brief summarizing the **views of the Executive Board as expressed during its July 11, 2001 discussion** of the staff report that completed the review.

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INTERNATIONAL MONETARY FUND
PAKISTAN

Second Review Under the Stand-By Arrangement and Request for Waivers of Performance Criteria

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

(In consultation with other departments)

Approved by P. Chabrier and M. T. Hadjimichael

June 28, 2001

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Text Boxes

Appendix

Attachment

List of Acronyms

AsDB	Asian Development Bank
CBR	Central Board Revenue
FCD	Foreign currency deposit
FDI	Foreign Direct Investment
GRA	Gas Regulatory Act
HUBCO	Hub Power Corporation
IFI	International Financial Institutions
ILO	International Labor Organization
IPPs	Independent Power Producers
KESC	Karachi Electric Supply Company
MEFP	Memorandum on Economic and Financial Policies
NDA	Net Domestic Assets
NFA	Net Foreign Assets
NSS	National Savings Schemes
PIA	Pakistan International Airlines
PRGF	Poverty Reduction and Growth Facility
PSDP	Public Sector Development Program
PTCL	Pakistan Telecommunications Company Limited
SBP	State Bank of Pakistan
SROs	Statutory Regulatory Orders
UBL	United Bank Limited
WAPDA	Water and Power Development Authority
WPI	Wholesale Price Index
WTO	World Trade Organization

I. Introduction and Background

1. The discussions for the second review under the Stand-By Arrangement were held in Islamabad and Karachi during May 9–25, 2001.[1] The arrangement, amounting to SDR 465 million (45 percent of quota) was approved on November 29, 2000, on which occasion the Executive Board concluded the last Article IV consultation.[2] On March 30, the Executive Board completed the first review and granted two waivers for the nonobservance of one quantitative and one structural performance criteria.[3] In the attached letter dated June 27, 2001, the authorities request the completion of the second review under the Stand-By Arrangement and seek waivers for the anticipated nonobservance of two quantitative performance criterion for end-June 2001, as well as waivers of applicability for all other quantitative performance criteria at end-June 2001; these performance criteria would apply to the purchase subject to the completion of the third review. The accompanying Supplementary Memorandum on Economic and Financial Policies (SMEFP) describes economic developments and policy implementation during the third quarter and part of the last quarter of 2000/01 (fiscal year ending June 30) and economic and financial policies and indicative targets for the next fiscal year (2001/02).

2. In concluding the first review of the arrangement, Executive Directors welcomed the encouraging macroeconomic performance and the progress in the implementation of structural reforms. They observed, however, that sustained implementation of firm demand management policies, an increased revenue collection effort and a substantial reallocation of public expenditure toward poverty-reducing spending, as well as adherence to the structural reform agenda will be preconditions for a successor arrangement under the Poverty Reduction and Growth Facility (PRGF).

3. Pakistan purchased the equivalent of SDR 150 million under the Stand-By Arrangement, following Board approval on November 29, 2000, and the equivalent of SDR 105 million following completion of the first program review on March 30, 2001. A third tranche of SDR 105 million would become available upon completion of the second review. As of end-May 2001, total Fund credit and loans outstanding to Pakistan amounted to SDR 1,231.5 million (119.1 percent of quota).[4]

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[1] The mission met with the Finance Minister, the Governor of the State Bank of Pakistan (SBP), the Secretary General and Secretary Finance, and other senior officials. Mr. Ahmed (OED) participated in the discussions. The staff team consisted of Mr. Enders (Head), Ms. Fichera, and Mr. Le Dem (all MED); Mr. Taube (FAD); and Mr. Ronci (PDR). Mr. Panzer (World Bank) participated in the work of the mission, which was assisted by Mr. Mansur, the Fund's senior resident representative.

[2] See EBS/00/230.

[3] See EBS/01/39.

[4] Pakistan's relations with the Fund are described in Appendix I.

II. PERFORMANCE AND POLICIES THROUGH MID-2001[5]

4. **Economic growth performance during the first 10 months of the current fiscal year has been weaker than expected on account of the drought**. Against a growth objective of 3.8 percent, the latest estimates indicate that GDP will only grow by 2.6 percent as a severe drought entailed a substantial drop (of about 10 percent) in the production of major crops. This steep decline follows an unusual bumper crop in 1999/2000. Although growth in manufacturing value added is now estimated at 7 percent, with stepped up sugar refining, the overall performance of the industrial sector has suffered from poor outcomes in electricity and construction. Value added in electricity declined mainly because of a drought-induced shift from low-cost hydro to high-cost thermal generation. The slow-down in construction activity, mainly in private housing, appears partly related to the tax documentation drive and revamped tax inspection under which the tax authorities requested documentation on the sources of income financing building, which have temporarily discouraged the start up of new housing projects, and probably also reflects high real interest rates.

5. **Average annual inflation through May remained subdued and is expected to be contained at 4.7 percent through end-June**. Through May, the wholesale price index (WPI) and the CPI rose by 4.4 percent and 3.6 percent, respectively, over the corresponding month of last year (Figure 1). The moderate inflation rate reflects fiscal restraint, a relatively tight monetary policy implemented by the State Bank of Pakistan (SBP), and lower food prices resulting from stocks still left from last year's bumper crops and declining international prices of imported items such as palm oil and tea. Relatively low food prices compensated for large increases in energy and transportation prices reflecting high international oil prices and a more rapid than programmed depreciation of the rupee.

6. **Developments in external balances as of March indicate a deterioration of the current account, which will make achievement of the external objectives for end-June difficult**. The trade balance deficit for the first three quarters of 2000/01 was about US$200 million higher than projected. Export shortfalls from projections mainly resulted from a decline in unit prices, particularly in textiles, reflecting to some extent the slowdown in the world economy, but nontraditional export volume continued to grow rapidly. On the import side, the drought contributed to raising fuel import volumes to substitute for hydropower, as well as to higher sugar imports. Unfavorable current account developments were offset by larger than projected capital inflows resulting from long-term swap operations with foreign branches of domestic banks and higher U.S. dollar purchases in the kerb market by the SBP.[6]

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[5] Tables 1–5, as per data available through early June 2001.

[6] SBP kerb market purchases have traditionally been recorded—also by staff—as private remittances in the current account. This classification might distort the correct assessment of the country's current account position. The SBP argues that kerb market purchases indeed absorb remittances from non-resident Pakistani through non-official channels. However, the purchases may also tap otherwise unrecorded capital flows accumulated in the form of foreign-exchange cash holdings. In Table 2 staff has presented an estimated breakdown of the purchases between remittances and capital flows. The split is largely based on staff's judgment and consistent with trends

(continued…)

Through these operations, and also stepped-up purchases in the interbank market, the SBP attempted to offset the decline in reserves resulting from its sales of foreign exchange for bulky oil payments in the interbank market and large debt payments. Gross official reserves reached US$889 million at end-March, above target, and the performance criteria on net foreign assets (NFA) of the SBP was met (Figure 2). Unfavorable export and import trends are expected to continue through June, and the current account deficit in the revised presentation (excluding official transfers) is likely to reach 3.7 percent of GDP by end-June. The better than projected outcome of the capital account reflects in part the SBP's afore-mentioned operations but masks a decline in FDI and in project financing.

7. **The fiscal outcome for July 2000–March 2001 was broadly as projected under the revised program and the quantitative performance criteria on the fiscal deficit and net bank borrowing for end-March were met.** Revenue once again fell short of the program objective mainly on account of lower GDP growth. Lower than projected Central Board Revenue (CBR) revenue (by 0.2 percent of GDP), mainly on account of lower sales tax collection, was only partially offset by higher-than-expected petroleum surcharges and larger nontax revenue (including interest and dividend payments from public enterprises). Expenditure was contained below the projected level, with small overruns on subsidies at the federal level more than offset by shortfalls in provincial current spending and in development spending, some of which likely fell on social expenditure (see below). As yet unidentified expenditure amounting to 0.9 percent of GDP (a level comparable to the pattern of previous years) could partially account for the low level of recorded federal development spending; the authorities explained, however, that defense spending was monitored with particular attention and could not be part of the unidentified expenditure. Social and pro-poor outlays picked up somewhat in the third quarter, but still fell short of the indicative program target. The authorities maintain that this does not necessarily imply a deterioration of public service delivery because of less waste due to better accountability and governance, and that this year's social and poverty related spending is on track to far exceed last year's level (by 28 percent).

8. **A tightening of monetary policy by the SBP in January–March partially reversed the expansionary monetary stance of the previous quarter, but the SBP resorted also to one exceptional operation to meet the net domestic assets (NDA) target for end-March.** Broad money growth of 11 percent through March was slightly below program, while reserve money growth at 6.6 percent was kept well below the 9.7 percent targeted, in part by raising the six-month treasury bill rate from 11 percent to 11.6 percent in March (Figure 3). To meet its performance criterion on NDA, the SBP, in late March, encouraged commercial banks to convert PRs 28 billion of reserves held under special deposit accounts (the counterpart of the frozen foreign currency deposits (FCDs)) into treasury bills (with the same remuneration as the special deposit accounts) thus artificially further reducing reserve money. The operation was

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before 1998/99 (i.e., before the SBP started to intervene in the kerb market). A better understanding of the nature of such flows, including through better reporting of money changers or surveys among nonresident Pakistanis, will be needed to provide a meaningful assessment of the amounts and scope of these flows.

unwound in early April. However, the authorities fully agreed to the Board's recommendation made slightly later, during the discussion of the first review, to avoid such exceptional operations in the future. Excluding this operation, reserve money would have grown by 12.7 percent, still signaling a marked decline with respect to December, but the NDA target would have been slightly missed. The rupee cash-to-deposit ratio remained stable over the last three months, against a projected decline in the program. The persistent cash preference that has emerged over the last year likely reflects a temporary strengthening of private sector preference for use of cash in response to the tax and accountability drive, in order to avoid tracking and unwelcome tax inspection, along with more widespread use of the rupee in Afghanistan.[7] The larger than expected devaluation of the rupee likely contributed to an increase in U.S. dollar deposits, which now account for 12.7 percent of total bank deposits (against 10.5 percent in July 2000).

9. **Following a surge during the second quarter, credit to the private sector slowed in the quarter through March to 8.7 percent, in line with program projections.** The cooling-off during the third quarter reflected seasonal factors as well as the tighter monetary stance adopted by the SBP. Outstanding credit to the seven major public enterprises was considerably below the limits of the program at end-March (PRs 30 billion against PRs 54 billion), apparently reflecting some improvements in the financial situation of these enterprises, as, for example, the new pricing mechanism restored margins for the Water and Power Development Authority (WAPDA) and the two gas distribution companies. On the other hand, net borrowing by other public sector enterprises has been higher than envisaged under the program, possibly reflecting recent financial distress encountered by two large enterprises, Pakistan International Airlines (PIA) (which recently raised ticket prices by 15 percent) and People Steel Mills.

10. **The implementation of the structural reform agenda through March was broadly on schedule**. Notwithstanding the difficult circumstances created by the drought, the General Sales Tax (GST) was extended to fertilizers and petroleum price adjustments were implemented as programmed (two structural performance criteria). However, the authorities were experiencing some delays in preparing the draft income tax ordinance,[8] as well as reconciling provincial budget figures (two structural benchmarks) (see Table 2 of SMEFP for details).

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[7] The persistent preference of the public for cash holdings is also reflected in the changed structure of deposits over the last 12 months, with demand deposits declining by 2.4 percent, whereas time and saving deposits have increased by 17.4 percent, despite a decline in deposit rates.

[8] The ordinance is, however, expected to be promulgated by end-July 2001, as envisaged under the program.

III. Report on the Discussions

11. The discussions covered developments thus far under the program, the impact of the drought during this and the next fiscal years; revisions to the medium-term macroeconomic framework; the main parameters of next fiscal year's budget and the underlying tax, expenditure, and financial policies; specification of indicative quantitative targets for September and December 2001; and the structural reform agenda for the months ahead, most of which is directed toward strengthening economic governance.

A. Macroeconomic Objectives and Policies for the Remainder of 2000/01

12. **The foreign reserves target of US$1.6 billion for end-June 2001 will be difficult to reach without destabilizing the thin interbank exchange market or depressing further the economy through excessive interest rate increases**, given the weaker external current account and the expected shortfall in balance of payments support loans of US$112 million (mostly related to Asian Development Bank (AsDB) loans). The mission expressed concern about the decline of official reserves in April, and the slow buildup in the early weeks of May (Figure 2), which partly resulted from the continued selling of foreign exchange by the SBP to the interbank market for oil imports contrary to understandings under the program. Since then, the SBP has stepped its purchases in both interbank and kerb markets and official reserves reached US$1.38 billion on June 15 (a prior action for the completion of this review). Reflecting the SBP's interventions (as well as the present strength of the U.S. dollar against other currencies), the rupee has further depreciated in the last six weeks, bringing the cumulative depreciation against the U.S. dollar since last June to 22 percent as of June 21, 2001. At the same time, the daily spread between the kerb and interbank market rates has remained close to 5 percent (Figure 4).[9] Effective June 7, the SBP has also increased by 1 percent (to 14 percent) its three-day repo rate, and via open market operations achieved a similar increase in treasury bill rates.[10] However, given the risk that massive intervention in the interbank market in a context of rapid depreciation of the rupee against the U.S. dollar could rekindle inflation, the authorities and staff expect a shortfall from the NFA target for end-June of at most US$200 million, with reserves reaching around US$1.4 billion (5.7 weeks of imports), still a substantial improvement compared to last year's level of US$0.9 billion. In these circumstances, the government requests a waiver for the anticipated nonobservance of the end-June NFA performance criterion.

[9] See EBS/00/230 for an analytical review on the segmentation of foreign exchange markets in Pakistan. Based on available information, the staff believes that the current system does not constitute a breach of Pakistan's obligations under Article VIII of the Articles of Agreement or a multiple currency practice. The staff plans to further review this issue during the discussions for the third review.

[10] The six-month treasury bill rate was at 12.5 percent as of mid-June 2001.

13. **The authorities are confident that the fiscal deficit for FY2000/01 can be maintained within the program limits, but lower growth has made virtually impossible the meeting of the CBR revenue target for end-June 2001**. CBR performance during April/May has shown a widening of the shortfalls from program targets, which may have been overly ambitious even after the revised projections made last February.[11] CBR expects to collect realistically about PRs 406 billion for the year as a whole if collection efforts are maintained in June, 2.6 percent less than the PRs 417 billion target. This would still amount to an increase of 17 percent over the previous year, an impressive achievement compared to past trends. In view of the satisfactory implementation of the remedial measures (short-term action plan elaborated with FAD assistance that put the focus on audits, nonfilers and arrears) that were put in place during the last quarter, and the expenditure control measures that are being implemented to ensure the achievement of the original budget deficit target, the government requests a waiver for the nonobservance of the end-June 2001 performance criterion on CBR revenue. The fiscal deficit target is expected to be met through a further tightening of public expenditure, mainly provincial current spending and the Public Sector Development Program (PSDP), while protecting social and poverty-related expenditures.

14. **With the recent tightening of monetary policy and lower-than-expected economic activity, the authorities are confident that the end-June monetary targets are within reach,** even if the projected slowdown in demand for currency does not fully materialize during the last quarter. As of end-April, broad and reserve money were growing at an annual pace of 10.2 percent and 12.9 percent, respectively. With the further tightening of interest rates in June and substantial open market operations, the mission shared the authorities' view there was a reasonable prospect for observance of the NDA target for end-June, but suggested close monitoring by the SBP and, if needed, further open market operations to mop up liquidity. While demand for currency could turn out to be stronger than projected, the authorities agreed not to resort to any exceptional operation to meet the end-June NDA target.

B. Medium-Term Macroeconomic Framework and 2001/02 Budget

15. **The revised medium-term framework differs from previous staff projections on account of lower real GDP growth and a weaker balance of payments**. Inflation is expected to pick up slightly in 2001/02, due to the likely impact of the drought and of the larger-than-envisaged depreciation of the rupee against the U.S. dollar on domestic prices, but will be contained at about 5 percent over the next three years. Official reserves are expected to rise gradually to 10 weeks of imports of goods and services in 2004, a level that would allow the SBP to absorb some short-term fluctuations in the context of a fully flexible exchange rate. Output growth should recover to 4 percent in 2001/02, boosted by improved competitiveness in the manufacturing industries, while agricultural output growth (2 percent) is expected to lag

[11] The CBR revenue target of the original program for end-June 2001 had already been revised downward by 3 percent at the time of the first review, to take into account the persistent weaknesses in tax administration (EBS/01/39).

behind. Even with normal rainfall in 2001/02, the impact of the present drought will still be perceptible for rice and sugar, because of a reduced availability of water for irrigation and a projected shift away from water intensive crops toward less demanding cotton crops; delays in the present sowing season due to reduced availability of water are also expected to affect negatively yields next year. Real GDP growth would increase to 4.7 percent in 2002/03 and 5.5 percent in 2003/04. The current account deficit is expected to decline gradually to 2.3 percent of GDP in 2003/04.

16. **The medium-term fiscal framework is driven by the need to reduce the debt overhang through continued fiscal adjustment while pursuing ambitious pro-growth and pro-poor tax and spending policies**. The authorities concurred with the staff on the need for steadily reducing the fiscal deficit (excluding grants) by 2003/04; the staff's projection is slightly more ambitious than the indicative path published with the 2001/02 Budget on June 18, with a deficit of 3 percent of GDP by 2003/04. Tax revenue is expected to increase by 0.4 percent of GDP on average annually over the next three years, slightly less than previously envisaged, on account of the expected medium-term negative impact of the business-friendly income tax reform to be launched in 2001/02 (Box 1). Income tax rates will be progressively brought down to 35 percent (a significant reduction for banks and companies), surcharges will be eliminated, and the most distortive presumptive and withholding tax schemes, including those on imports and contracts, will be phased out starting in 2002/03. The staff stressed also the need for a simple system of accelerated depreciation to replace the complex and inefficient investment incentives in the actual income law, and the authorities agreed to implement the new system, effective July 1, 2002. The negative impact of lower tax rates is expected to be progressively offset by positive supply-side and governance-enhancing effects, as the reform will reduce sources of corruption in the tax administration, provided that these measures are accompanied by the envisaged fundamental reform of the CBR. The staff welcomed the authorities' intention to collaborate closely with FAD on preparing an action plan to fundamentally reform the CBR through major organizational restructuring, substantial process redesign, a strengthened audit capability, enhanced use of technology, and better human resource management. More specifically, the reform should aim at phasing in over the next 2–3 years self-assessment and more automated procedures and thus reduce the need for face-to-face contact between taxpayers and tax officials. Apart from building a more buoyant tax system, this reform would clearly be a core element of the government's drive to strengthen governance and reduce the scope for corruption. On the expenditure side, the medium-term framework assumes that defense spending is kept stable in real terms; an expansion of poverty-related spending by at least 0.3 percent of GDP each year, and a wage and pension bill that would be constant as a share of GDP over the next three years.

17. **The discussions on the 2001/02 budget focused on finding the right balance between, on the one hand, the financing of crucial structural reforms and one-off drought-related spending, and continued fiscal adjustment on the other hand**. The main issue was the envisaged cost of the civil service and pension reform (Box 2). The government stressed the urgent need for this reform whose broad objectives and principles are strongly

Box 1. Tax Measures in the 2001/02 Budget

- The 2001/02 budget includes tax measures that are conservatively projected to add revenue estimated at PRs 16 billion, or 0.4 percent of GDP. Revenue will benefit from further broadening of the sales tax base, improved tax administration, and a number of other measures which are expected to more than offset revenue losses from lower import tariffs and the elimination and reduction of some withholding taxes.

- Effective July 1, 2001, the authorities intend to extend the **sales tax** to all retailers and traders above a threshold of PRs 5 million, and eliminate a number of exemptions. Sales tax administration will be strengthened further as outlined in the CBR short-term action plan, focusing specifically on audit, nonfilers, and arrears (see Attachment to the MEFP in EBS/01/39). The authorities also intend to introduce, for three years, a 20 percent GST rate on sales of certain inputs and intermediate products as an incentive to register under the sales tax. In addition, the "further tax" (levied on sales to unregistered agents in selected sectors) will be raised from 1.5 percent to 3 percent.

- Eleven minor **excise taxes** will be abolished, while the structure of the cigarette excise tax will be rationalized. However, these two measures are likely to generate only little additional revenue on a net basis. On **customs tariffs**, the authorities will lower the maximum rate to 30 percent (from 35 percent) and cut the number of tariff slabs from five to four, although some items will remain zero-rated under special regulatory ordinances. In part, the revenue loss from these reforms will be offset by introducing a new streamlined duty refund system based on more realistic input-output coefficients.

- **A fundamental reform of the highly complex and distortionary federal income tax** will be introduced under a substantially streamlined income tax law by end-July. Major measures that will become effective July 1 include: (a) unifying and simplifying the personal income tax for salary and non-salary earners by applying five rates (7.5, 12.5, 20, 25, and 35 percent) and increasing the minimum threshold (from PRs 40,000 to PRs 60,000); (b) beginning the process of unifying over the medium term the corporate income tax rates at 35 percent by abolishing surcharges (5 percent for publicly traded and private enterprises) and reducing the rate for banks to 50 percent (from 58 percent), maintaining the rate for private companies at 45 percent, and raising the rate for publicly traded companies marginally to 35 percent; (c) eliminate five minor withholding taxes effective July 1, 2001, and another five withholding taxes effective fiscal year 2002/03; (d) abolish the exemption for interest income from all new National Saving Scheme (NSS) and a few other financial instruments; and (e) beginning the process of eliminating other exemptions as proposed by the Committee to Revise the Income Tax Ordinance (CRITO). These policy reforms will be coupled with a strengthening of self-assessment procedures backed by stronger audit, and other improvements in income tax administration.

- The provincial **agricultural income tax** will become fully operational on July 1 this year. Legislation which became effective July 2000 is currently being harmonized and uniform regulations prepared for each province, to take effect with the next fiscal year. A taxpayer education campaign is underway, and farmers are expected to file their returns by end-September 2001. Collection efforts will focus primarily on the 30,000 largest farmers. Owing to anticipated teething problems and tax exemptions for farmers in drought affected areas (e.g., Balochistan), only modest additional revenue is expected next year. All agricultural income above a threshold of PRs 80,000 will be taxed on the basis of rate schedules which are broadly the same across provinces (four positive rates and a top marginal rate of 15 percent for annual income above PRs 300,000). While the tax rates are significantly lower than those for non-agricultural income, the minimum threshold is higher, which the authorities defend on poverty grounds and considering the greater uncertainty and risk in agriculture as well as a typically larger number of dependents.

Box 1. Tax Measures in the 2001/02 Budget (concluded)

Estimated Revenue Impact

	In billions of rupees	In percent of GDP
Overall revenue impact	**15.8**	**0.4**
Sales tax	10.9	0.3
Extension to other agricultural inputs from October 1, 2001	1.4	0.0
Extension to retailers/traders from July 1, 2001	1.0	0.0
Extension of domestically produced cooking oil and vegetable ghee from December 1, 2001	1.4	0.0
Improvements in tax administration (better enforcement, arrears collection, etc.) and tax survey	5.0	0.1
Increase in further tax from 1.5 percent to 3 percent	3.0	0.1
Impact of changes in customs tariffs on sales tax collection	-0.9	0.0
Customs tariffs	**-2.6**	**-0.1**
Reduction in maximum tariff from 35 to 30 percent	-3.0	-0.1
Reduction of 25 percent slab to 20 percent slab	-3.0	-0.1
Reduction of 15 percent slab to 10 percent slab	-2.0	-0.1
Reduction of 10 percent slab to 5 percent slab	-2.0	-0.1
Increase of tariffs from zero to 5 percent	2.5	0.1
Increase in tariff on tea from 25 percent to 30 percent	1.2	0.0
Impact of change in refund system on revenues	3.7	0.1
Income tax	**5.2**	**0.1**
Effect from change in withholding on salary income	-1.2	0.0
Abolition of 5 minor withholding taxes	-1.2	0.0
Elimination of exemption for interest income on new NSS schemes	0.3	0.0
Other minor reforms	0.3	0.0
Impact of government pay reform on salary withholding tax	1.0	0.0
Improvements in tax administration and impact of tax survey	6.0	0.2
Excise tax	0.4	0.0
Abolition of 10 minor excise taxes	-0.2	0.0
Rationalizing cigarette excise structure	0.5	0.0
Agricultural income tax (provincial)	**2.0**	**0.1**
Other measures		
Increase in GST rate on certain inputs to 20 percent	Authorities expect PRs 3–4 billion	
Other income tax reform (fourth bullet point above)	No effect in 2001	

Box 2. The Proposed Pay and Pension Reform Package

- The authorities have announced with the 2001/02 budget a pay and pension reform package for all federal and provincial civil servants and the military, to be implemented in the middle of the 2001/02 fiscal year. On a full-year basis, the package would add about PRs 35 billion (close to 1 percent of GDP) to the budget, and result in an average pay increase of around 15 percent. Pay and pension reforms will be offered as a package to each civil servant, as a unilateral reduction in pension benefits seems legally not feasible.

- Proposed pay reforms include: (a) decompressing the pay scale and bringing civil service wages, especially those in higher grades, closer in line with comparable private sector remuneration; (b) monetizing in-kind allowances and incorporating cash allowances into basic pay; (c) eliminating automatic promotion and "move-over" into higher grades while establishing a better performance appraisal system; (d) eliminating several ad-hoc benefits; and (e) offering time-bound contracts for new entrants, especially in routine functions.

- The associated pension reforms include: (a) a lower replacement ratio (60 percent instead of 70 percent), (b) less favorable commutation terms (the share of pensions that can be paid out in cash upon retirement will be reduced from 50 percent to 40 percent; and lower commutation factors will reduce the cash value of pension entitlements); (c) reductions in survivor benefits, and (d) elimination of a number of other pension benefits. New entrants will participate in a new, yet to be fully specified, fully or partially funded pension system.

- The pay and pension reform will be combined with stronger efforts at federal government restructuring, including the privatization of functions (e.g., cleaning services, maintenance of government services); mergers and closures of agencies and divisions; and placing about 40,000 federal staff in the "surplus pool" (i.e., these staff will go on paid leave). As a result, within the federal government the officer-staff ratio would be reduced from currently 1:4 to 1:3.2 from July 1 this year, and to 1:2.5 from July 1, 2002.

- The World Bank strongly supports the broad objectives and principles of package as a first step towards addressing important structural weaknesses and distortions of the current system such as rapidly increasing pension payments, especially for defense staff, which are due to a combination of large commutation payments, low retirement ages, and strong increases in employment. Over the coming months, the authorities will in close consultation with the World Bank review the pay and pension outlook, including further actuarial analysis, with a view to develop a comprehensive medium-term pension reform.

supported by the World Bank. It argued (a) that the sizable initial cost of the reform was largely unavoidable in order to provide civil servants with a decent living wage, given the substantial erosion since the last general adjustment in 1994; (b) that the reduction of the gap with private sector wages, essentially for the high grades, was a key element of their governance and anti-corruption strategy; and (c) that the associated pension reform would yield substantial savings over the medium-term. The mission agreed on the need for reform, but pointed at the destabilizing effect of looser fiscal policies, given the difficult balance of payments situation and the unfavorable public debt dynamics. It noted that the budget should not undermine the credibility of the government's recently adopted and widely publicized report on a debt burden reduction and management strategy, which envisages continued strong fiscal adjustment and economic and governance reforms that could help Pakistan obtain more concessional support from donor countries, including through debt rescheduling at more concessional terms.[12]

18. **In the event, the budget announced in mid-June calls for containing the deficit (excluding grants) to 4.9 percent of GDP, compared to an estimated 5.3 percent in 2000/01**. Excluding two one-off operations (drought relief and bank restructuring, see below), fiscal adjustment would amount to 1 percent of GDP. This fiscal adjustment will be complemented by a further reduction in the combined deficit of the seven major public enterprises to 1.0 percent of GDP, from an estimated 1.2 percent in 2000/01. The projected increase in tax revenue (by 0.4 percent of GDP) reflects strong tax policy and administration reforms such as the extension of GST to retail trade and agricultural inputs, the abolition of several income tax exemptions, and the introduction of a provincial agricultural income tax (Box 1). The authorities also instituted for three years an increase in the GST rate from 15 percent to 20 percent on selected raw materials and intermediate inputs, with a view to strengthen incentives for unregistered users of these inputs to enter the tax net. The mission recognized this objective, but expressed strong reservations about the likely administrative complications. The authorities agreed to revisit this issue in the context of the next review mission and scrap the measure if it did not have the intended positive effects on revenue and registration. In addition, the budget incorporates major steps toward a more investment-friendly tax environment such as the reduction of the maximum customs tariff from 35 to 30 percent; first steps toward the unification of the individual and corporate tax rates, and the phasing out of distortive withholding practices. The budget also includes specific tax and nontax incentives for the depressed housing sector.

19. **On the expenditure side, the budget maintains pay and pension outlays at 6.2 percent of GDP, but provides for a strong increase in development (0.6 percentage points of GDP) and social and poverty-related (0.3 percent) spending**. The pay increase to be offered to civil servants will be effective only in December 2001 with new higher wages paid from January 2002, which will allow time for the government to review further, with the

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[12] Summary Report of the Debt Reduction and Management Committee, Government of Pakistan, Finance Division, March 2001.

assistance of the World Bank, the specifics of the reform package and develop a longer-term reform of the pension system based on in-depth actuarial analysis. Some concerns of the staff relates to (a) sequencing issues, in particular the fact that the envisaged pay increases will provide incentives for low-grade personnel to remain in the civil service and may thus increase the cost of the subsequent needed downsizing; and (b) the remaining uncertainties regarding the design of the pay and pension reform at the provincial level. Nonwage and nonpension defense expenditure would be frozen in nominal terms. The budget will incorporate also two one-off spending programs, both financed by concessional resources from IDA and the Asian Development Fund. The first (for about 0.3 percent of GDP) is an emergency program to assist the (mainly rain-fed) areas most affected by the drought through vaccination programs to save cattle stocks, and small-scale labor-intensive programs on irrigation water-saving and road projects. The second program would finance over the next two years the costs of redundancy packages aimed to reduce over-employment in the three large nationalized banks and support the closure of hundreds of unprofitable branches. This step is considered essential by the authorities and the World Bank to prepare for a successful privatization of the three banks. Development expenditures in the 2001/02 budget aim at meeting critical needs in water and transportation infrastructure, while providing substantial financing for labor-intensive, human capital-enhancing and poverty-reducing programs in the area of public works, education, and food support for the poorest.

20. **The planned fiscal stance would underpin a prudent monetary policy while allowing adequate private sector credit.** Broad money growth is targeted at 9.3 percent, in line with nominal GDP, while private credit would grow somewhat faster (10.6 percent). The authorities recognized that in view of the risks of further unexpected shifts in the money multiplier and market sentiments, and a possible rebound of inflation in the coming months, vigilance is needed to ensure that the monetary policy stance remains sufficiently tight to keep inflation under control. The mission noted also the inefficient functioning of the interbank money market, since call money rates are frequently far below the central bank's intervention rates. This calls for more active SBP intervention through instruments that would signal the monetary stance on a day-to-day basis and offer more attractive alternatives for banks' short-term liquidity in rupees. At present, the absence of such alternatives may force banks to keep unnecessary long foreign exchange positions, and contributes to the lack of depth of the interbank foreign exchange market.

21. **The authorities reiterated their commitment to make the exchange rate fully flexible.** The mission expressed concerns about SBP's continued purchases on the kerb market and sales in the interbank market to finance oil imports, and emphasized the need for a truly market-based flexible rate, with minimum intervention, including refraining from moral suasion to cap exchange rate volatility. Staff noted that some of the observed volatility reflects the exchange rate cycles induced by SBP policy: a relatively stable exchange rate in the period following a program test dates, leading to the depletion of official of foreign reserves, followed by subsequent substantial exchange rate depreciation and interest rate increases to meet the reserves target as the next test date was getting closer. The mission welcomed plans for more steady efforts to build up reserves (as signaled in the authorities' commitment to monthly

floors starting in July) and for limiting SBP's interventions to smoothing out the temporary effects of bulky transactions in the thin interbank market, while reducing purchases in the kerb market and relaxing nostro limits on banks' balances held abroad on account of trading activities. In particular, staff emphasized that in its view resources in the kerb market should eventually find their way into the interbank market, provided the foreign exchange operations of commercial banks were gradually liberalized as recommended in recent MAE technical assistance reports. The authorities cautioned, however, that an immediate withdrawal of the SBP from the kerb market was not feasible, as the required deepening of the interbank market deepening would take time; in the meantime there was a need for smoothing operations to avoid destabilizing the thin interbank market.

C. Structural Reforms.

22. **The authorities have set an ambitious structural reform agenda for the months to come that is driven by the need to improve economic governance**. As detailed in the supplementary MEFP and TMU, in addition to the tax measures under next year's budget, the authorities plan the liberalization of wheat trade and marketing; further steps toward market-based pricing in the energy sector; reform of the public sector enterprises and privatization; fiscal devolution; and other specific governance reforms. The mission also discussed preparations for the transition of the financial sector to Islamic financing principles and the revised draft of the interim Poverty Reduction Strategy Paper (IPRSP).

23. **Improving fiscal and financial transparency and the quality of statistics remains a key priority of the government.** In recent months, considerable efforts have been made to release and discuss publicly reports such as the first blueprint of the IPRSP, the report on the debt strategy, and preliminary budget proposals. Reconciled public accounts have been recently put on the Internet for the first three quarters of FY2000/01, both at the federal and provincial levels. The mission reiterated its strong concern about large unidentified expenditure, pointing to the urgent need to strengthen accounting especially at the provincial/district levels. The authorities concurred, and plan to set up a system for the tracking of poverty-related expenditures at federal and provincial levels. Recent legislation separates audit and accounting functions, and both are being further strengthened under a World Bank sponsored project. The implementation of the remedial actions that were agreed after the Stage Two safeguards (on-site) assessment of the SBP conducted in November of last year appears to remain on track. The SMEFP provides details on the status of the two structural performance criteria to be completed by end-June and the one remaining prior action to be met prior to the third review under the program. The mission pointed out that recent revisions to past GDP data highlight the need for improving national accounts data, and welcomed that the preparatory work for a comprehensive overhaul of the national accounts statistics was proceeding as scheduled with technical support from the Fund's Statistics Department. In April 2001, three sectoral research studies were completed for fishing, shipping, and services, and another four studies are scheduled for completion by end-June. The mission also welcomed that the authorities are preparing for a data-ROSC in September 2001.

24. **Reforms in the other areas of governance are also under way.** The delivery of relevant government services will be devolved to elected local governments, effective August 14, 2001. The mission received further assurances that devolution will not lead to fiscal indiscipline: accounting and audit functions will be the responsibility of the newly established national Controller General of Accounts, and audits will be conducted by the Pakistan Auditor General. In addition, salaries, recruitment and the management of certain development projects will remain under provincial control, at least during the transition period. Resources would be allocated from provinces to districts according to a formula—to be announced by end-December 2001—that would be based on population criteria along with a mechanism to tilt support to relatively poorer districts. Starting next fiscal year, the government is embarking on a comprehensive reform of the judiciary with support from the AsDB, with the view in particular to reducing court delays, introducing alternative dispute resolution mechanisms, enhancing training for judges, improving budgetary and financial management for courts, and posting all judgments on a website.

25. **Plans to make the financial system more market-based are proceeding as scheduled (SMEFP, paragraph 24) and the SBP is strengthening prudential regulations.** Effective July 1, 2001, interest rates on National Saving Schemes (NSS) instruments will be linked to market rates, interest income on newly-issued NSS instruments will be taxed, and subsidies on the Export Financing Scheme will be eliminated. A doubling of minimum capital requirements for commercial banks is being phased in and banks' ratings and external audits are being strengthened. An FSAP mission scheduled for this summer will assist the authorities in assessing the weaknesses of the banking sector and in formulating a comprehensive strategy to develop a viable financial sector that would be conducive to growth and investment, while ensuring that Pakistan applies best international practices against money laundering. In this regard, the mission urged the authorities that a planned law, aimed to attract more capital from nonresident Pakistanis through banking channels (as opposed to the nontransparent "Hundi" system) by clarifying taxation issues relating to remittances, should provide scope for appropriate scrutiny by the tax authorities as to the origin of funds remitted from abroad.

26. **The deadline of July 1, 2001 for compliance of the financial sector with Islamic Financing Principles has been extended by one year by the Supreme Court in a judgment on several petitions filed by a commercial bank and joined by the government.** The authorities have reiterated assurances that the transition will not endanger financial stability and efficiency, the conduct of monetary policy and the domestic financing of the budget, and that all foreign and existing domestic debt and loan contracts will be honored. Under the circumstances, the government intends to make public in the coming months its plan on the modalities and the timetable for the transition to Islamic Financing Principles. Preparation is already underway to design a legal framework to encourage practice of Islamic banks in the area of housing and trade financing. The government's plan will take into account experiences in other Islamic countries. Staff expressed concern about the impact of the uncertainty surrounding the future "rules of the game" on investors and savers, and

emphasized that a clear and publicly announced strategy for financial sector reforms, including the application of Islamic Financing Principles, will need to be elaborated before any medium-term program supported by the PRGF can be finalized.

27. **Substantial steps towards the elaboration of a Poverty Reduction Strategy have been achieved in the last months, both on the content and on the process.** The authorities have elaborated a draft IPRSP that aims to set out a credible strategy to extract the country from the debt and poverty traps of the last decades. It has been discussed extensively within the government, with local communities, NGOs, and donors. In commenting on the draft IPRSP, the mission stressed mainly the need for further analysis of the causes of poverty, better tracking and budgeting of the required public spending, in particular in the area of primary education and health, and further consultation with NGOs and civil society.

28. **The authorities intend to liberalize gradually the wheat sector, starting next fiscal year**. State intervention, trade controls and subsidies still play a crucial role in the procurement and commercialization of wheat in Pakistan, leading to distortions and rent situations at specific stages of the transformation process (such as mills). Starting July 1, the government will eliminate the licensing requirements for wheat imports (to be replaced by tariffs) and exports. Over the next two years, the government will phase out provincial subsidies to consumers and millers, transfer to the private sector a large portion of trading and storage activity, and limit its intervention to the maintenance of strategic stocks equivalent to one to two months of domestic consumption. Further steps scheduled to deregulate the energy sector include decontrol of petroleum prices at the wholesale and retail trade levels effective July 1. WAPDA will also initiate the passing on to all private consumers of the GST on electricity tariffs, in conjunction with the next tariff adjustment planned before September 2001.

29. **The government remains firmly committed to trade liberalization.** As of July 1, 2001, the maximum tariff will be reduced to 30 percent and the number of tariff slabs reduced to four (5, 10, 20 and 30 percent), except for a few zero-rated items including IT imports. At the same time, to promote transparency in the customs tariff regime, the use of Statutory Regulating Orders (SROs) will be substantially curtailed (from 120 to 60). Effective July 1, 2001, discrimination in excise rates between imported and domestically produced goods will be eliminated, while regulatory duties imposed on several items [13] will be abolished. The few remaining regulatory duties will be allowed to lapse gradually to comply with outstanding agreements with some domestic industries. In any event, the combined duty (including customs duty) will not exceed 30 percent after July 1, 2001. The government will phase out quantitative import restrictions maintained for balance of payments reasons, as agreed with the WTO Committee on Balance of Payments Restrictions.

[13] Calcium carbide, urea fertilizer, steel bars, formic acid, urea formaldehyde moulding compound, BOPP film, medium intensity fibre board, craft paper sacks and jute bags .

30. **The privatization of two large public enterprises, Pakistan Telecommunications Company Limited (PTCL) and United Bank Limited (UBL), is under way.** Several foreign investors are expected to confirm formally their interest by June 2001, and the authorities expect that the privatization process will be completed in 2001 with proceeds accruing to the budget. They hope that this strong signal to other potential foreign investors will facilitate the privatization of the other two banks and several other public companies, notably in the energy sector.

31. **The authorities agreed that the financial situation of several public companies, including Karachi Electric Supply Company (KESC) and PIA will need close monitoring to avoid a potential drain on next year's budget.** KESC continues to run large operating deficits in spite of the substantial increase in tariffs granted in March. This is mostly due to difficulties in recovering bills from private customers on account of the difficult law and order situation in Karachi, as well as mismanagement. KESC (and WAPDA) also claim that public entities accumulate payment arrears, an issue that the government has decided to address through specific remedial actions (SMEFP, paragraph 23). A financial and technical restructuring operation supported by the AsDB aims to turn around KESC's financial position and prepare it for privatization by mid-2002, but a specific action plan will need to be adopted to ensure that KESC's deficit is contained and financed appropriately in 2001/02. More generally, the mission urged the authorities to make sure that tariff adjustments for these companies and WAPDA are timely and adequate, with a view to absorbing operating cost drifts, including those related to world energy price increases and the recent exchange rate depreciation against the U.S. dollar.

IV. Balance of Payments Outlook and External Financing Issues

32. **The current account deficit (excluding official transfers) for 2001/02 is projected to decline to 3.2 percent of GDP**. The trade deficit is projected to improve by 0.3 percentage points of GDP over the current year, because of continued strong export volume growth, improved terms of trade and increased public savings. The capital account balance will deteriorate further largely because about US$700 million of the special U.S. dollar bonds, which were exchanged mainly by residents against frozen currency deposits in 1998, are maturing in 2001/02. Expected private capital inflows include US$600 million in foreign direct investment in the energy sector, and US$500 million in portfolio investment as a result of privatization of UBL and PTCL. On the basis of international financial institutions' (IFIs) financing commitments and debt relief under the current Paris Club agreement,[14] the program would be fully financed until end-September, when the present arrangement ends. For the

[14] The authorities have already signed eight bilateral agreements with the Paris Club creditors and are confident that all other agreements (including those with non-Paris Club bilateral creditors) will be concluded by end-August 2001.

fiscal year as a whole, the external financing gap is projected at US$3.4 billion (about 6 percent of GDP), which would need further IFI support as well as debt relief and other exceptional financing to be fully covered (Box 3).

33. **Over the medium-term, the external current account (excluding official transfers) is projected to narrow to a deficit of 2.3 percent of GDP by 2003/04, assuming continued fiscal adjustment and structural reform**. Export volume growth is expected to be sustained at about 7 percent a year as a result of structural reforms, the recent real depreciation of the exchange rate, and expected further gains in competitiveness. Textile exports may also benefit from a possible liberalization of textiles imports to the European Union ahead of the schedule of WTO agreement on textiles. Import volumes are projected to grow at 7 percent a year, somewhat above real GDP growth. The capital account should also improve substantially mainly due to large private direct and portfolio investments, following the implementation of the reforms under the program and its beneficial effects in terms of building-up of confidence.[15] However, the financing gap will remain large (about US$3 billion or 5 percent of GDP on average over 2002/03 and 2003/04), and will have to be closed by continuing financial support from multilateral and bilateral creditors, as well as by additional debt rescheduling. The mission encouraged the authorities to put in place the key elements of their debt strategy (see above) in order to provide investors and the public a clear and credible vision of the path towards a sustainable external position. External debt is projected to decline from the current level of 244 percent of exports of goods and services to 215 percent by end-2003/04 (Table 6). Gross reserves (net of FCDs) are projected to reach US$ 3.6 billion by end-June 2004 (12 weeks of imports of goods and nonfactor services).

34. **Despite the risks to the projections, arising in particular from possibly higher oil prices[16] and lower private capital inflows, Pakistan should not encounter difficulties with respect to its capacity to repay the Fund**, provided the momentum of adjustment and reform is maintained. Assuming that all purchases under the Stand-By Arrangement are made, Pakistan's liabilities to the Fund would peak at a maximum of 5.7 percent of total public and publicly-guaranteed debt in 2000/01 and 14 percent of projected exports (Table 7). Debt service obligations would peak at 3.1 percent of exports during the repayment period and would not exceed 15 percent of gross official reserves after 2000/01.

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[15] The government is preparing an ordinance that would protect both residents and non-residents' foreign currency accounts against any possible future seizing or freezing.

[16] An increase by US$1 in the price per barrel of crude oil implies a deterioration, other things being equal, of US$100 million (0.2 percent of GDP) in the current account.

Box 3. Pakistan: Closing the External Financing Gap, 2001/02

Of the total projected gap for 2001/02, possibly US$1.2 billion could come from additional World Bank and AsDB program loans. The World Bank disbursements could include US$100 million for drought-related emergency assistance, US$200 million for the Banking Sector Reform project (this was included as a balance of payments support because the loan will support severance payments only with no direct impact on the current account), and US$350 million for a PRSC or SAC II. The AsDB disbursements could include US$175 million for the Agricultural Program, US$50 million for TEPI, US$75 million for the Energy Sector Restructuring Program, US$80 million for the Legal Reform Program, US$20 million for Microfinance Credit Program, US$60 million for the SMETEF, and US$100 million for drought-related emergency assistance. Additional bilateral creditors' debt relief could provide an additional US$780 million to cover the gap. The remainder of US$770 million would need to be covered from other resources, including additional support from IFIs (including the Fund) and private sector contributions yet to be defined.

Closing the External Financing Gap, 2001/02

	First Quarter 2001/02		2001/02	
	In millions of U.S. dollars	In percent of GDP	In millions of U.S. dollars	In percent of GDP
Financing gap	**328**	**0.6**	**3,420**	**5.8**
World Bank	200	0.3	650	1.1
AsDB	100	0.2	560	0.9
Rescheduling of Special U.S. bonds	10	0.02	600	1.0
Savings in interest payments	18	0.03	60	0.1
Additional bilateral creditors debt relief 1/	0	0.0	780	1.3
Other	0.0	0.0	770 2/	1.3

1/ Assuming rescheduling of pre-cutoff maturities falling due on same terms as under the Paris Club agreement of January 2001.

2/ Includes additional support of IFIs (including the Fund) and private sector contribution yet to be defined.

V. Program Monitoring and Design

35. Prior actions and performance criteria are specified in the SMEFP, and are critical for achieving the macroeconomic objectives of the program (Box 4). The SMEFP specifies also indicative quantitative and structural targets for end-September 2001 and end-December 2001 to guide the transition from the present Stand-By Arrangement to a possible successor arrangement.

VI. Staff Appraisal

36. **Macroeconomic performance under the program through April has been mixed, with inflation lower than programmed but a weakening of growth and external balances partly due to a severe drought**. The inflation outcome reflects a broadly successful effort by the authorities to maintain a cautious monetary policy; the fiscal effort left room for private credit to continue growing at a healthy pace. However, the rebuilding of official reserves was disappointingly slow and CBR tax revenue collection again fell short of the targeted levels—although the improvement in revenue collection over last year is still impressive. In both cases, drought-related factors clearly complicated the authorities' task. However, staff feels that a timely stepping up of purchases in the interbank market could have kept reserves closer to the programmed path, and could have avoided recent strains on a thin foreign exchange market. On tax revenue, staff is encouraged that the CBR is now implementing with determination the short-term action plan elaborated with FAD. The revenue shortfalls have necessitated cuts in expenditure, some of which may well have fallen on social expenditure. However, the weaknesses in expenditure data, which must be addressed urgently, does not allow a more specific analysis of the data. Staff is impressed with the strong determination of the authorities to implement structural reforms; virtually all measures planned for end-March were implemented and reforms appear on track for the remainder of the fiscal year.

37. **Looking ahead, the main immediate challenge will be implementation of next year's budget (July 2001–June 2002) and the underlying tax/expenditure reform packages.** The planned deficit (excluding grants) of 4.9 percent of GDP attempts to strike a balance between the need to finance various critical development programs and structural reforms, and the overarching need for fiscal adjustment to reduce Pakistan's debt overhang. The budget provides for a strong increase in development expenditure with emphasis on infrastructure (in particular water management) and a further increase in social and poverty-related spending, including the launching of an education reform strategy that is a centerpiece of Pakistan's emerging poverty reduction strategy. Nonwage/nonpension defense expenditure would be frozen in nominal terms—a step strongly welcomed by the staff. The budget also includes emergency assistance to the most drought-stricken areas and the cost of restructuring three public banks in preparation for their privatization. The staff encourages the authorities to ensure that emergency assistance is well targeted and that the bank restructuring leads to rapid privatization of the banks.

Box 4. Structural Conditionality

1. Coverage of Structural Conditionality in the Current Program

Structural conditionality is detailed in Tables 2 and 3 attached to the SMEFP. The structural measures included in the Fund program are rather comprehensive given the poor track record of Pakistan under earlier programs, but focused on critical areas. Virtually all measures are part of the original program as approved by the Executive Board in November and under the first review in March. Additional steps in the context of the second review involve prior actions as well as benchmarks for the period July–September 2001 that have a direct bearing on achieving the targeted macro balances, related to official reserves and key elements of the 2001/02 budget (tax and subsidy reform, the wage and pension bill). Another benchmark—development of a financial sector reform strategy—is in the Fund's domain and aimed at improving medium-term growth prospects.

2. Status of Structural Conditionality from Earlier Programs

The status of all measures under the earlier program (i.e., the original program as well as changes approved under the first review) is reported in Table 2.

3. Structural Areas Covered by World Bank and other Donors' Lending and Conditionality

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

The Asian Development Bank (AsDB) is supporting Pakistan adjustment effort through an Energy Sector Restructuring Program loan (including conditionality leading to the privatization of KESC and the corporatized WAPDA entities); a Small and Medium Enterprise Trade Enhancement Finance loan and a Trade, Export Promotion and Industry program.

38. **On the revenue side, staff concurs with the authorities' cautious expectations regarding any immediate gains from the enactment of various tax policy reforms**. While staff argued for a somewhat more ambitious pace in tax reform—notably a faster phasing out of withholding taxes, a more rapid convergence of corporate tax rates, and no tinkering with the GST rate structure—staff recognizes the difficulties of financing additional revenue losses that would result from faster income tax reform, and the package is clearly a strong step in the right direction.

39. **The staff supports the thrust of the authorities' civil service reform strategy**, which has been strongly endorsed by the World Bank, starting with the recent overhaul of recruitment practices, the planned down/right sizing of the Federal Service, and better training. There is also a case for overhauling the pay structure to address governance issues and for slowing the worrisome growth of pension outlays, in particular for military pensions. Staff shares the result of a preliminary World Bank analysis indicating that the proposed package goes into the right direction, but it urges the authorities to conduct in consultation with the World Bank in the coming months an in-depth (including actuarial) analysis of the package, in order to identify any problematic features before it is implemented and to formulate a long-term strategy for pension and pay reform.

40. With significant expected privatization receipts and foreign financing, **the planned budget would allow a prudent monetary policy while leaving room for adequate private credit growth**. Careful coordination of monetary and exchange rate policies will be critical to achieve the inflation and reserves targets. Provided that the fiscal targets are adhered to, inflation remains on target, and the needed reserve purchases be well spread over time, the staff sees some prospect for gradually reducing interest rates in the coming months. In this regard, staff urges the authorities to gradually phase out purchases in the kerb market and develop further the interbank market, while maintaining a genuinely flexible exchange rate policy, free from intervention and informal directions from the authorities. Given the continued uncertainties with regard to rupee cash demand, the SBP needs to monitor monetary aggregates very closely and adjust interest rates/use open market operations as needed to achieve the inflation target.

41. **The staff looks forward to the timely implementation of the authorities' ambitious structural reform agenda, with emphasis on improving governance on various fronts**. Staff agrees that devolution offers an opportunity to improve the targeting and productivity of public expenditure through better monitoring by elected representatives, citizen boards, and stronger representation of women in local councils, but urges the authorities to make sure that there is no loss of fiscal discipline. In particular the authorities need to ensure that local governments would not be able to borrow and would be sufficiently constrained in their ability to hire; that during the transition over the next few years accounting would remain with the established provincial structures; and that the devolution of expenditures would be commensurate with the capacity of local governments to manage larger resources.

42. **The staff is of the view that the additional delay provided by the Supreme Court for the transition to Islamic Finance principles should be used to elaborate,** as soon as possible, a clear medium-term strategy for financial sector reform in order to reduce uncertainty for banks and investors. A viable strategy that honors existing contracts and provides for workable instruments to conduct monetary policy and mobilize budget financing is also essential for Fund support under any successor arrangement.

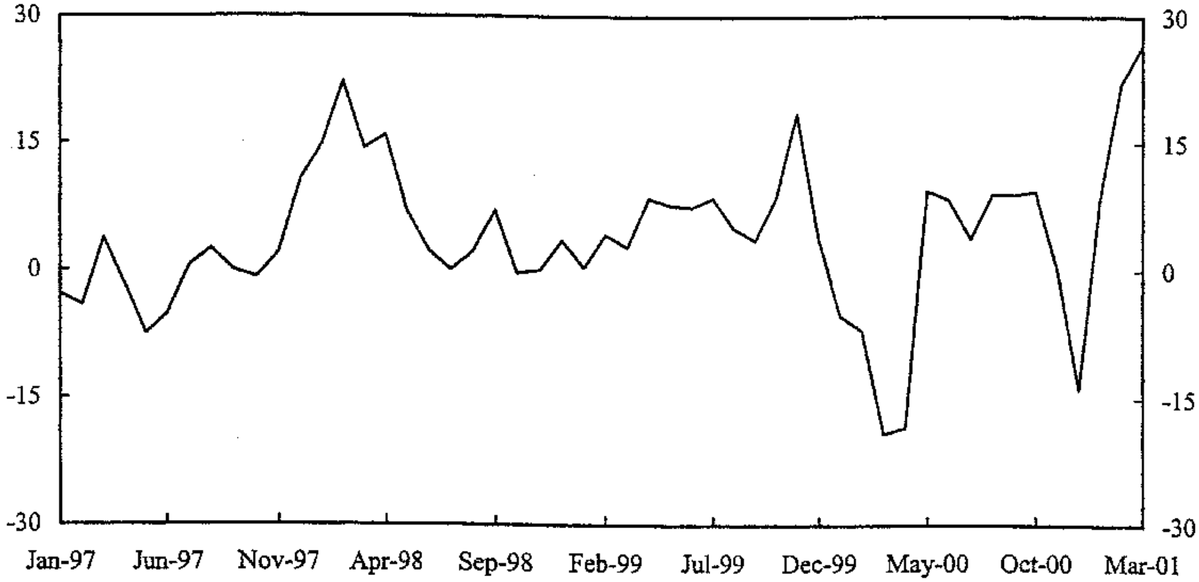
43. **Financing needs for the coming year remain large**, and the staff encourages the authorities to firm up a financing strategy along the lines laid out in their recent debt management report, focusing on the steps needed to attract highly concessional external support. For the more immediate future, staff encourages the authorities to complete on schedule all remaining bilateral agreements with Paris Club creditors and ensure comparable treatment from all other bilateral creditors, and implement without delay the measures needed to allow disbursement of planned AsDB and World Bank resources. On the basis of the financing elements fully secured through September 2001, the staff recommends the completion of the second quarterly financing review.

44. **There are significant risks to achieving the program objectives**. Persistence of the drought would further weaken growth and external balances while aggravating already severe economic and social dislocations mostly in rain-fed areas. A more pronounced global slowdown would affect in particular industrial sector growth and exports. External balances remain vulnerable to higher oil prices—especially if the drought-related switch for hydropower to thermal power generation persists—as well as private capital inflows. The budget continues to be highly exposed to financial developments of major public enterprises, which remain vulnerable to a further deterioration of cost recovery, as well as higher oil prices. The authorities need to closely monitor the financial situation of the utilities, and press ahead with the preparation of privatization for KESC, as well as with corporatization and as needed further tariff adjustments for WAPDA.

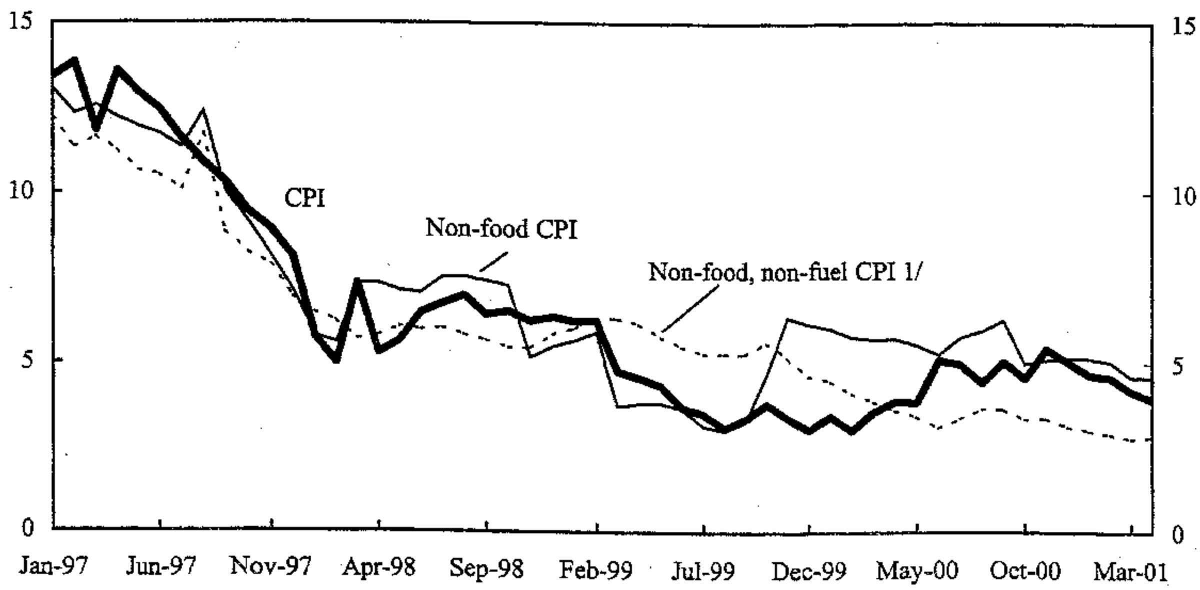
45. Despite the risks, the staff believes that in view of the authorities' continued commitment to prudent financial policies and solid recent track record on structural reform, with essential steps included in the budget to be announced prior to the Executive Board meeting, Pakistan merits continued Fund support. Accordingly, the staff recommends granting the necessary waivers and completion of the second review under the Stand-By Arrangement.

Figure 1. Pakistan: Output and Inflation, 1997–2001

Manufacturing Production Index, 1997-March 2001
(Year-on-year percentage change)



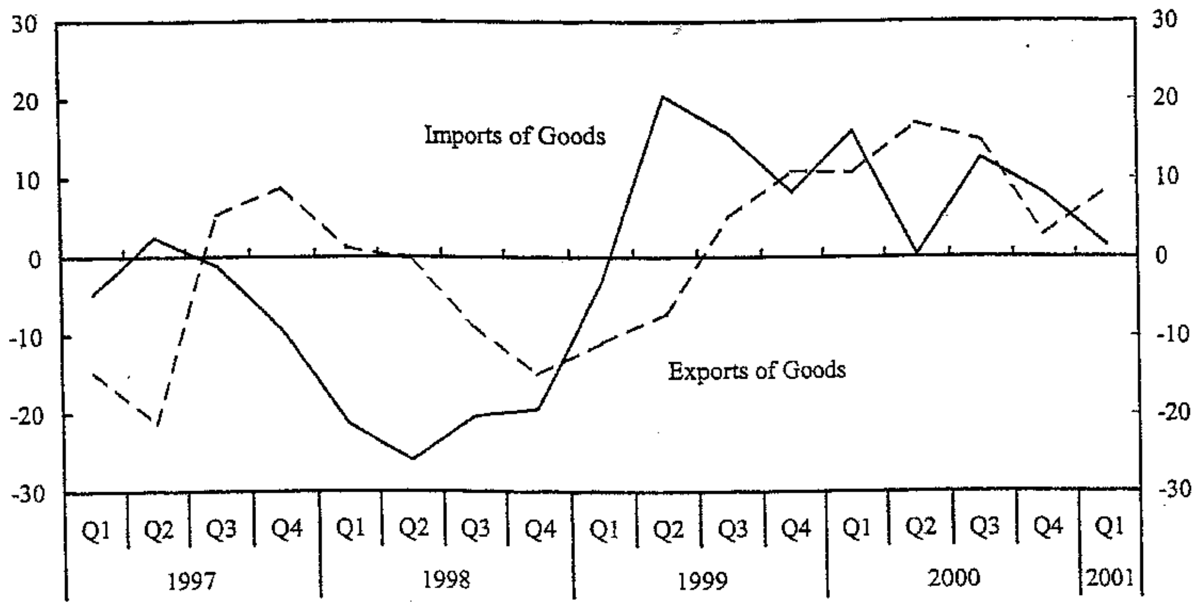
CPI Inflation, 1997 -April 2001
(Year-on-year percentage change)



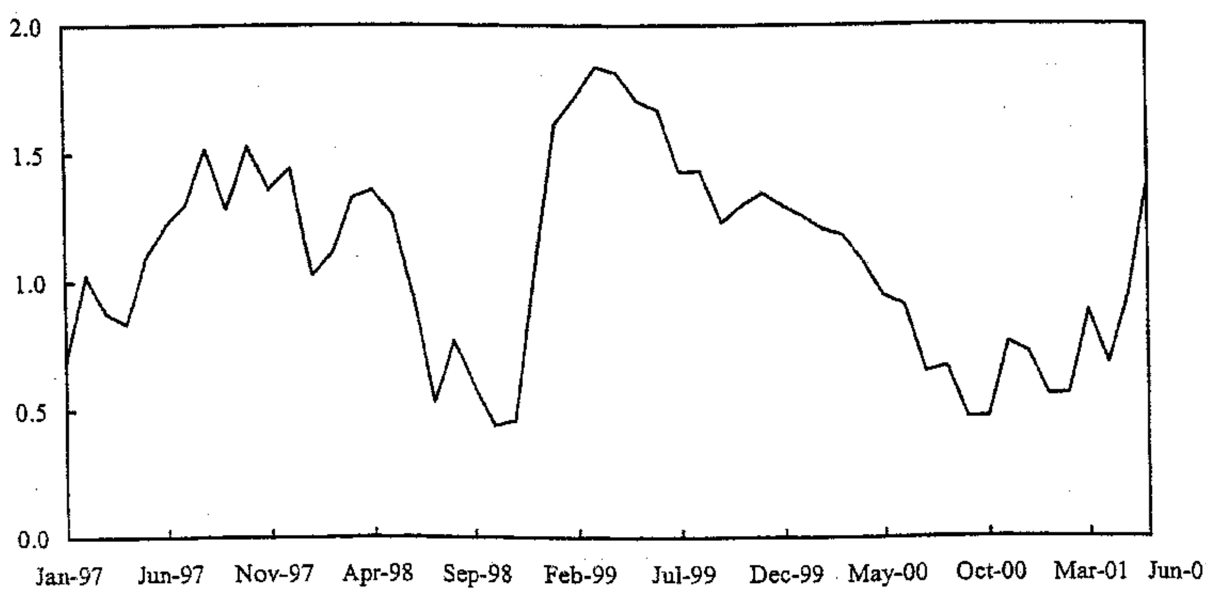
Source: Data provided by the Pakistan authorities.
1/ This excludes the Food, Fuel & Lighting, and Transportation & Communications Groups.

Figure 2. Pakistan: External Sector Developments, 1997–2001

Exports and Imports
(Year-on-year percentage changes of values in U.S. dollars)

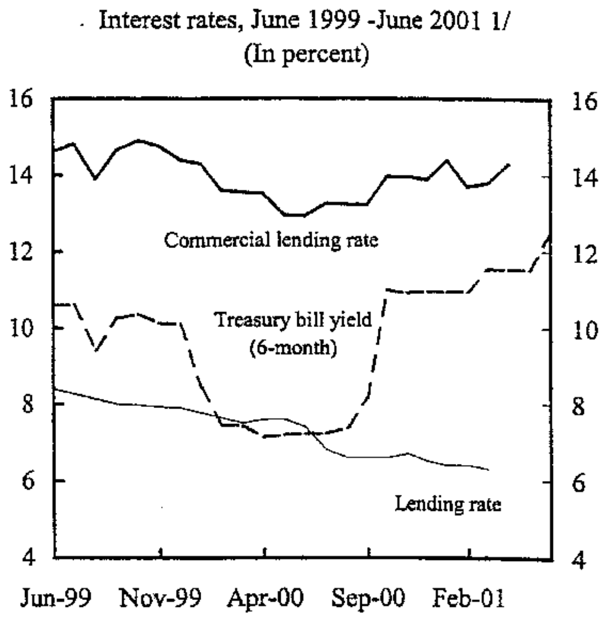


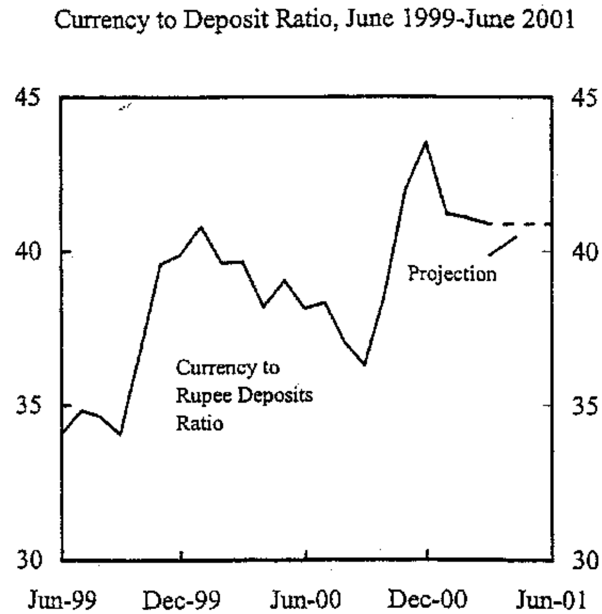
Gross Official Reserves, 1997 - June 2001 1/
(In billions of U.S. dollars)

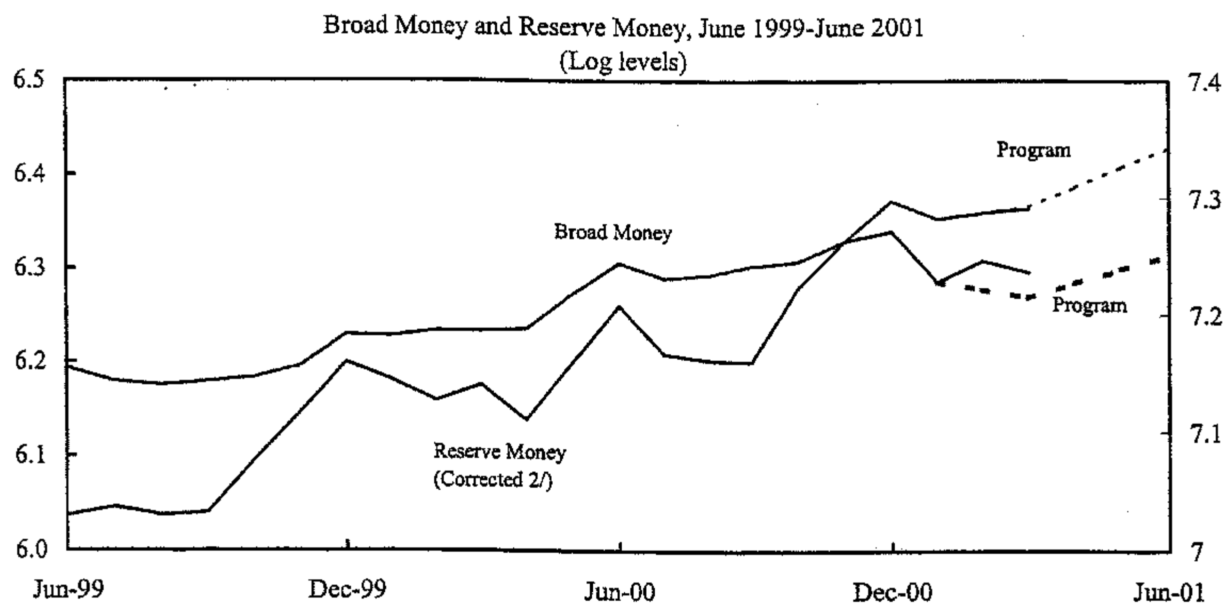


Source: Data provided by the Pakistan authorities.
1/ Excluding foreign currency deposits held with the SBP (State Bank of Pakistan) and short-term foreign currency swaps. June data as of June 20, 2001.

Figure 3. Pakistan: Monetary Developments, 1999–2001

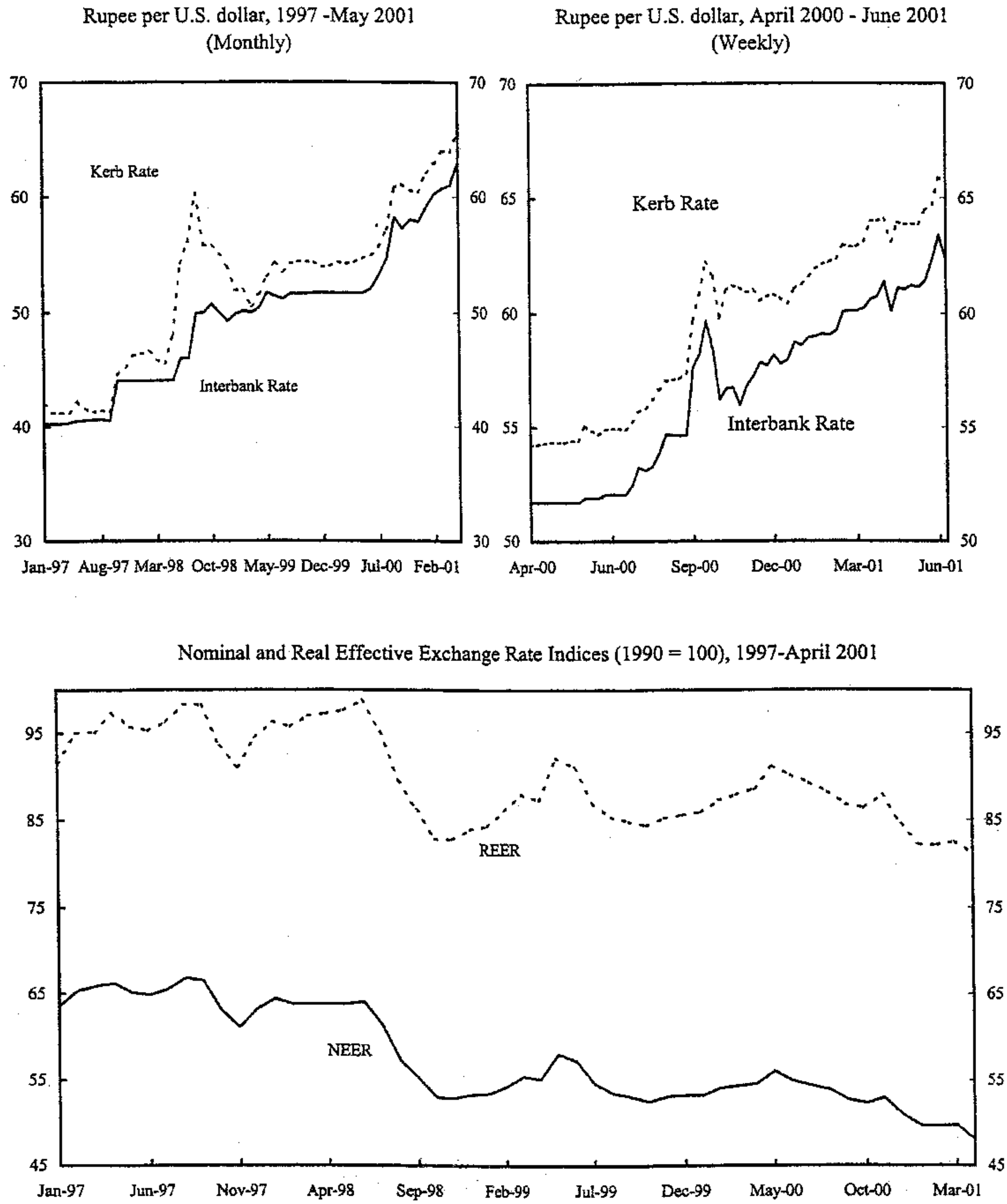






Source: Data provided by the Pakistan authorities.
1/ Data for commercial lending rate and lending rate are through April 2001.
2/ Adjusted for exceptional operations at end December and end March.

Figure 4. Pakistan: Exchange Rate Developments, 1997–2001



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

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

	1998/99	1999/2000	Rev.Prog. 2000/01	Est. 2000/01	Proj. 2001/02	2002/03	2003/04
	(Annual changes in percent)						
Output and prices							
Real GDP at factor costs	4.2	3.9	3.8	2.6	4.0	4.7	5.5
Real GDP at market prices	3.7	4.4	4.3	3.3	4.5	4.7	5.5
Partner country demand	2.5	4.0	4.0	3.7	3.0	3.5	3.7
Consumer prices (p.a.)	5.7	3.6	5.0	4.7	5.1	5.2	5.1
Partner country consumer prices 1/	-0.7	0.0	-1.3	-2.1	0.1	1.9	2.0
Rupees per U.S. dollar (p.a.)	17.0	3.0	11.7	11.8	...	...	...
	(In percent of GDP)						
Savings and investment							
Gross national savings	11.9	13.5	13.9	12.4	13.5	13.6	14.8
Public 2/	-1.1	-2.1	-1.0	-1.2	-0.5	0.8	1.9
Private	13.0	15.6	14.9	13.6	13.9	12.8	12.9
Gross capital formation	15.6	15.6	15.5	14.7	15.2	16.0	16.8
Public 2/	5.0	4.3	4.5	4.2	4.5	4.6	4.9
Private	10.6	11.3	11.0	10.4	10.7	11.4	11.9
Savings-investment balances	-3.6	-2.1	-1.6	-2.2	-1.7	-2.4	-2.0
Public 2/	-6.0	-6.3	-5.5	-5.4	-5.0	-3.8	-3.0
Private	2.4	4.2	3.8	3.2	3.2	1.4	1.0
Public finances							
Budgetary revenue	16.2	16.5	16.3	16.1	16.9	17.2	17.4
Budgetary expenditure	22.2	22.9	21.5	21.3	21.8	20.9	20.4
Budgetary balance (excluding grants)	-6.0	-6.4	-5.3	-5.3	-4.9	-3.7	-3.0
Primary balance	1.3	1.2	1.5	1.5	1.9	2.4	2.5
Net public debt	91.2	91.6	94.3	96.7	93.2	90.9	85.7
Net domestic public debt	43.9	45.9	43.5	43.8	39.8	37.8	35.1
Implicit interest rate on public debt (percent) 3/	8.9	9.1	8.1	8.1	7.7	7.3	6.8
	(Annual changes in percent of initial stock of broad money)						
Monetary sector							
Net foreign assets	1.6	2.0	3.5	3.9	5.4	...	...
Net domestic assets	4.5	7.3	6.8	5.9	3.9	...	...
Of which: credit to the private sector	8.5	1.4	6.6	5.7	5.8	...	...
Of which: net credit to government	-3.9	3.1	-1.0	-0.8	-2.7	...	...
Broad money	6.2	9.4	10.3	9.8	9.3	...	...
Six-month treasury bill rate (in percent, p.a.)	13.1	8.6	...	...	...	...	...
	(In percent of GDP)						
External sector							
Merchandise trade balance	-3.6	-2.3	-1.7	-2.2	-1.9	-1.6	-1.1
Merchandise exports	12.8	13.3	15.0	14.9	15.9	17.7	18.4
Merchandise imports	16.4	15.6	16.7	17.1	17.8	19.3	19.5
Current account excluding official transfers	-4.6	-3.6	-1.8	-3.7	-3.2	-2.6	-2.3
Current account including official transfers	-3.6	-2.1	-1.6	-2.2	-1.7	-2.4	-2.0

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

	1998/99	1999/2000	Rev.Prog. 2000/01	Est. 2000/01	Proj. 2001/02	2002/03	2003/04
	(In percent of current foreign exchange receipts 4/)						
External public and publicly guaranteed debt	280.2	267.2	225.7	243.8	229.7	223.6	215.4
Debt service	32.6	30.9	28.6	25.8	21.8	21.7	21.2
Implicit interest rate (in percent) 5/	4.2	4.7	5.1	4.8	5.0	4.6	4.7
Gross reserves (in millions of U.S. dollars) 6/	1,672	916	1,636	1,480	2,325	2,863	3,590
In weeks of next years' imports 7/	7.7	3.9	6.6	6.1	8.7	10.1	12.0
In percent of short-term external debt 8/	36.6	28.8	84.8	68.7	81.5	101.2	132.9
In percent of broad money	6.2	5.0	8.6	7.0	...	...	...
Memorandum items:							
ICOR, three-year moving average	4.5	4.8	3.5	4.6	4.4	3.3	3.0
Real effective exchange rate (percentage change)	-9.1	-0.5	-5.4	-5.0	...	...	...
Terms of trade (percentage change)	4.1	-9.2	-3.0	-1.3	1.1	2.8	2.3
Real per-capita consumption (percentage change)	5.4	-0.4	2.0	3.9	1.4	1.5	1.7
GDP at market prices (PRs billion)	2,938	3,183	3,510	3,472	3,815	4,201	4,660

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

1/ In U.S. dollar terms, import-based weights from WEO.
2/ Includes public sector enterprises throughout the projection period even though some of them may be (partially) privatized.
3/ The implicit interest rate on public debt is calculated as interest payments in percent of the end-of-period debt stock of the previous year.
4/ Defined as sum of receipts from exports of merchandise and services, and from private transfers.
5/ The implicit interest rate on external public debt is calculated as interest payments in percent of the end-of-period debt stock of the previous year.
6/ Excluding gold, foreign assets relating to FCDs contracted after May 1998 (FE-25s), and short-term foreign exchange swaps and outright forward sales by the SBP.
7/ Imports of goods and non factor services.
8/ Data on short-term external debt includes public and private short-term at original maturity and amortization payments on public medium- and long-term debt of the following year. Data on external short-term debt is preliminary.

Table 2. Pakistan: Balance of Payments, 1998/99–2003/04 (Concluded)

	1998/99	1999/2000	Rev. Proj. 2000/01	Jul.–Sep. Proj. 2001/02	Rev. Proj. 2001/02	Projections 2002/03	Projections 2003/04
			(In millions of U.S. dollars)				
Current account (excl. official transfers)	-2,699	-2,208	-2,207	-778	-1,869	-1,591	-1,453
Current account balance	-2,126	-1,282	-1,340	-566	-1,018	-1,440	-1,257
Trade balance	-2,085	-1,411	-1,350	-368	-1,186	-987	-699
Exports f.o.b.	7,528	8,191	8,950	2,228	9,814	10,782	11,838
Imports f.o.b	-9,613	-9,602	-10,300	-2,596	-11,000	-11,768	-12,538
Services (net)	-2,619	-2,795	-3,144	-839	-3,152	-3,209	-3,416
Of which: interest payments	-1,460	-1,676	-1,658	-483	-1,737	-1,693	-1,757
Private transfers (net)	2,005	1,997	2,287	430	2,469	2,604	2,662
Official transfers (net) 1/	573	926	867	211	850	151	196
Capital account	-1,017	-2,610	-571	-278	-2,980	-1,340	-636
Public medium- and long-term capital	591	-1,452	-281	-258	-1,647	-815	-680
Project and nonproject loans	241	-664	-197	-248	-946	-561	-474
Disbursements	2,279	1,304	1,603	177	641	958	1,013
Of which: non-project financing 2/	550	125	633	0	0	0	0
Amortization	-2,038	-1,968	-1,801	-425	-1,587	-1,519	-1,487
Commercial banks and IDB	-370	-170	-84	-12	-52	-58	-15
Other	720	-618	0	2	-649	-196	-191
Net public sector short-term (net)	-968	-221	-81	-250	-212	-317	-465
Private medium- and long-term	466	273	177	87	700 4/	751	971
Private short-term (incl. errors & omissions) 3/	-1,106	-1,211	-437	143	-1,820	-959	-462
Overall balance (before debt relief)	-3,143	-3,892	-1,911	-844	-3,998	-2,780	-1,892
Financing	3,143	3,892	1,911	844	3,998	2,780	1,892
Reserve assets (increase -)	-1,254	208	-903	-184	-1,130	-600	-790
SBP (including FE-25s)	-807	379	-535	-129	-909	-600	-790
Deposit money banks	-447	-171	-368	-55	-221	0	0
Use of Fund credit (net)	430	-280	81	90	84	-336	-406
Net exceptional Financing	3,969	3,965	2,736	610	1,624	500	0
Arrears (increase +)	0	343	-542	0	0	0	0
Rescheduling	2,240	1,750	1,602	310	310	0	0
Rollover of foreign deposits with banking system	1,512	1,872	1,676	300	1,314	500	0
Bridge financing	218	0	0	0	0	0	0
Financing gap	0	0	0	328 5/	3,420	3,217	3,088
			(In percent of GDP)				
Current account (excl. official transfers)	-4.6	-3.6	-3.7		-3.2	-2.6	-2.3
Current account balance	-3.6	-2.1	-2.2		-1.7	-2.4	-2.0
Trade balance	-3.6	-2.3	-2.2		-1.9	-1.6	-1.1
Exports f.o.b.	12.8	13.3	14.9		15.9	17.7	18.4
Imports f.o.b.	-16.4	-15.6	-17.1		-17.8	-19.3	-19.5
			(Annual percent change)				
Exports f.o.b.	-10.7	8.8	9.3		9.6	9.9	9.8
Imports f.o.b.	-6.7	-0.1	7.3		6.8	7.0	6.5
Export unit value	-3.8	-3.3	-2.0		-0.1	2.5	2.4
Import unit value	-7.5	6.4	-0.8		-1.2	-0.3	0.1
Export volume	-7.2	12.5	11.5		9.7	7.2	7.2
Import volume	0.9	-6.2	8.1		8.0	7.3	6.5
Terms of trade	4.1	-9.2	-1.3		1.1	2.8	2.3

Table 2. Pakistan: Balance of Payments, 1998/99–2003/04 (Concluded)

	1998/99	1999/2000	Rev. Proj. 2000/01	Jul.–Sep. Proj. 2001/02	Rev. Proj. 2001/02	Projections 2002/03	Projections 2003/04
Memorandum Items:							
End-period gross official reserves	1,740	1,359	1,890	2,019	2,799	3,399	4,189
End-period gross official reserves 6/	1,672	916	1,480	1,600	2,325	2,863	3,590
(In weeks of imports of goods and nonfactor services	7.7	3.9	6.1	6.0	8.7	10.1	12.0
SBP's purchases in the kerb market	539	1,600	2,015	...	...	...	...
Counterpart of private transfers.	270	533	672	...	...	...	...
Counterpart of short-term private capital	270	1,067	1,343	...	...	...	...

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

1/ Includes a grant from Saudi Arabia in the form of oil deliveries that has been agreed through 2001/02.
2/ IBRD, IDA and AsDB program loan disbursements.
3/ Includes repayment of FCDs held in NBFIs and banks (reschedulings shown as exceptional financing).
4/ Includes privatization receipts of US$500 million and FDI flows of US$600 million.
5/ On the basis of the current IFI pipeline and debt relief agreed so far, the gap would be covered until end-September 2001 (see Box 3).
6/ Excluding new foreign currency deposits (FE-25s) held with the SBP, and net of outstanding short-term foreign currency swap and forward contracts. The indicative program level for June 2001 is US$1,636 million (EBS/01/39).

Table 3. Pakistan: Consolidated Government Budget, 1999/2000–2001/02 (Continued)

	1999/2000	2000/01				2001/02	
	Year	Jul.–Mar.		Year		Year	Jul.–Sep.
	Rev. Act.	Orig. Prog.	Prel. Act.	Rev. Prog.	Proj.	Budget/Proj.	Proj.
	(In billions of Pakistani rupees)						
Revenue and grants	528.4	427.6	421.6	615.1	605.3	693.8	140.9
Revenue	524.4	391.0	386.2	570.4	557.9	643.3	128.6
Tax revenue	406.8	333.3	314.7	471.4	461.5	524.1	105.4
Federal	388.4	317.2	300.6	451.3	441.3	499.9	100.4
CBR Revenue	348.1	291.6	276.7 1/	417.3	406.5	458.2	92.1
Direct tax	109.8	89.5	86.9	133.9	133.9	147.2	25.8
Federal excise duty	56.9	34.4	35.2	52.5	52.2	53.2	12.7
Sales tax	117.6	121.3	108.3	166.2	155.9	185.1	35.7
Customs duties	63.8	46.3	46.3	64.6	64.6	72.6	18.0
Petroleum surcharge	25.4	13.5	14.5	18.0	18.0	25.0	5.0
Gas surcharge	13.5	10.3	8.7	13.6	15.0	15.0	3.0
Other	1.4	1.9	0.7	2.5	1.7	1.7	0.2
Provincial	18.4	16.0	14.1	20.1	20.2	24.2	5.0
Nontax revenue	117.6	57.7	71.5	99.0	96.5	119.2	23.2
Federal	97.5	47.2	61.0	85.6	82.5	103.8	19.4
Provincial	20.1	10.5	10.5	13.4	14.0	15.4	3.8
Grants	4.0	36.6	35.4	44.7	47.4	50.5	12.3
Expenditure	728.7	543.8	530.7	756.1	741.2	829.8	184.5
Current expenditure	640.2	469.4	472.9	659.4	649.5	699.5	156.6
Federal	484.9	339.0	368.9	488.5	488.5	524.5	119.2
Interest payments	243.3	170.6	166.6	237.0	235.0	258.5	63.5
Domestic	198.4	129.9	128.5	185.0	185.0	197.4	45.9
Foreign	44.9	40.7	38.1	52.0	50.0	61.1	17.6
Defense 2/	150.8	105.2	111.4	157.5	157.5	162.8	32.8
Running of the civil government	47.9	35.4	32.4	52.1	52.0	57.4	9.3
Subsidies	20.4	6.0	8.3	14.0	12.2	14.5	2.9
Grants	11.8	19.7	18.1	26.6	31.5	19.3	3.7
Other	9.9	2.1	0.1	1.3	0.3	12.0	7.0
Of which: bank restructuring						9.7	7.0
Unidentified	0.8	0.0	32.1	0.0	0.0	0.0	0.0
Provincial	155.3	130.4	104.0	171.0	161.0	175.1	37.4
Development expenditure and net lending	88.5	74.4	57.8	96.7	91.7	130.3	27.9
Public Sector Development Program	100.7	79.9	62.6	110.9	98.8	130.0	27.9
Federal 3/	64.4	49.5	48.4	68.2	66.4	100.0	19.0
Provincial	36.3	30.4	14.2	42.7	32.4	30.0	8.9
Net lending	-12.2	-5.5	-4.8	-14.3	-7.1	0.3	0.1
Budget balance (excluding grants)	-204.3	-152.8	-144.5	-185.7	-183.2	-186.5	-55.9
Budget balance (including grants)	-200.3	-116.2	-109.1	-141.0	-135.9	-136.0	-43.6
Financing	200.3	116.2	109.1	141.0	135.9	136.0	43.6
External	70.2	50.4	26.3	77.3	72.3	62.7	30.2
Domestic	130.1	65.8	82.8	63.7	63.6	34.4	13.4
Bank	40.0	19.9	13.0	-14.5	-14.5	-26.8	8.1
Nonbank	90.2	45.9	69.8	78.1	78.1	61.2	5.3
Privatization proceeds	0.0	0.0	0	0	0	38.8	0
Memorandum items:							
Primary balance	38.9	17.7	22.1	51.4	51.8	72.0	7.6
Social and poverty-related expenditure	76.3	78.4	73.1	97.5	97.5	117.0	23.4

Table 3. Pakistan: Consolidated Government Budget, 1999/2000–2001/02 (Concluded)

	1999/2000	2000/01				2001/02	
	Year	Jul.–Mar.		Year		Year	Jul.-Sep.
	Rev. Act.	Orig. Prog.	Prel. Act.	Rev. Prog.	Proj.	Budget/Proj.	Proj.
	(In percent of GDP)						
Revenue and grants	16.6	12.1	12.1	17.7	17.4	18.2	3.7
Revenue	16.5	11.0	11.1	16.4	16.1	16.9	3.4
Tax revenue	12.8	9.4	9.1	13.6	13.3	13.7	2.8
Federal	12.2	9.0	8.7	13.0	12.7	13.1	2.6
CBR Revenue	10.9	8.2	8.0 1/	12.0	11.7	12.0	2.4
Direct tax	3.4	2.5	2.5	3.9	3.9	3.9	0.7
Federal excise duty	1.8	1.0	1.0	1.5	1.5	1.4	0.3
Sales tax	3.7	3.4	3.1	4.8	4.5	4.9	0.9
Customs duties	2.0	1.3	1.3	1.9	1.9	1.9	0.5
Petroleum surcharge	0.8	0.4	0.4	0.5	0.5	0.7	0.1
Gas surcharge	0.4	0.3	0.3	0.4	0.4	0.4	0.1
Other	0.0	0.1	0.0	0.1	0.1	0.0	0.0
Provincial	0.6	0.5	0.4	0.6	0.6	0.6	0.1
Nontax revenue	3.7	1.6	2.1	2.9	2.8	3.1	0.6
Federal	3.1	1.3	1.8	2.5	2.4	2.7	0.5
Provincial	0.6	0.3	0.3	0.4	0.4	0.4	0.1
Grants	0.1	1.0	1.0	1.3	1.4	1.3	0.3
Expenditure	22.9	15.3	15.3	21.8	21.3	21.8	4.8
Current expenditure	20.1	13.2	13.6	19.0	18.7	18.3	4.1
Federal	15.2	9.6	10.6	14.1	14.1	13.7	3.1
Interest payments	7.6	4.8	4.8	6.8	6.8	6.8	1.7
Domestic	6.2	3.7	3.7	5.3	5.3	5.2	1.2
Foreign	1.4	1.1	1.1	1.5	1.4	1.6	0.5
Defense 2/	4.7	3.0	3.2	4.5	4.5	4.3	0.9
Running of the civil government	1.5	1.0	0.9	1.5	1.5	1.5	0.2
Subsidies	0.6	0.2	0.2	0.4	0.4	0.4	0.1
Grants	0.4	0.6	0.5	0.8	0.9	0.5	0.1
Other	0.3	0.1	0.0	0.0	0.0	0.3	0.2
Of which : bank restructuring						0.3	0.2
Unidentified	0.0	0.0	0.9	0.0	0.0	0.0	0.0
Provincial	4.9	3.7	3.0	4.9	4.6	4.6	1.0
Development expenditure and net lending	2.8	2.1	1.7	2.8	2.6	3.4	0.7
Public Sector Development Program	3.2	2.3	1.8	3.2	2.8	3.4	0.7
Federal 3/	2.0	1.4	1.4	2.0	1.9	2.6	0.5
Provincial	1.1	0.9	0.4	1.2	0.9	0.8	0.2
Net lending	-0.4	-0.2	-0.1	-0.4	-0.2	0.0	0.0
Budget balance (excluding grants)	-6.4	-4.3	-4.2	-5.4	-5.3	-4.9	-1.5
Budget balance (including grants)	-6.3	-3.3	-3.1	-4.1	-3.9	-3.6	-1.1
Financing	6.3	3.3	3.1	4.1	3.9	3.6	1.1
External	2.2	1.4	0.8	2.2	2.1	1.6	0.8
Domestic	4.1	1.9	2.4	1.8	1.8	0.9	0.4
Bank	1.3	0.6	0.4	-0.4	-0.4	-0.7	0.2
Nonbank	2.8	1.3	2.0	2.3	2.2	1.6	0.1
Privatization proceeds	0.0	0.0	0.0	0.0	0.0	1.0	0.0
Memorandum items:							
Primary balance	1.2	0.5	0.6	1.5	1.5	1.9	0.2
Social and poverty-related expenditure	2.4	2.2	2.1	2.8	2.8	3.1	0.6
GDP (in PRs billions)	3,183	3,543	3,472	3,510	3,472	3,815	3,815

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

1/ Under the revised program, the performance criterion on CBR revenue for the first three quarters of 2000/01 was PRs 279.3 billion (EBS/01/39).

2/ Military pensions are included in defense expenditure.

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

Table 4. Pakistan: Monetary Developments, 1997/98–2001/02

	1997/98	1998/99	1999/2000				2000/01 1/							2001/02 1/	
			Sept.	Dec.	Mar.	Jun.	Sep.	Dec.		Mar.		Jun.		Sep.	Jun.
								Prog.	Act.	Prog.	Act.	Prog.	Proj.	Proj.	Proj.
	(End-of-period stocks in billions of Pakistan rupees)														
Net foreign assets	-90.1	-70.7	-69.9	-68.7	-54.5	-43.9	-60.2	-48.7	-49.9	-41.4	-27.7	5.5	11.1	13.2	87.0
Net domestic assets	1,296.4	1,351.3	1,335.6	1,385.7	1,375.6	1,444.5	1,457.4	1,480.8	1,526.5	1,510.6	1,494.4	1,539.4	1,526.8	1,518.2	1,593.9
Net claims on government	597.5	551.4	557.8	553.4	555.1	629.6	653.3	612.0	601.9	595.6	603.1	615.2	617.8	606.1	577.0
Of which:															
Net bank borrowing	552.4	505.9	516.8	518.8	530.0	545.8	581.8	552.2	536.5	551.8	558.9	531.4	531.4	539.7	504.6
Commodity operations	63.7	67.3	63.1	58.0	49.4	107.4	95.8	85.4	91.1	67.4	70.3	107.4	110.0	90.0	95.0
Net claims on nongovernment	697.5	816.7	791.9	837.6	841.2	842.8	834.1	891.6	924.7	938.6	919.9	947.8	941.7	937.3	1,042.2
Of which:															
Private sector	632.0	734.7	719.7	762.2	768.9	753.2	753.6	794.8	836.3	840.1	836.0	845.2	833.2	833.8	921.6
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	-2.9	-2.9
Other items (net)	4.3	-13.9	-11.2	-2.3	-17.8	-25.0	-27.2	-19.9	2.9	-20.7	-25.6	-20.7	-29.8	-22.3	-22.3
Total liquidity (broad money)	1,206.3	1,280.5	1,265.7	1,317.0	1,321.0	1,400.6	1,397.2	1,432.1	1,476.7	1,469.2	1,466.8	1,544.9	1,537.9	1,531.4	1,680.9
	(Changes in percent of stock of broad money at the beginning of the fiscal year)														
Net foreign assets	-2.7	1.6	0.1	0.2	1.3	2.0	-1.2	-0.3	-0.4	0.2	1.2	3.5	3.9	0.6	5.4
Net domestic assets	17.3	4.5	-1.2	2.7	1.9	7.3	0.9	2.6	5.9	4.7	3.6	6.8	5.9	-1.0	3.9
Of which:															
Net bank borrowing by govt.	4.5	-3.9	0.8	1.0	1.9	3.1	1.7	-1.3	-2.0	-2.4	-1.9	-1.0	-0.8	-0.8	-2.7
Net claims on private sector	8.1	8.5	-1.2	2.1	2.7	1.4	0.0	3.0	5.9	6.2	5.9	6.6	5.7	0.0	5.8
	(Changes over 12 months; in percent)														
Broad money	14.5	6.2	4.7	4.3	5.8	9.4	10.4	8.7	12.1	11.2	11.0	10.3	9.8	9.6	9.3
Net domestic assets	16.3	4.2	1.6	2.6	5.0	7.0	9.1	6.9	10.2	9.8	8.6	6.6	5.7	4.2	4.4
Net bank borrowing by govt.	9.5	-8.4	-10.3	-7.0	2.7	7.9	12.6	6.5	3.4	4.1	5.5	-2.6	-2.6	-7.2	-5.0
Net claims on private sector	13.7	16.2	17.5	9.9	8.8	2.5	4.7	4.3	9.7	9.3	8.7	12.2	10.6	10.6	10.6

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

1/ At indicative program exchange rates.

Table 5. Pakistan: Accounts of the State Bank of Pakistan, 1997/98–2001/02

	1997/98	1998/99	1999/2000				2000/01 1/							2001/02 1/	
			Sep.	Dec.	Mar.	Jun.	Sep.	Dec.		Mar.		Jun.		Sep.	Jun.
								Prog.	Act.	Prog.	Act.	Prog.	Proj.	Proj.	Proj.
	(End-of-period stocks in billions of Pakistan rupees)														
Net foreign assets	-48.6	-42.5	-49.7	-55.9	-49.2	-55.1	-74.7	-63.3	-53.0	-58.9	-57.3	-13.5	-24.4	-33.7	16.1
Net domestic assets	418.1	440.4	449.1	524.4	506.6	552.9	543.4	526.6	511.9	560.8	544.9	538.6	548.3	581.3	583.7
Net claims on government	223.7	257.8	276.8	338.0	350.0	391.0	391.8	381.0	338.6	418.5	387.8	389.2	401.7	406.2	413.7
Of which :															
Budgetary support	242.2	279.6	298.8	361.4	374.3	414.6	416.1	406.6	364.3	442.2	413.8	412.8	425.3	429.8	436.3
Claims on nongovernmen	40.8	56.1	53.8	52.2	51.1	51.2	49.6	45.9	48.9	41.6	47.8	40.7	40.7	40.7	40.7
Claims on scheduled ban	158.5	187.2	182.3	192.9	186.7	193.4	195.0	190.4	204.0	191.4	202.9	199.4	199.4	194.4	189.4
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	-2.9	-2.9
Other items (net)	-2.0	-57.7	-60.9	-55.8	-78.3	-79.8	-90.1	-87.8	-76.7	-87.8	-90.6	-87.8	-90.6	-57.1	-57.1
Reserve money	369.5	398.0	399.4	468.5	457.4	497.8	468.8	463.3	458.8	501.9	487.6	525.0	523.9	523.8	574.1
Of which :															
Banks' reserves	71.4	85.2	88.6	99.0	89.9	114.7	102.5	99.7	20.4	87.2	74.5	92.3	87.3	97.7	108.8
Currency	291.7	306.6	304.1	363.1	361.2	375.1	355.7	355.2	430.7	406.0	404.8	423.7	427.6	417.2	456.4
	(Changes in percent of stock of reserve money in the beginning of the fiscal year)														
Net foreign assets	-10.8	1.7	-1.8	-3.4	-1.7	-3.2	-3.9	-1.7	0.4	-0.8	-0.5	8.3	6.2	0.5	10.0
Net domestic assets	17.3	6.0	2.2	21.1	16.6	28.3	-1.9	-5.3	-8.2	1.6	-1.6	-2.9	-0.9	-0.1	0.4
Of which :															
Budgetary support	-1.3	10.1	4.8	20.6	23.8	33.9	0.2	-78.5	-10.5	5.5	-0.7	-0.4	2.2	0.9	2.3
	(Changes over 12 months; in percent)														
Reserve money	6.5	7.7	9.7	13.0	10.9	25.1	17.4	-1.1	-2.1	9.7	6.6	5.5	5.2	11.7	9.6
Banks' reserves	-8.4	19.3	24.6	13.6	22.9	34.7	15.7	0.8	-79.4	-3.0	-17.1	-19.5	-23.9	11.8	24.5
Currency	11.3	5.1	6.4	13.7	9.0	22.4	16.9	-2.2	18.6	12.4	12.1	13.0	14.0	17.3	6.7

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

1/ At indicative program exchange rates.

Table 6. Pakistan: Summary of Public External Debt and Debt Service, 1995/96–2003/04

	1998/99	1999/2000	Proj. 2000/01	2001/02	2002/03	2003/04
			(In millions of U.S. dollars)			
Total public and publicly guaranteed external debt	30,480	31,010	30,929	31,651	33,372	34,791
Medium- and Long-term Debt	26,607	27,262	27,029	28,054	30,457	32,719
Project & nonproject aid	23,101	23,834	23,727	22,780	22,371	21,897
Commercial banks and IDB	730	560	476	424	366	351
Other 1/	2,776	2,868	2,827	4,850	7,720	10,471
Short-term Debt (by initial maturity)	2,049	2,253	2,172	1,960	1,643	1,178
Commercial banks and IDB	583	671	1,086	1,191	1,291	1,321
FEBCs and DBCs	196	147	122	105	88	88
Deposits of nonresidents with the SBP	1,270	1,435	964	664	264	-231
Fund credit and loans 2/	1,825	1,496	1,728	1,637	1,273	895
Service of medium- and long-term						
Public and publicly guaranteed debt	3,546	3,586	3,275	2,998	3,239	3,415
Of which: to the Fund 2/	191	347	312	240	414	467
Amortization	2,569	2,452	2,126	1,823	1,913	1,908
Of which: to the Fund 2/	147	287	242	184	336	406
Interest	977	1,133	1,149	1,176	1,326	1,507
Of which: to the Fund 2/	44	60	65	56	78	62
Interest on public and publicly guaranteed short-term debt	96	94	95	85	49	47
			(In percent of GDP)			
Total public and publicly guaranteed external debt	52.0	50.3	51.4	53.7	54.7	54.2
Long-term	45.4	44.2	45.0	47.6	49.9	51.0
Short-term	3.5	3.7	3.6	3.3	2.7	1.8
Fund credit and loans 2/	3.1	2.4	2.9	2.8	2.1	1.4
Service of medium- and long-term public and publicly guaranteed debt	6.1	5.8	5.4	5.1	5.3	5.3
Amortization	4.4	4.0	3.5	3.1	3.1	3.0
Interest	1.7	1.8	1.9	2.0	2.2	2.3
Interest on public and publicly guaranteed short-term debt	0.2	0.2	0.2	0.1	0.1	0.1
	(In percent of exports of goods and nonfactor services, and private transfers)					
Total public and publicly guaranteed external debt	280.2	267.2	243.8	229.7	223.6	215.9
Of which: Fund credits and loans 2/	16.8	12.9	14.1	12.3	8.8	5.8
Service of medium- and long-term public and publicly guaranteed debt	32.6	30.9	25.8	21.8	21.7	21.2
Of which: to the Fund 2/	1.8	3.0	2.5	1.7	2.8	2.9
Amortization	23.6	21.1	16.8	13.2	12.8	11.8
Of which: to the Fund 2/	1.4	2.5	1.9	1.3	2.3	2.5
Interest	9.0	9.8	9.1	8.5	8.9	9.4
Of which: to the Fund	0.4	0.5	0.5	0.4	0.5	0.4

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

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

2/ Includes the possible use of Fund resources in 2000/01 and 2001/02.

Table 7. Pakistan: Indicators of Fund Credit, 1999/2000–2007/08 1/

	1999/2000	Prog. 2000/01	Proj. 2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08
Outstanding Fund Credit									
In millions of SDRs	1,132	1,308	1,266	1,014	712	502	353	281	223
In millions of U.S. dollars	1,496	1,728	1,637	1,273	895	632	445	355	282
In percent of:									
Quota	109.5	126.5	122.5	98.1	68.9	48.5	34.1	27.2	21.6
GDP	2.4	2.9	2.8	2.1	1.4	0.9	0.6	0.4	0.4
Exports 2/	12.9	14.1	12.3	8.8	5.8	4.4	3.1	2.5	2.0
Public and publicly guaranteed debt	4.8	5.7	5.3	3.9	2.6	1.9	1.4	1.1	0.9
Debt service to the Fund									
In millions of SDRs	233	237	191	289	329	229	160	80	64
In millions of U.S. dollars	347	312	240	414	467	453	370	130	90
In percent of:									
Exports 2/	3.0	2.5	1.7	2.8	2.9	3.1	2.6	0.9	0.6
Gross official reserves	37.9	21.1	10.3	14.5	13.0	11.3	9.2	3.2	2.2

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

1/ Under the assumptions of the program.
2/ Exports of goods and nonfactor services and workers' remittances.

Table 8. Pakistan: Indicatiors of External Vulnerability, 1998/99–2000/01

	1998/99	1999/2000	2000/01	
			Latest	Rev. Proj.
Financial indicators				
Net public debt (in percent of GDP)	91.2	91.6	. . .	96.7
Broad money (12-month percentage change)	6.2	5.7	10.6	10.3
Private sector credit (12-month percentage change)	16.2	4.7	9.3	6.6
180-day treasury bill yield (in percent)	13.1	8.6	11.5	. . .
180-day treasury bill yield, real (in percent)	7.4	5.1	7.0	. . .
Karachi Stock Exchange index				
End-of-period	1,055.0	1,521.0	1,363.0	. . .
Period average	985.0	1,514.0	1,374.0	. . .
External Indicators				
Exports (12-month percentage changes, in US$)	-10.7	8.8	7.6	9.3
Imports (12-month percentage changes, in US$)	-6.7	-0.1	6.1	7.3
Terms of trade (12-month percentage changes)	4.1	-9.2	. . .	-1.3
Current account balance (excl. official transfers in percent of GDP)	-4.6	-3.6	-3.9	-3.7
Gross Official Reserves (in millions of U.S dollars) 1/ 2/	1,672.0	916.0	1,666.0	1,480.0
In months of imports of goods and nonfactor services	7.7	3.9	3.2	6.1
In percent of broad money	6.5	3.4	6.9	6.1
In percent of short-term external debt 3/	40.1	28.5	41.0	36.4
Total external debt (in millions of U.S. dollars)	36,470.7	35,590.7	. . .	33,459.5
In percent of exports of goods and nonfactor services 4/	335.2	306.7	. . .	263.7
Actual debt services (in percent of goods and services) 4/ 5/	30.7	26.4	. . .	21.6
Exchange rate (Rupees per US dollar, period average)	50.1	51.6	63.7	. . .
Real exchange rate (12-month percentage changes)	-9.1	-0.5	. . .	-5.0

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

1/ Including gold.

2/ Excluding foreign deposits FE-25 and swaps and forward operations.
3/ Short-term external debt includes public and private short term at original maturity plus actual amortization payments
4/ Exports of goods and nonfactor services including workers' remittances.
5/ Scheduled debt service minus rescheduled debt service plus debt service on previously rescheduled debt.

Pakistan: Fund Relations
As of May 31, 2001

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

II. General Resources Account:	SDR Million	%Quota
Quota	1,033.70	100.0
Fund Holdings of Currency	1,867.48	180.7
Reserve position in Fund	0.11	0.0

III. SDR Department:	SDR Million	%Allocation
Net cumulative allocation	169.99	100.0
Holdings	2.84	1.7

IV. Outstanding Purchases and Loans:	SDR Million	%Quota
Stand-By arrangements	295.19	28.6
Extended arrangements	186.00	18.0
Contingency and Compensatory	352.70	34.1
SAF arrangements	21.85	2.1
ESAF/PRGF arrangements	375.80	36.4

V. Latest Financial Arrangements:

Type	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
Stand-By	11/29/2000	09/30/2001	465.00	255.00
EFF	10/20/1997	10/19/2000	454.92	113.74
ESAF/PRGF	10/20/1997	10/19/2000	682.38	265.37

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

	Overdue		Forthcoming			
	05/31/2001	2001	2002	2003	2004	2005
Principal	...	89.9	201.8	279.7	264.9	199.5
Charges/Interest	...	23.1	39.8	30.8	21.6	14.4
Total	...	113.0	241.6	310.5	286.5	213.9

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

A. Nonfinancial Relations

VII. Exchange System

Over the last few years, Pakistan implemented a fixed exchange rate system with periodic step devaluation to compensate for the inflation differential with major trading partners. On July 21, 1998, a dual exchange system was introduced consisting of a fixed official exchange rate at PRs 46 per US$1 and a floating interbank market exchange rate (FIBR). Under this system, all authorized transactions were effectively conducted at the so-called "composite rate" which was the weighted average of the FIBR and the official exchange rate. In addition, since May 28, 1998, withdrawals from foreign currency accounts have only been allowed in rupees (at the official exchange rate). Also, an advance import deposit of 30 percent was introduced on July 12, 1998; it was subsequently reduced to 20 percent on January 9, 1999 and 10 percent on January 24, 1999, and was eliminated on February 24, 1999. On May 19, 1999, the official exchange rate of PRs 46 per U.S. dollar was eliminated and the exchange rate system unified, with all international transactions conducted at the FIBR. As of May 31, 2001 the FIBR was PRs 63.04 per U.S. dollar.

VIII. Last Article IV Consultation

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

IX. Recent Technical Assistance

There have been a number of technical assistance (TA) missions during the past several years.

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

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

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

d. **LEG**: In May/June 2001 a LEG consultant assisted the authorities in the preparation of the new income tax law, which will become effective in July 2001.

X. Resident Representative

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

June 27, 2001

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

Dear Mr. Köhler:

The Pakistan authorities held discussions with Fund staff during May 2001 for the second review under the Stand-By Arrangement. Based on these discussions, the attached Supplementary Memorandum on Economic and Financial Policies (MEFP) reviews economic developments and policy implementation in the first three quarters of fiscal year 2000/01 (July 2000–March 2001), updates the macroeconomic framework, and discusses the stabilization policies and structural reform program for the remainder of the calendar year.

All performance criteria for end-March 2001 were met, except for the performance criterion on Central Board of Revenue (CBR) revenue, which was missed by a small margin. We are confident that all structural and most quantitative performance criteria for end-June 2001 will also be met, although data on the quantitative targets will only become available in late July. However, in part reflecting the drought and despite a determined implementation of the short-term action plan for CBR elaborated in consultation with FAD, we expect CBR revenue through June to reach only PRs 406 billion, PRs 11 billion short of the target, but nonetheless an increase of 17 percent over last year. We are also making our best effort to meet the target for net foreign assets of the SBP, and based on most recent data we are not very far from the target. However, we will have to avoid that stepped-up purchases of foreign exchange do not destabilize a fragile foreign exchange market, and with weaker external balances (again drought related) and shortfalls in external financing, a small shortfall from the NFA-target for end-June may not be ruled out. Accordingly, we request a waiver for nonobservance of the quantitative performance criteria on revenue of the CBR and the State Bank of Pakistan's NFA at end-June 2001, and waiver of applicability for all other quantitative performance criteria at end-June 2001. These latter performance criteria would apply to the purchases after July 20, 2001. On the basis of the performance up to end-March 2001 and policies set out in the attached memorandum, the government requests the completion of the second review.

The Government of Pakistan will provide the Fund with such information as the Fund may request in connection with Pakistan's progress in implementing the economic and financial policies and achieving the objectives of the program. The government believes that the policies set out in the attached memorandum are adequate to achieve the objectives of the program. However, it stands ready to take any additional measures appropriate for this purpose, and will consult with the Fund in accordance with the policies of the Fund on such consultations.

Sincerely yours,

s
Shaukat Aziz
Minister of Finance and Economic Affairs

s
Ishrat Husain
Governor
State Bank of Pakistan

Attachments:
Supplementary Memorandum of Economic and Financial Policies
Supplementary Technical Memorandum of Understanding

PAKISTAN

Supplementary Memorandum of Economic and Financial Policies (SMEFP) for the Second Review Under the Stand-By Arrangement

I. Developments During July 2000–April 2001 and Outlook for the Remainder of FY 2000/01

1. **Macroeconomic performance suffered from a persistent drought, one of the worst in recent decades.** Rainfed agriculture is most severely affected, but with water levels in reservoirs running very low the outlook for irrigated agriculture is clouded as well. The loss of hydropower necessitated additional petroleum imports for electricity production, weakening already vulnerable external balances. At the same time, available data confirm the continued recovery in the industrial sector. In the circumstances, we now expect real GDP (at factor cost) growth at 2.6 percent in FY 2000/01, compared to a target of 3.8 percent. Inflation as measured by the CPI slowed to 4.7 percent in the year through April, reflecting prudent financial policies and low food prices resulting from last year's bumper crops. Wholesale price inflation is running somewhat higher, driven mainly by increased petroleum and raw cotton prices, and may signal greater inflationary pressures ahead. Nonetheless, we expect average inflation (CPI) for FY 2000/01 to come in at 4.7 percent, slightly lower than was earlier expected.

2. **External balances for FY 2000/01 are projected to be somewhat weaker than programmed.** Trends through April point to some deterioration in the trade balance, roughly compensated by higher worker remittances (including through the kerb market). Export shortfalls were due to lower unit values reflecting a softening mostly in the US market, whereas volumes increased as programmed with strong growth in nontraditional exports, such as pharmaceuticals, chemicals, and leather goods; imports were somewhat higher mostly because of higher sugar and oil import volumes. With an expected increase in remittances, we expect the external current account deficit (excluding grants) for the year to be contained to 3.7 percent of GDP. The capital account was broadly on track through March, with shortfalls in official financing offset by higher private capital inflows, but a weakening in the last quarter seems likely as the pace of private inflows seems to have slackened.

3. **Reserves targets for March were met and SBP purchases of foreign exchange are being stepped up**. Gross official reserves (excluding FE-25 foreign currency deposits and short-term swaps and forwards) at end-March 2001 exceeded the program target, and the performance criterion on net foreign assets of the SBP was met (Table 1). The interbank market exchange rate depreciated further by 5 percent during December 2000–March 2001, while the premium on the kerb market remained mostly in a daily range of 4–5 percent. Because of much larger than expected program financing shortfalls, lower than expected inflows of FDI and portfolio investment, and the drought-related worsening of the trade balance, the SBP has stepped up—admittedly somewhat belatedly—purchases from the

interbank and kerb markets to protect its reserves and service external debt. However, care needs to be taken to avoid that excessive purchases destabilize the market and excessive depreciation not rekindle inflationary pressures. To support the reserves target, we have also tightened monetary policy further and are making best efforts to ensure timely disbursements of project financing from the World Bank, Asian Development Bank, and European Union, and are also making efforts to mobilize bilateral resources. Despite these efforts, a small shortfall from the NFA target for end-June target may not be ruled out. The government has ensured, and remains committed to ensure that all current account operations can be transacted on the interbank market free of any restrictions or undue delays in the approval of payments and transfers for such transactions, and ensure compliance with Pakistan's obligations under Article VIII of the Articles of Agreement.

4. **The consolidated government deficit (excluding grants) for the first three quarters of FY 2000/01 amounted to 4.2 percent of annual GDP, lower-than-programmed.** Shortfalls in tax revenues from programmed levels were more than compensated by higher nontax revenue and expenditure restraint. The revenue shortfalls were mostly in sales tax collections while all other tax categories were close to or above target. Lower current and especially capital spending at the provincial levels result from deliberate expenditure restraint and better enforcement of accountability and governance standards. In particular, despite release at the federal level of budgeted appropriations at the beginning of the year, as envisaged in the program, social and poverty-related expenditures fell short of program objectives by PRs 5 billion (as per provisional accounts). In the circumstances, the end-March performance criteria on the fiscal deficit and net bank borrowing were met while that on the CBR revenue was breached with a small margin (0.1 percent of GDP).

5. **Similar trends are expected to continue through June, and the government is confident that the deficit target for the year will be met**. The main risk is a widening shortfall in revenue. In April, CBR revenue collection fell again short of the target despite a strong improvement in the number of sales tax audits and implementation of the agreed short-term CBR action plan. Although we expect the plan to begin yielding more visible results in the weeks ahead, reflecting also lower GDP because of the drought, the end-June target for CBR revenue are unlikely to be observed. However, every effort will be made to reach a level of at least PRs 406.5 billion for the year. To achieve the deficit target, we have implemented cuts mainly affecting provincial nonwage current spending and further slowed spending on low-priority public investment projects.

6. **Monetary policy remains tight to keep inflation on target.** A further tightening of monetary policy (six-month treasury bill rates were raised to 11.5 percent in March) helped slow reserve money growth to 6.6 percent in the year through end-March 2001, well below the program target. To ensure observing the performance criteria on central bank NDA at end-March, the SBP gave banks the option to convert temporarily the rupee counterpart of the frozen foreign currency deposits of nonresident institutional investors, held with the SBP, into treasury bills. In the event, the NDA target was met with a comfortable margin. Even after adjusting for this temporary operation, underlying reserve money growth was 12.7 percent through March, a sharp slowdown from the underlying rate of reserve money

growth through December 2000. We expect reserve money growth to slow further through June, supported by a further tightening of interest rates to ensure observance of the NDA target for end-June, and will not resort to any exceptional operations.

7. Broad money growth slowed to 11 percent in the year through March 2001, roughly in line with the program target, and we expect it to remain on track through June. On the liability side, the expansion continued to be driven by growth in currency holdings as well as growth in foreign currency and rupee time deposits. Continued high cash preference reflects mostly the ongoing tax survey/documentation drive and increased transaction demand for the rupee in Afghanistan as confidence in the Afghani declined further with the catastrophic drought and the tightening of UN sanctions. Private credit growth (8.7 percent over the year through March) continues at a healthy pace, reflecting largely the pick-up in industrial activity.

8. **Structural reforms are on track.** All structural performance criteria and most benchmarks for end-March 2001 were observed, including the extension of the sales tax to urea fertilizer and pesticides despite the difficult circumstances arising from the drought (Table 2). The report on the long-term tax administration reform strategy was released in April, and is now being reviewed by the government. As part of the drive to enhance **fiscal transparency,** the publishing of reconciled fiscal data continues; public expenditure during the first 3 quarters equivalent to some 0.9 percent of GDP is in the process of being identified through reconciliation. The envisaged price adjustments for petroleum products, electricity, and gas prices were implemented on time. In early April, the SBP reduced subsidies under the Export Finance Scheme; and enforced licensing requirements on all moneychangers. The SBP also replaced the restriction on commercial banks' placement of new foreign currency deposits abroad (FE-25) by prudential regulations and cash reserve requirements. In addition, to discourage dollarization, remuneration of the FE-25s is capped at LIBOR, and banks may not accept FE-25s beyond 20 percent of total deposits. In March 2001, the SBP established a formal process for reconciling data reported to the IMF, as well as guidelines to prohibit operations that pledge or encumber reserves, or place restrictions on or otherwise impair the availability of foreign exchange reserves outside an authorized framework.

II. Macroeconomic Objectives and Policies for FY 2001/02 and the Medium-term

9. **The formulation of macroeconomic targets for the coming years is complicated by uncertainty as to the impact of the drought.** On the basis of latest available data, and assuming normal monsoon rains this summer, we expect real GDP growth at 4 percent for 2001/02, and a further pick-up to about 5 percent during 2002/03–2003/04 fuelled by a recovery of agriculture from the drought and continued strong growth in large-scale manufacturing and in particular the textile sector. A number of factors should support growth: the large ongoing investments especially in high-value added textile sectors; declining real interest rates as crowding out and risk premia are reduced; further market opening in industrial countries that should strengthen export prospects; and the lagged impact of the recent real depreciation of the rupee. For 2001/02 and beyond, we will target an annual

average inflation rate of around 5 percent, and external current account deficits at around 2 percent of GDP. However, we expect a gradual return of foreign investors' confidence and accordingly, aim at a build-up of reserves to US$2.3 billion (equivalent to 9 weeks of imports) by end-June 2002, with the aim to reach US$3.6 billion at end-June 2004.

10. **The macroeconomic policy mix will remain broadly unchanged, with the focus on continued fiscal adjustment to reduce the debt overhang, a flexible exchange rate system, and monetary policy geared towards ensuring that inflation targets are met.** The draft budget for 2001/02 aims to strike a balance between the over-arching need to reduce the public debt overhang and create long-term fiscal space through debt and debt-service reduction, and the need to finance critical structural reforms and investments in infrastructure and social sectors. The budget calls for reducing the overall fiscal deficit, excluding grants, to 4.9 percent of GDP (from 5.3 percent expected for this year). While the implied fiscal adjustment appears to be less ambitious than indicated in our November-memorandum, we believe that the need for some emergency assistance to those areas most affected by the drought, the cost of launching certain structural reforms, as well as the confirmation that the Saudi oil facility is being provided as a grant rather than a loan justifies a somewhat higher deficit. The deficit also reflects one-off operations to restructure the three nationalized banks, in preparation of their privatization within 10-15 months. Excluding the exceptional outlays related to the drought and the bank restructuring, the underlying structural fiscal adjustment would be much stronger at about 1 percent of GDP. Including grants, the fiscal deficit would decline to 3.6 percent of GDP in 2001/02, from 3.9 percent in the current year. Any privatization receipts (net of the cost of financing the privatization process itself) will be used to reduce public debt.

11. Total tax revenue is targeted to increase to 13.7 percent of GDP in 2001/02, compared to an expected 13.3 percent of GDP in 2000/01. The increase in the tax ratio is based upon the envisaged gains from various tax policy reforms (detailed below), the full year effects of the ongoing short-term action plan and envisaged gains from the tax survey and documentation drive (0.3 percent of GDP). We do not anticipate any gain from the major restructuring of the CBR during the first year. Nontax revenue is expected to rise to 3.1 percent of GDP, mostly on account of higher SBP profits as one-time charges related to loss provisioning in the current year go out of the base and higher interest rates earned on treasury bills.

12. Total expenditure and net lending will rise to 21.8 percent of GDP. The increase is in part explained by one-off expenditure related to the drought emergency package (0.3 percent of GDP), the cost of establishing and making local governments functional under the devolution plan (0.1 percent of GDP), and a golden handshake package for nationalized banks in preparation for their privatization (0.3 percent of GDP). A cautious beginning has been made to implementing a wide-ranging civil service reform (see below); an associated wage and pension reform package addressing the quality of the civil service and containing the fast growth of pension liabilities will become effective from January 1, 2002; as a result outlays for government wages and pensions will be kept broadly stable as a share of GDP. Development spending will increase to 3.4 percent of GDP, while defense expenditure

(including military pensions) will decline to 4.3 percent of GDP, with non-wage/non-pension defense outlays kept at 2000/01 levels. The budget includes an increase in social/poverty-related spending by 0.3 percentage points of GDP, much of it related to the launching of an education reform strategy focused on basic education as detailed in the draft interim PRSP and the increased pay for health and education sector staff. Expenditure authorizations for social sectors and poverty alleviation will be released as programmed and the provincial governments have been encouraged to achieve targeted spending levels.

13. The containment of expenditures will importantly hinge on a package of measures to strengthen WAPDA's and KESC's finances (discussed below). For the seven large public enterprises (WAPDA, KESC, PCTL, Sui-N, Sui-S, OGDC, and the railways), we will aim to reduce the overall deficit to 1.0 percent of GDP from an estimated 1.2 percent in 2000/01; this will require continued close monitoring, rapid progress in the restructuring of these enterprises, further price adjustments, and application of commercial principles. To ensure achievement of the fiscal deficit target in the event of revenue shortfalls, the MOF will continue to monitor expenditures closely and, for spending other than for social sectors or poverty alleviation, budgetary provisions will be released only gradually keeping in view the fiscal deficit target and overall revenue performance.

14. **Monetary policy will be geared towards achievement of the inflation and reserve targets.** For the year through June 2002 we will aim to reduce reserve money growth to 9 percent. Given the uncertainty surrounding the evolution of the cash-to-deposit ratio, the SBP will exercise vigilance to ensure that monetary policy is adjusted through indirect instruments (principally open market operations, repos, and discount rate) as needed. As a result, broad money growth for the year through end-June 2002 is projected at 9.3 percent, in line with expected nominal GDP growth. Given the envisaged buildup of net foreign assets and public sector borrowing, this would allow for an 10.6 percent growth in private sector credit.

15. **The government remains committed to deepen the market-based exchange rate system.** The SBP will phase out any intervention other than purchases required to meet the NIR target and for smoothing the impact of bulky transactions in the thin interbank market. As the official reserves position becomes more comfortable, we will phase out purchases in the kerb market and relax nostro limits on banks' balances held abroad on account of trading activities. The government reiterates its firm commitment to not delay approval of payments and transfers or hinder the flow of funds for current account transactions. The government will also ensure that no multiple currency practice will emerge and that Pakistan will comply with its obligations under Article VIII of the Articles of Agreement.

III. Structural Reforms

16. The government is committed to implementing an ambitious structural reform agenda as a crucial part of its strategy to revive the economy and to address the many distortions and governance problems that have impeded higher sustainable growth and contributed to widespread poverty.

A. Tax and Subsidy Reforms

17. **The government aims to build a much more efficient tax administration and tax system that is less vulnerable to governance problems.** The tax survey continues to bring additional taxpayers into the tax net. At the same time, we continue to pursue the aforementioned short-term action plan to improve tax administration, prepared with FAD technical assistance, emphasizing the audit and arrears collection process, along with a tighter penalty regime for nonfilers and late payments. We are elaborating, in close consultation with the Fund and the World Bank, a multi-year action plan for fundamental reform of the CBR, to be ready for Cabinet approval in October 2001. Key elements of the reforms will be the introduction of self-assessment for all taxes, combined with a stronger emphasis on auditing and fundamental modernization and computerization of the CBR, to reduce direct contact between tax officials and taxpayers and thereby the scope for corruption.

18. **Tax policy reforms aim to broaden the base while reducing and rationalizing rates and increasing transparency.** The GST will be extended to all traders, including at the retail level (for turnover exceeding PRs 5 million) in July 2001, and to all remaining agricultural inputs (fertilizers) in September 2001. We will also seek to eliminate some other GST exemptions by July 1, 2001, but cautiously expect for 2001/02 only gains of about 0.1 percent of GDP. The GST rate for certain industrial raw material inputs will be raised to 20 percent, as an incentive for users of these inputs to register under the GST. We believe this will have a strong positive revenue impact by bringing part of the informal sector into the tax net, and the measure is strongly supported by the formal sector as helping to establish a level playing field. However, we also recognize that this measure is a deviation from the administratively simple single-rate structure that remains our objective, and will therefore review the measure after one year; in any case this measure will automatically lapse after three years. Nine minor excises will be abolished. Agricultural income has been brought into the tax net for the first time in 2000/01. Relevant legislation is in place and provincial implementing regulations will be issued in June 2001 to allow filing of returns to commence. However, administrative problems mainly relating to the lack of documentation are daunting and the measure is expected to yield only about 0.1 percent of GDP in the first year.

19. A new income tax law will be promulgated by end-July, 2001. It aims to eliminate a host of exemptions, with specific phasing to be communicated to Fund staff in July 2001, reduce the number of rates and reduce distortions between corporate and individual income taxation, and provide for the phasing out of distortive withholding practices as the CBR administrative reforms discussed above allow the introduction of self-assessment. Specifically, individual income taxation will start above a threshold of PRs 60,000 and will feature 5 brackets (7.5, 12.5, 20, 25, 35 percent), with the same treatment for salary and non-salary income, implying an increase in the top rate by 5 percentage points. Corporate tax rates will be lowered to 50 percent for banks, and will be set at 45 percent for other privately held corporations and at 35 percent for publicly traded companies. All surcharges will be abolished. The medium-term aim will be to unify corporate rates at 35 percent. The law will phase out 5 minor withholding taxes by July 1, 2001, and another 5 a year later. Withholding

on imports and on domestic contracts/sales will be phased out by July 2003 as the administrative machinery for self-assessment is being put in place. It is estimated that the reform will yield a small gain in 2001/02, but losses in subsequent years.

20. **The government is pressing ahead with trade liberalization.** By July 1, 2001, the maximum tariff will be reduced to 30 percent and the number of tariff slabs will be reduced to four (5, 10, 20, and 30 percent), except for a few zero-rated items including IT imports. Discrimination in excise rates between imported and domestically produced goods will be eliminated effective July 1, 2001. Remaining regulatory duties will be allowed to lapse as soon as possible but in no case the combined duty rate (including customs duty) would exceed 30 percent after July 1, 2001. The government will phase out quantitative import restrictions/temporary high duties maintained for balance of payments reasons by end-June 2002 according to the schedule agreed with the WTO, but in advance of schedule will replace licensing requirements on wheat imports with a tariff effective with the 2001/02 budget, following the liberalization of wheat exports in May 2001.

21. **Moves towards market-based pricing in Pakistan's economy will continue** with the deregulation of petroleum prices by September 2001; the gradual dismantling of the residual freight pool for petroleum products, to be completed by 2003; and six-monthly adjustments in consumer gas prices in order to move towards parity with oil prices, with the next adjustment planned for October, 2001. In the agricultural sector, the government will phase out over a two-year period the wheat subsidy accruing to millers and consumers, by selling wheat purchased under the price support program at prices that fully cover holding and other costs. This should encourage private sector entry into domestic wheat marketing and allow phasing out the government's role in wheat procurement and marketing.

B. Public Enterprise Reform and Privatization

22. **The government is implementing an ambitious program to streamline, restructure, corporatize, and in some cases privatize public enterprises.** For the three large nationalized commercial banks, a restructuring plan supported by a World Bank credit is underway, while in parallel privatization is being pursued (see below). For a number of major enterprises financial advisors are in place to prepare for privatization; as the next major step, expressions of interest will be obtained by June for United Bank Limited as well as the Pakistan Telecommunications Company Ltd.; formal offers would be sought in the fall and privatization completed by December 2001. A market-friendly regulatory framework encouraging competition in the telecom and energy sector will be fully put in place over the coming months, which should facilitate privatization in these sectors.

23. The financial difficulties of WAPDA and KESC are being addressed in close consultation with, and support from, the World Bank and AsDB. The federal government will continue to ensure that an agreed few key federal and provincial priority connections remain current on their electricity bills, including if needed through deduction at source from the provincial share in tax revenues; for all other agencies, WAPDA and KESC will apply normal commercial practice of switching off supply if bills are not settled. WAPDA will

adjust electricity and water rates in the coming months, allowing, inter alia, to initiate the phasing out of the GST subsidy on electricity. Together with a streamlining of its expenditure, corporatization, and unbundling of local distribution companies, this should allow WAPDA to remain current in its debt service payments and obligations towards the independent power producers (IPPs) and other suppliers. However, the government will keep WAPDA's situation under close review, as its financial position remains vulnerable to furnace fuel price increases on international markets and shortfalls in rain that would force WAPDA to substitute expensive thermal power production for hydro-power. The financial situation of KESC remains of even greater concern. A financial and technical restructuring operation supported by the AsDB aims to turn around KESC's financial position and prepare it for privatization by mid-2002. While KESC will need substantial exceptional financing for its projected cash shortfalls, net borrowing from the banking system by the seven major public enterprises for FY 2001/02 will be limited to PRs 12 billion.

C. Financial Sector Reforms

24. **The government remains committed to establishing a market-based financial system.** Beginning July 1, 2001 interest on all NSS instruments will be linked to comparable market rates at or below par; defense certificates are already closely linked to returns to benchmark bonds of similar maturities. The tax-exempt status for new NSS instruments will be removed. All subsidies under the existing export finance scheme (EFS) will be eliminated by mid-2001, by raising the EFS interest rate to the 6-month T-bill rate + 1.5 percent. A new fully market based export finance window is being developed with support from the AsDB to enhance export credit access for small- and medium-sized enterprises. Regarding the move to Islamic Finance, a petition filed by a bank is currently before the Supreme Court. Once the issue is clarified we will prepare a clear strategy for transition to an Islamic financial system that will not endanger financial stability and efficiency, the conduct of monetary policy, and the domestic financing of the budget. Under any circumstances, all foreign and existing domestic debt and loan contracts will be honored.

25. **To strengthen the financial soundness of the banking system, the government is strengthening prudential regulations.** A doubling of minimum capital requirements is being phased in; and effective July 1, 2001 all banks have to be rated by local rating agencies and the ratings published. The SBP has classified external auditors by quality and will prescribe minimum quality of external audits for banks. The SBP has also initiated the liquidation of most public development finance institutions, starting with the biggest (NDFC), and is working to rationalize the nonbank financial sector. To further strengthen the profitability of the nationalized banks, and prepare for their privatization, the closure of nonprofitable branches in the rural areas and strong efforts to recover nonperforming loans are underway, while World Bank support is being sought for financing a major staff shedding. An FSAP mission during July/August 2001 will assist us in assessing the weaknesses in the banking sector and in formulating a comprehensive strategy to develop a financial sector that is viable and contributes to higher investment and growth, as part of Pakistan's Poverty Reduction Strategy (PRS). In this context we also will seek advise on implementing best international practices to combat money laundering.

D. Transparency, Governance, and Public Sector Financial Management and Accountability

26. **The government remains committed to a wide-ranging agenda of reforms aimed at enhancing governance and transparency with respect to economic and financial developments and policy intentions.** The government has been holding in recent months broad consultations with NGOs, donors, and other elements of civil society on the report on the government's debt strategy as well as on a first blueprint of an interim poverty reduction strategy paper. The 2001/02 budget will be prepared in the context of a medium-term strategy centered on reducing public debt, and the budget document will include for the first time a report on public contingent liabilities and the schedule of tax expenditure.

27. Other steps to improve public sector financial accountability include the recent promulgation of legislation separating the government audit and accounting functions into two separate departments. Accounting and audit functions are being strengthened under a World Bank project (PIFRA), including through computerization and better human resource management. A recently promulgated new accounting model (NAM) broadly consistent with GFS methodology will be gradually implemented over the next two years, consistent with the devolution process, in the context of a major computerization drive and with technical and financial assistance from the World Bank. Public access to the deliberations of the ad-hoc Federal Public Accounts Committee will be provided. The quarterly report of the fiscal monitoring committee and fiscal data for the first three-quarters of fiscal year 2000/01 has been published on May 31, 2001. The government will further speed up the process of reconciliation of provincial fiscal data, especially against the background of the forthcoming devolution of many fiscal tasks to the newly created district administrations. At the provincial level, quarterly detailed expenditure accounts will be prepared with a lag of at most two months starting next fiscal year. In addition, we will set up by September 2001 a system for the tracking of poverty-related expenditures at federal, provincial, and district levels.

28. **A key element of the government's strategy to strengthen the efficiency of public expenditure is the devolution of the delivery of relevant government services to local government starting in August 2001.** To ensure fiscal control and accountability, the fiscal transfer systems and financial accountability mechanisms will be devolved gradually over 3 years; salaries, recruitment, and spending on certain development projects will remain largely under provincial control throughout the transition. Particular emphasis will be given to ensuring that transfers for health and education reflect needs at the district levels, are well coordinated with donor programs, and that strong incentives for good performance on agreed outcome indicators are in place from July 1, 2001. Responsibility for accounting and auditing will remain for the time being with the established structures reporting to provincial/federal rather than local government.

29. **An important element of the drive towards better governance is a comprehensive civil service reform.** We strongly believe that insufficient training, wages far below market especially for the most qualified civil servants, and non-transparent

recruitment and promotion practices go a long way to explain persistent governance problems and administrative lethargy. These issues need to be addressed as implementing the reform agenda will require a highly motivated and efficient civil service. Accordingly, competitive and transparent recruitment procedures have been introduced at both the federal and provincial level and the federal public service commission has been made more independent; no federal recruitment can take place without its approval, except for well-specified exemptions for temporary appointments. Teachers are now recruited only on two-year contracts with renewal dependent on performance as assessed by the local authorities to which teachers are assigned; similar rules apply for certain other categories of employees. The forthcoming budget will include a sizable increase in resources for the training of civil servants. The Cabinet has recently approved a right-and downsizing plan for federal ministries, which will reduce the number of federal civil positions by about 40,000 (11 percent of the total). Redundant staff will be placed in surplus pools (but remain on payroll) and may apply to relevant vacancies as they come up; the government will also seek donor support for financing separation packages for the surplus staff. Similar plans are being prepared at the provincial levels. These federal and provincial plans are expected to lead to an annual reduction of about 2 percent in the number of paid civil servants over the next three years. Finally, the pay and pension commission has prepared a report documenting the erosion of real wages and the growing divergence of public service salaries and private sector pay. As a first step, the 2001/02 budget includes an average wage increase of about 15 percent, to be implemented in mid-fiscal year, with some differentiation between grades to address wage compression. The increase will only be granted to workers accepting concomitantly a revision in their pension rights, notably a reduced commutation option and pensions based on 60 percent of the last wage (rather than 70 percent under the current system). This will also apply to the military. In collaboration with the World Bank we will over the coming months undertake a further in-depth evaluation of the pay and pension system, including additional actuarial analysis and on this basis as needed amend the package and, in any case formulate a strategy for long-term pension reform.

30. **The government will complete implementation of the recommendations arising out of the Fund's recent assessment of the SBP's financial safeguards in the coming months.** By mid-2001 the SBP will prepare an IAS-compliant reporting format and comparable IAS financial statements for the previous years ended June 30, 2000, and will complete an independent review of SBP's internal audit function. By mid-September 2001, the SBP will publish audited IAS financial statements for the year ended June 30, 2001 and the external auditors will, as part of the annual audit, prepare a separate report on net foreign assets reported to the IMF. To strengthen the safeguarding of reserves, the SBP will reduce its term deposits with Pakistani banks abroad to a maximum of US$200 million by end-June 2001, to US$100 million by end-September and eliminate such deposits by end-2001. Current account deposits will be capped at US$120 million throughout the period. Finally, before end-August 2001 the government will prepare draft revisions to the SBP Act and issue resolutions to the Monetary and Fiscal Policy Coordination Board to: (a) ensure that the Governor and other SBP board members can be removed only by legal cause; and (b) guarantee autonomy of the SBP in respect of reserves management.

IV. External Financing Issues

31. **External financing needs for 2001/02 and onwards remain large**. Continuing support from multilateral and bilateral creditors and private sector will be essential, preferably on concessional terms. For 2001/02, the financing gap is projected at about US$ 3.4 billion. On the basis of the current IFI pipeline and debt relief agreed so far, the gap would be fully covered until end-September. For the balance of the fiscal year, part of the gap could be covered by US$1.2 billion from prospective World Bank and AsDB program loans (World Bank: US$100 million for drought-related emergency assistance, US$200 million for the Banking Sector Reform project, and US$350 million for the SAC II or a PRSC; AsDB: US$175 million for the Agricultural Program, US$50 million for TEPI, US$75 million for the Energy Sector Restructuring Program, US$80 million for the Legal Reform Program, US$20 million for Microfinance Credit Program, US$60 million for the SMETEF, and US$100 million for drought-related emergency assistance). To cover the remaining gap, we will seek further rescheduling from Paris Club and other bilateral creditors, and will also seek strong private sector involvement, mostly through the refinancing of the outstanding special bonds denominated in U.S. dollar issued in the past against frozen currency deposits.

V. Program Monitoring

32. The government is aware that purchases under the Stand-By Arrangement remain contingent on the observance of quantitative and structural performance criteria and the completion of reviews. The last review under the SBA will focus on financial sector reform.

33. For purposes of monitoring the remainder of the program, performance criteria, indicative targets and structural benchmarks remain as agreed during the first review (Tables 1 and 2). The government has implemented or will implement a number of measures as prior actions for the Board completion of the second review under the arrangement (Table 3). Definitions of each of the monitoring variables and, where necessary, of the structural performance criteria and benchmarks, together with reporting requirements and monitoring mechanisms remain as detailed in the Technical Memorandum of Understanding attached to the February 2001 MEFP. The last purchase under the Stand-By Arrangement shall be subject to a review to be completed by September 2001. Indicative quantitative targets agreed for the second half of calendar year 2001 and relevant definitions and reporting requirements are outlined in the attached supplementary Technical Memorandum of Understanding.

Table 1. Pakistan: Quantitative Performance Criteria, and Indicative Targets Under the Stand-By Arrangement, December 2000–June 2001

(Cumulative flows from July 1, 2000 unless otherwise specified)

	Outstanding Stock End-June 2000	Performance Criteria						
		End-December 2000			End-Mar.			End-Jun.
		Prog.	Adj.	Act.	Mod. Prog.	Adj.	Act.	Prog.
Performance Criteria								
		(In billions of Pakistan rupees)						
Net foreign assets of the SBP 1/	-55.1	-8.2	-12.2	2.1	8.7	-4.1	-2.1	41.5
Net domestic assets of the SBP 2/	552.9	-26.3	-22.1	-41.1	8.0	8.2	-8.1	-14.3
Overall budget deficit	206.4	103.8	103.8	77.9	152.8	152.8	144.5	185.7
Of which : net bank borrowing 3/	40.0	6.4	21.1	-9.4	19.9	34.8	13.0	-14.5
CBR revenue	346.6	189.9	189.9	182.0	279.3	279.3	276.7	417.3
Credit to the seven major public enterprises 4/	44.5	6.5	0.0	-9.4	9.5	2.0	-14.2	11.5
Accumulation of budgetary arrears to WAPDA		0.0	0.0	-3.7	0.0	0.0	-3.4	0.0
		(In millions of U.S. dollars)						
Contracting of short-term public and publicly guaranteed external debt 5/	657	800	...	264	800	...	474	800
Contracting of nonconcessional medium- and long-term public and publicly guaranteed external debt 5/		2,000	...	533	2,500	...	688	3,000
Of which: External debt with an initial maturity of over one year and up to five years 5/		1,000	...	33	1,500	...	33	1,500
Accumulation of external payments arrears (continuous performance criterion during the program period)		0	...	0	0	...	0	0
Indicative Targets								
		(In billions of Pakistan rupees)						
Net domestic assets of the banking system 6/	1,451.5	29.3	44.0	71.7	59.8	74.7	46.3	88.6
Federal tax revenue 7/	386.8	207.5	207.5	195.5	317.2	317.2	300.6	451.3
Social and poverty-related spending 8/	76.3	48.5	48.5	35.2	77.9	77.9	73.1	97.5
Memorandum items:								
Net external budget financing 9/	73.6	71.5	...	43.6	87.0	...	61.7	122.0
Net foreign assets of the SBP (level; PRs bln)	-55.1	-63.3	...	-52.9	-46.4	...	-57.2	-13.5
Net domestic assets of the SBP (level; PRs bln)	552.9	526.6	...	511.8	560.8	...	544.8	538.6
		(In millions of U.S. dollars)						
Stock of non-resident institutional foreign currency deposits with SBP forward exchange cover	1,072	1,007	...	1,001	798.0	...	811.0	790
Program financing		1,690	...	1,301	1,997	...	1,693	2,550
BOP support loans 10/		570	...	212	567	...	316	918
Debt rescheduling		1,120	...	1,089	1,430	...	1,377	1,632
Stock of foreign exchange swaps of the SBP	756	717	...	798	717	...	753	717
Of which: short-term	104	65	...	256	0	...	0	0
Forward exchange contracts of the SBP	0	23	...	27	23	...	10	23
External financing counted as SBP liability		117	...	79	220	...	107	207

Sources: Quarterly macroeconomic projections for 2000/01 agreed between the Pakistan authorities and the Fund staff.

1/ These floors will be adjusted: (a) upward by the rupee equivalent of the excess in program financing; (b) downward by the rupee equivalent of the shortfall in program financing provided that the SBP net foreign assets remain above PRs –78 billion at end-December 2000, above PRs –61.3 billion at end-March 2001, and above PRs –20 billion at end-June 2001; (c) upward by the rupee equivalent of the full amount of any privatization proceeds from abroad; and (d) upward by the rupee equivalent of the excess in nonresident institutional foreign currency deposits with SBP forward exchange cover above the end-August 2000 level (US$1,068 million), in foreign exchange swaps of the SBP above the end-August 2000 level (US$717 million), in outright forward sales of foreign exchange by the SBP above the end-August 2000 level (US$23 million), and in SBP foreign exchange reserves held with foreign branches of domestic banks above the end-June 2000 level (US$545 million). The floor for end-June 2001 will also be adjusted upward/downward for the excess/shortfall in FE25s held with the SBP above their projected end-June 2001 level of US$530 million.

2/ These ceilings will be adjusted (a) downward by the rupee equivalent of the excess in program financing; (b) upward by the rupee equivalent of the shortfall in program financing provided that the net domestic assets of the SBP remain below PRs 541.3 billion at end-2000, below PRs 563.1 billion at end-March 2001, and below PRs 545 billion at end-June 2001; (c) downward by the rupee equivalent of the full amount of any privatization proceeds from abroad used by the budget; and (d) downward by the rupee equivalent of the excess in foreign currency deposits with SBP forward exchange cover above the end-August 2000 level and in foreign exchange swaps of the SBP above the end-August 2000 level, in outright forward sales of foreign exchange by the SBP above the end-August 2000 level, and in SBP foreign exchange reserves held with foreign branches of domestic banks above the end-June 2000 level. The ceiling for end-June will be adjusted downward/upward for the excess/shortfall in FE25s held with the SBP above their projected end-June 2001 level of US$530 million (PRs 31.62 billion). These ceilings will also be adjusted downward/upward by the amount of banks' reserves freed/seized by any reduction/increase of daily CRR of 4 percent and by the amount of any reduction/increase in the deposit base with respect to the programmed levels of PRs 1,084 billion at end-March 2001 and PRs 1,143 billion at end-June 2001 that is related to changes in definition of deposits subject to CRR.

3/ These ceilings will be adjusted: (a) downward by the rupee equivalent of the excess in net external budget financing; (b) upward by the equivalent of any shortfall in net external budget financing provided that net bank borrowing by the government remains below PRs 21.1 billion at end-December 2000, below PRs 34.8 billion at end-March 2001, and below PRs –8 billion at end-June 2001; and (c) downward by the rupee equivalent of the amount of new privatization proceeds used by the budget.

4/ The seven major enterprises are Pakistan Railways, the Water and Power Development Authority, the Karachi Electricity Supply Corporation, Ltd., Sui Northern Gas Pipelines Ltd., Sui Southern Gas Company Ltd., the Pakistan Telecommunications Corporation Ltd., and the Oil and Gas Development Corporation. This ceiling will be adjusted downward if the difference between program and actual amounts of restructuring credits to KESC related to the financing of its cash shortfall is positive; the program amount is PRs 7.5 billion.

5/ This performance criteria applies not only to debt as defined in point No. 9 of the Guidelines on Performance criteria with respect to Foreign Debt (adopted on August 24, 2000), but also to commitments contracted or guaranteed for which value has not been received. See paragraph 12 of the Annex to the attached Technical Memorandum of Understanding.

6/ These ceilings include the rupee counterpart of external debt service due on rescheduled government and government guaranteed debt. These indicative ceilings will be adjusted: (a) downward by the rupee equivalent of the excess in program financing; (b) upward by the rupee equivalent of the shortfall in program financing provided that the net domestic assets of the banking system remain below PRs 1,495.5 billion at end-2000, below PRs 1,515.7 billion at end-March 2001, and below PRs 1,545.8 billion at end-June 2001; (c) downward by the rupee equivalent of the full amount of any privatization proceeds from abroad; and (d) downward by the rupee equivalent of the excess in foreign currency deposits with SBP forward exchange cover above the end-August 2000 level.

7/ Consists of the taxes collected by the Central Board of Revenue, gas and petroleum surcharges, and the foreign travel tax.

8/ Consists of central and provincial government spending under the Public Sector Development Program and the Social Action Program (SAP), including outlays on agricultural income generating programs, education and training, health and nutrition, rural development (farm to market roads), manpower and employment, women development, population welfare, social welfare, environment, integrated rural and urban development, and the special areas social action program. SAP spending also includes basic education and health sector current outlays. Expenditures under the Zakat program outside the budget are excluded.

9/ Includes all receipts from foreign currency government debt (including net amount of special dollar bonds issued), except for Non-Plan resources; receipts (cash or in kind) from the refund from the purchase of war planes from the United States; the accumulation of arrears on foreign currency government debt (including arrears on military debt); and the rescheduling of foreign currency government debt (including military debt); less the repayment of principal on foreign currency government debt (excluding military debt).

10/ Include adjustment loans from the World Bank and the AsDB net of principal payments due to the World Bank, AsDB, IDB, and IFAD; bilateral grants and loans for balance of payments support; additional loans from commercial banks; and debt relief from commercial banks.

Table 2. Pakistan: Structural Performance Criteria and Benchmarks
Under the Stand-By Arrangement

Measures	Timing	Status
I. Structural Performance Criteria		
Implementation of the quarterly petroleum price adjustment mechanism for all major petroleum products as described in Section VI of the Technical Memorandum of Understanding as amended in the Supplementary TMU.	December 15, 2000, March 15, 2001, June 15, 2001.	Implemented on December 31, 2000 March 15, 2001, June 15, 2001.
Ban on introduction of new GST exemptions and fixed-tax schemes under the GST.	Continuous during the program period.	Met through March 2001.
Publication of quarterly fiscal reports that have been verified by the Accountant General Pakistan Revenue (starting with the first quarter of 2000/01; reports are to be published no later than two months after the end of the quarter).	End-February 2001, end-May 2001, and end-August 2001.	Met in May 2001 .
GST extension to urea fertilizer and pesticides.	By end-March 2001.	Met.
GST extension to all other agricultural inputs.	By September 1, 2001.	
Promulgation of a new income tax law, that puts into place a global income tax with: (a) a simpler rate structure for individuals; (b) uniform tax of all companies; (c) less emphasis on withholding and presumptive taxes; (d) fewer exemptions; and (e) replacement of investment incentives by a simple system of accelerated depreciation.	With the passage of the 2001/02 budget before end-July 2001.	
Extension of income tax to all new issuance of NSS instruments on the same basis as the income tax currently applies to other financial instruments.	With the passage of the 2001/02 budget before end-July 2001.	
The extension of GST to all retailers/traders above the PRs 5 million threshold.	With the passage of the 2001/02 budget before end-July 2001.	
The reduction of the maximum customs tariff to 30 percent and the number of tariff slabs to four.	July 1, 2001.	
The elimination of interest subsidy element of the export finance scheme.	July 1, 2001.	
Prepare an IAS-compliant reporting format and comparable IAS financial statements for the SBP for the previous year ended June 30, 2000.	End-June 2001.	
Reduce SBP deposits with Pakistani banks abroad to a maximum of US$200 million and formulate plan to further reduce placements with Pakistani banks abroad.	End-June 2001.	

Table 2. Pakistan: Structural Performance Criteria and Benchmarks
Under the Stand-By Arrangement

Measures	Timing	Status
II. Structural Benchmarks		
Completion and publication of a special audit in line with international standards of the Central Directorate of National Savings.	End-October 2000.	Met.
Establishment and implementation of a formula linking interest rates on new Defense Savings Certificates to the market-determined yield of the new government bond.	January 1, 2001.	Met.
Enactment of the anti-dumping law that would lead to the withdrawal of the different excises applied to domestically produced and imported goods as an anti-dumping measure.	End-December 2000.	Met.
Preparatory steps relating to the promulgation of a new income tax law with the 2001/02 budget:		
The income tax committee will submit its preliminary recommendations to the Ministry of Finance.	End-December 2000.	Met.
The final report and draft law will be submitted to cabinet.	End-March 2001.	Pending.
Establish basic reconciliation processes in all provinces. All provinces will produce quarterly reports for internal use and reporting to the MoF that are fully reconciled in terms of AG/Departmental accounts, clearance of suspense accounts, SBP and scheduled bank accounts, and provincial/federal records of intergovernmental flows.	Quarterly, starting end-March 2001 (covering data through December 2000).	Pending.
Publication of public sector contingent liabilities as an annex to the Economic Survey.	By end-June 2001, with the economic survey presented prior to the 2001/02 budget.	Met.
Publications of a schedule of tax expenditures as an annex to the Economic Survey.	By end-June 2001, with the economic survey presented prior to the 2001/02 budget.	Met.
Initiate a review of Part A of the budget (covering costs of government services such as wages and salaries).	By end-December 2000.	Met.
Establish a fiscal reform unit to build up technical capacity and more effective ownership of fiscal reform programs, which would cover tax reform as well as public expenditure management reform.	January 2001.	Established in February 2001.
Commission and complete an independent review of SBP's internal audit function.	End-June 2001.	

Table 2. Pakistan: Structural Performance Criteria and Benchmarks
Under the Stand-By Arrangement

Measures	Timing	Status
Prepare draft revisions to the SBP Act and issue resolutions by the MFP Coordination Board: (i) to ensure that the Governor and other Central Board members can only be removed by legal cause; and (ii) to guarantee autonomy of the SBP in respect of the management of reserves.	End-August 2001.	
Send report on research studies in the framework of National Accounts Project to the Fund's Statistics Department according to the following schedule:		
- Those related to fishing, shipping, and services.	End-March 2001.	Report provided in April 2001.
- Those related to livestock, mining and quarrying, and public administration and defense.	End-June 2001.	
Assess in context of FSAP exercise weaknesses in financial sector and formulate comprehensive strategy to develop a financial sector that is viable and contributes to higher investment and growth; ensure implementation of best international practices to combat money laundering.	Mid-September 2001.	
Full implementation of agricultural income taxes on the basis of provincial implementing regulations to become effective in each province by end-June 2001.	End-June 2001	
Cabinet approval of a right-and downsizing plan restructuring all federal ministries; and corresponding plans to be adopted by the provinces. On this basis, recruitment to be limited with a view to achieve a 2 percent decline in the government payroll per year through 2003/04. Similar plans to be adopted at the provincial levels.	End-July 2001.	
Deregulation of diesel prices.	Mid-September 2001	

Table 3. Pakistan: Prior Actions

1. Increase in net reserves of the SBP (gross reserves minus FE-25 foreign currency deposits with the SBP, short-term foreign currency swaps and forwards), and excluding any disbursements under the World Bank SAC to at least US$990 million by June 15, 2001 (and US$1,340 million if the SAC is disbursed by that time).

2. Announcement of budget for 2001/02 consistent with the agreed financial program (Table 4). The budget document will include a report on public contingent liabilities and the schedule of tax expenditure. Concomitant with the budget, the following will be announced to become effective July 1, 2001: elimination of some GST exemptions; elimination of any discrimination in excise rates between imported and domestically produced goods; and elimination of nine minor excise taxes and rationalization of the excise on cigarettes.

3. The budget announcement will also include the following steps towards income tax reform to become effective end-July 2001: removal of the tax exempt status for new NSS instruments; abolition of 5 minor withholding taxes; a new schedule for the personal income tax with five rates (7.5, 12.5, 20, 25 and 35 percent); a first step towards unifying corporate income tax rates (to 50 percent for banks; 45 percent for private companies; and 35 percent for publicly traded companies); abolition of all surcharges; and the abolition of income tax exemptions for income from FEBCs, TFCs, and donations for National Debt retirement and the National Self Reliance Fund.

4. Liberalization of the ban on wheat imports (and replacement by tariff) and liberalization of wheat exports.

Table 4. Pakistan: Consolidated Government Budget, 1999/2000–2001/02

	1999/2000	2000/01				2001/02	
	Year	Jul.-Mar.		Year		Year	Jul.-Sep.
	Rev. Act.	Orig. Prog.	Prel. Act.	Rev. Prog.	Proj.	Budget	Proj.
	(In billions of Pakistani rupees)						
Revenue and grants	528.4	427.6	421.6	615.1	605.3	693.8	140.9
Revenue	524.4	391.0	386.2	570.4	557.9	643.3	128.6
Tax revenue	406.8	333.3	314.7	471.4	461.5	524.1	105.4
Federal	388.4	317.2	300.6	451.3	441.3	499.9	100.4
CBR Revenue	348.1	291.6	276.7 1/	417.3	406.5	458.2	92.1
Direct tax	109.8	89.5	86.9	133.9	133.9	147.2	25.8
Federal excise duty	56.9	34.4	35.2	52.5	52.2	53.2	12.7
Sales tax	117.6	121.3	108.3	166.2	155.9	185.1	35.7
Customs duties	63.8	46.3	46.3	64.6	64.6	72.6	18.0
Petroleum surcharge	25.4	13.5	14.5	18.0	18.0	25.0	5.0
Gas surcharge	13.5	10.3	8.7	13.6	15.0	15.0	3.0
Other	1.4	1.9	0.7	2.5	1.7	1.7	0.2
Provincial	18.4	16.0	14.1	20.1	20.2	24.2	5.0
Nontax revenue	117.6	57.7	71.5	99.0	96.5	119.2	23.2
Federal	97.5	47.2	61.0	85.6	82.5	103.8	19.4
Provincial	20.1	10.5	10.5	13.4	14.0	15.4	3.8
Grants	4.0	36.6	35.4	44.7	47.4	50.5	12.3
Expenditure	728.7	543.8	530.7	756.1	741.2	829.8	184.5
Current expenditure	640.2	469.4	472.9	659.4	649.5	699.5	156.6
Federal	484.9	339.0	368.9	488.5	488.5	524.5	119.2
Interest payments	243.3	170.6	166.6	237.0	235.0	258.5	63.5
Domestic	198.4	129.9	128.5	185.0	185.0	197.4	45.9
Foreign	44.9	40.7	38.1	52.0	50.0	61.1	17.6
Defense 2/	150.8	105.2	111.4	157.5	157.5	162.8	32.8
Running of the civil governmen	47.9	35.4	32.4	52.1	52.0	57.4	9.3
Subsidies	20.4	6.0	8.3	14.0	12.2	14.5	2.9
Grants	11.8	19.7	18.1	26.6	31.5	19.3	3.7
Other	9.9	2.1	0.1	1.3	0.3	12.0	7.0
Of which: bank restructuring						9.7	7.0
Unidentified	0.8	0.0	32.1	0.0	0.0	0.0	0.0
Provincial	155.3	130.4	104.0	171.0	161.0	175.1	37.4
Development expenditure and net ler	88.5	74.4	57.8	96.7	91.7	130.3	27.9
Public Sector Development Progran	100.7	79.9	62.6	110.9	98.8	130.0	27.9
Federal 3/	64.4	49.5	48.4	68.2	66.4	100.0	19.0
Provincial	36.3	30.4	14.2	42.7	32.4	30.0	8.9
Net lending	-12.2	-5.5	-4.8	-14.3	-7.1	0.3	0.1
Budget balance (excluding grants)	-204.3	-152.8	-144.5	-185.7	-183.2	-186.5	-55.9
Budget balance (including grants)	-200.3	-116.2	-109.1	-141.0	-135.9	-136.0	-43.6
Financing	200.3	116.2	109.1	141.0	135.9	136.0	43.6
External	70.2	50.4	26.3	77.3	72.3	62.7	30.2
Domestic	130.1	65.8	82.8	63.7	63.6	34.4	13.4
Bank	40.0	19.9	13.0	-14.5	-14.5	-26.8	8.1
Nonbank	90.2	45.9	69.8	78.1	78.1	61.2	5.3
Privatization proceeds	0.0	0.0	0	0	0	38.8	0
Memorandum items:							
Primary balance	38.9	17.7	22.1	51.4	51.8	72.0	7.6
Social and poverty-related expendit	76.3	78.4	73.1	97.5	97.5	117.0	23.4

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

1/ Under the revised program, the performance criterion on CBR revenue for the first three quarters of 2000/01 was PRs 27
2/ Military pensions are included in defense expenditure.
3/ In 2001/02, includes PRs 10 billion and PRs 3 billion of spending related to drought and fiscal devolution.

PAKISTAN

Supplementary Technical Memorandum of Understanding on the Program Supported by the Stand-By Arrangement

(June 2001)

1. This memorandum supplements the Technical Memorandum of Understandings (TMU) between the Pakistan authorities and the Fund staff relating to the monitoring of the program for 2000/01 supported by the Stand-By Arrangement, dated March 2001. It specifies indicative quantitative and structural reform targets for end-September 2001 and end-December 2001 that will be reviewed and firmed up in the context of a successor arrangement expected to become operative in late 2001, as indicated in the Supplement to the MEFP (SMEFP), dated June __ 2001. The content and frequency of the data to be provided for monitoring these indicative targets remain the same as in the above-mentioned TMU; the relevant financial variables are defined in the Annex to the TMU, except for revisions in definitions described in section V.

I. Quantitative Indicative Targets

2. The quarterly indicative targets will consist of ceilings or floors on the following variables:

- Cumulative change from July 1, 2001 in the net foreign assets of the SBP;
- Cumulative change from July 1, 2001 in the net domestic assets of the SBP;
- Cumulative overall budget deficit from July 1, 2001;
- Net borrowing from the banking system by the government from July 1, 2001;
- Cumulative CBR revenue from July 1, 2001;
- Banking system's credit from July 1, 2001, to the following major public enterprises: WAPDA, KESC, OGDC, SNGPL, SSGCL, PTCL, (these acronyms are defined in EBS/01/39, page 3), and Pakistan Railways (excluding the SBP's overdraft that is already included in the net borrowing from the banking system by the government);
- Accumulation of arrears to the Water and Power Development Authority (WAPDA) from July 1, 2001, by a list of priority connections identified by the federal and provincial governments, which will be specified no later than June 30, 2001;
- Social and poverty-related spending;
- Contracting of short-term public and publicly guaranteed external debt;

- Contracting of new nonconcessional medium- and long-term public and publicly guaranteed external debt from July 1, 2000, with a subceiling on debt with an initial maturity of over one year and up to and including five years;

- Non-accumulation of external payments arrears;

- SBP foreign exchange reserves held with foreign branches of domestic banks; and

- No contracting of foreign currency swaps or outright forward sales and no provision of forward cover by the SBP.

3. The floors and the ceilings applicable to the preceding variables will be monitored on the basis of the magnitudes specified in the attached Table.

II. Adjustors

4. The floors on the **net foreign assets of the SBP** will be adjusted upward by the excess in program financing (as defined in Section V), and downward by the cumulative shortfall in program financing, capped however at US$100 million as of end-September 2001 and US$100 million as of end-December 2001. The floors will also be adjusted upward/downward for the excess/shortfall in foreign currency deposits with the SBP (including the reserve requirements) above their projected end-June 2001 level of US$410 million.

5. The ceilings on the net domestic assets of the SBP and on net bank borrowing by the government will be adjusted downward by the excess in program financing (as defined in Section V), and upward by the cumulative shortfall in program financing, capped however at US$100 million as of end-September 2001 and US$100 million as of end-December 2001 evaluated at the program exchange rate.

6. The ceilings on the net domestic assets of the SBP will also be adjusted downward/upward by the amount of banks' reserves freed/seized by any reduction/increase of the daily CRR of 4 percent, and by the amount of any reduction/increase in the deposit base with respect to the programmed level of PRs 980 billion at end-September 2001 and PRs 1030 billion at end-December 2001 that is related to changes in deposits subject to CRR. Changes in required reserve regulations will modify the NDA ceiling of the SBP according to the formula: $\Delta NDA = \Delta r B_0 + r_0 \Delta B + \Delta r \Delta B$, where r_0 denotes the daily reserve requirement ratio prior to any change; B_0 denotes the programmed level of the reservable money supply in the period prior to any change; Δr is the change in the reserve requirement ratio; and ΔB denotes the change in the reservable deposits with respect to the programmed level as a result of changes in definition of reservable money supply (deposits).

7. The ceilings on banking sector's credit to the seven major public enterprises for end-September 2001, and end-December 2001 will be adjusted downward (upward) by the amount by which the actual AsDB loans onlent to KESC and WAPDA from the budget

exceed (fall short) of the programmed amount (PRs 3 billion for KESC in the first quarter of 2001/02 and PRs 4.5 billion for WAPDA the second quarter of 2001/02).

III. Indicative Targets for Structural Reforms

8. The implementation of the following measures will be used to assess progress under the structural reform program of the authorities during October-December 2001:

- Continued implementation of the measures in the CBR short-term action plan to improve tax administration, prepared with FAD technical assistance, with specific emphasis on audit and arrears collection, along with a tighter penalty regime for nonfilers and late payments.

- Cabinet approval by October 2001 of a multi-year action plan to reform the CBR based on the phased introduction of self-assessment schemes for all taxes, and the modernization and computerization of the CBR.

- Finalization, in consultation with the World Bank, by end-December 2001 of a multi-year program to reform the civil service and the pension system at both federal and provincial levels based on actuarial assessment of the pay and pension package included in the 2001/02 budget. The program will include introduction of a fully funded pension scheme for new civil servants (as well as existing ones on a voluntary basis); outcontracting to the private sector of non-core activities; and a plan for an annual reduction in the number of paid civil servants by about 2 percent over the next three years.

- The government envisages a complete deregulation of the petroleum pricing effective next financial year. The proposed mechanism will be discussed with the Fund staff before its adoption; it would ensure that the current level of government revenues on account of Fixed Development Surcharge are protected. In case this arrangement is not put in place, the existing quarterly petroleum pricing adjustment mechanism would remain operative.

- Implementation of the formula-based automatic fuel adjustment clause for electricity tariffs.

- Ban on introduction of new GST exemptions and fixed-tax schemes under the GST throughout the year.

- Publication of quarterly fiscal reports that have been verified by the Accountant General Pakistan Revenue, based on internal reporting to the Ministry of Finance that are fully reconciled between Accountant General and departmental accounts, in terms of clearance of suspense accounts, SBP and scheduled bank accounts, and provincial/federal records of intergovernmental flows, by end-November 2001 (covering first quarter of FY 2001/02).

- Detailed expenditure accounts for FY 2000/01 for each province by end-September 2001.

- Progress report on setting up system for tracking the quarterly composition of public spending (including poverty-related expenditure) at the provincial and federal levels (September 2001).

- Adjustments in consumer gas prices in October 2001 in order to move towards parity with oil prices.

- Continue phasing out the wheat subsidy and the government's role in wheat procurement and marketing.

- Bring United Bank Limited and Pakistan Telecommunications Company, Ltd. to the point of sale before end-2001.

- Gradual phasing out of subsidy to WAPDA for GST on electricity and water, with about PRs 4 billion reduction during 2001/02 in the context of the next tariff adjustment.

- Continue preparation and publication of FMC reports and consolidate fiscal data on the same quarterly schedule as specified in the revised program. In addition, the FMS report for the last quarter of fiscal year 2000/01 will include data and information on progress in reconciling fiscal data at the provincial level, and report on the work of the Provincial Monitoring Committees.

- Begin implementation of PIFRA pilot projects, as agreed with the World Bank.

IV. Revised Definitions of Monitoring Variables

9. Starting July 1, 2001, the definitions of monitoring variables are changed as follows:

- Reserve money includes scheduled banks' required and excess foreign currency deposits with the SBP, but excludes the special deposit accounts of the commercial banks with the SBP on account of the frozen foreign currency deposits.

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

- Net program financing is defined to include budget support loans and grants from multilateral (other than the Fund), bilateral (excluding the Saudi oil facility), and private sector sources, net of government actual debt service on public and publicly guaranteed loans, and external privatization receipts. It includes foreign aid onlent to public enterprises, drought-related emergency relief and the World Bank loan for restructuring of the banking system. Program financing excludes all external financing counted as reserve liabilities of the SBP.

Table 1. Pakistan: Quantitative Indicative Targets, September--December 2001 1/

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

	Projected Outstanding Stock	Indicative Targets	
	End-June 2001	End-September 2001	End-December 2001
Net foreign assets of the SBP (in millions of U.S. dollars)	-574.3	39.0	211.0
	(In billions of Pakistan rupees)		
Net domestic assets of the SBP	581.8	-2.9	16.4
Overall budget deficit	-183.2 2/	-57.5	-90.9
Of which: net bank borrowing	531.4	8.3	29.4
CBR revenue	406.5 2/	91.8	207.6
Credit to the seven major public enterprises	52.0	-5.0	-10.0
Accumulation of budgetary arrears to WAPDA	...	0.0	0.0
Social and poverty-related spending	97.5 2/	21.9	49.2
	(In millions of U.S. dollars)		
Contracting of short-term public and publicly guaranteed external debt		900	900
Contracting of nonconcessional medium- and long-term public and publicly guaranteed external debt		500	1,000
Of which: External debt with an initial maturity of over one year and up to five years		250	250
Accumulation of external payments arrears (continuous performance criterion during the program period)	0	0	0
SBP's forex reserves held with foreign branches of domestic banks	320	-100	-200
Of which: other than current account	200	-100	-200
Contracting of foreign currency swap and forward sales	0	0	0
Memorandum items:			
Net program financing 3/		-228	-457
Foreign currency deposits with the SBP (incl. reserve requirements)	410	0	0
Daily cash reserve requirement ratio (in percentage points)	4.0	4.0	4.0

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

1/ As defined in the Technical Memorandum of Understanding dated March 2001, unless otherwise specified.
2/ Projected flow for 2000/01.
3/ See definition in section V.

Statement by the IMF Staff Representative
July 11, 2001

1. This statement summarizes information which has become available since the staff report (EBS/01/101) was circulated to the Executive Board on June 29, 2001.

Prior Actions

2. The information provided by the authorities indicates that all the prior actions listed in the supplementary Memorandum on Economic and Financial Policies (MEFP) (Table 3, Attachment I in EBS/01/101) have been implemented. In particular:

- net reserves of the State Bank of Pakistan (SBP) reached US$1,377 on June 15, 2001, compared to a target of US$ 1,340 million.

- the federal budget announced on June 18, 2001 is consistent with the financial program set out in table 4 of the MEFP, limiting the deficit, excluding grants, to PRs 186.5 billion. The budget includes published reports on contingent liabilities and a schedule of tax expenditures (thereby observing two end-June structural benchmarks). The budget for 2001/02 includes all the various tax measures in Table 3 of the MEFP, including the elimination of GST exemptions on retailers with a turnover of more than PRs 5 million, imported soya bean and palm oil, mobile phones, and jewelers, and the elimination of excises on 10 items.

- Ordinance No. 364 of June 14, 2001 authorizes the export of wheat, and with effect July 7, 2001 an amendment to the Import Trade Order eliminates the public sector monopoly on the import of wheat; the tariff on wheat imports was earlier set at 30 percent.

Structural Performance Criteria and Benchmarks for end-June 2001

3. The authorities have confirmed that with one exception **all the structural performance criteria for the period end-March 2001 to July 1, 2001 have been observed.** The GST was extended to urea fertilizer and pesticides on March 31, 2001; the maximum customs tariff was reduced effective July 1, 2001 to 30 percent; and the number of slabs reduced to four (with a few zero rated items such as Information Technology related imports).

4. An International Accounting Standards (IAS) compliant reporting format and comparable IAS financial statements for the SBP for the year ended June 30, 2000 was prepared and made available to staff. The SBP reduced its term deposits with Pakistani banks

abroad to US$172 million at end-June 2001, and plans to reduce such term deposits to US$100 million by end-September 2001. In addition, the current account position of the SBP with these banks has been capped at US$120 million.

5. To eliminate the interest rate subsidy for export finance, the rate on export finance was raised from 10.5 to 13 percent effective July 1, 2001. Elimination of the subsidy was defined in the Technical Memorandum of Understanding (TMU) as a margin of 1.5 percentage points over the average six-month treasury bill yield obtained in the auctions during the previous quarter. **This performance criterion was not observed**. The reason was that the authorities were concerned to take into account the last auctions in June, which resulted in exceptionally high yields (12.2 and 12.9 percent, respectively), raising the average yield for the quarter to 11.8 percent, as the SBP aggressively moved to meet the net domestic asset (NDA) and net foreign asset (NFA) targets.

Staff agrees that the last auctions in June were exceptional and that the action taken observes the spirit of the performance criteria, even if the export finance rate at 13 percent exceeded the average six-month treasury bill yield prevailing in all auctions during the previous quarter by only 1.2 percentage points rather than 1.5 percentage points as required in the TMU. In particular, staff considers that an export finance rate strictly at the level defined by the TMU could soon imply a tax on export finance once yields ease over the coming weeks, as expected. Accordingly staff recommends the granting of a waiver for the nonobservance of this performance criterion.

6. In **observance of end-June structural benchmarks**, the SBP has completed an independent review of its internal audit functions. However, provincial implementing regulations for the agricultural income tax have yet to become effective in each province. The report on research studies in the framework of the National Accounts project related to livestock, mining and quarrying, and public administration and defense was completed with some minor delay, and was made available to staff on July 10, 2001. Progress was also made in implementing measures that were structural benchmarks for end-March 2001: The final income tax reform report was completed at end-April 2001, and a new draft income tax law was posted on the CBR's website inviting public commentary and scrutiny in early July 2001. Basic reconciliation processes for fiscal data have been established in all provinces.

Other Structural Reforms

7. The authorities have implemented further steps towards the liberalization of petroleum product markets. Effective June 13, 2001, following a final adjustment of prices according to the formula under the program, the oil marketing companies (OMC) have been authorized to freely import petroleum products, and will jointly determine every two weeks the prices charged at the 29 central depots to reflect import prices (calculated as weighted average of the prices paid by the various OMCs), exchange rates, primary freight up to the 29 depots and domestic costs, while incorporating all taxes and duties. Any price changes

need to be approved by the regulatory authority. The new pricing system allows retail prices to reflect differences in transport costs from the depots to retail outlets, up to a fixed margin over ex-depot prices (e.g. 11 percent for high-speed diesel).

8. Deadlines for expression of interest for the privatization of United Bank Ltd., Pakistan Oils Ltd, Pakistan Telecom Company Ltd, and National Investment Trust expire during July, 2001. On July 5, 2001, the Privatization Commission invited expressions of interest by end-July, 2001 to divest the government's remaining equity stake (16.6 percent) in Muslim Commercial Bank, the largest private bank in Pakistan.

Recent Economic Developments

9. Latest real sector data indicate that through April large-scale manufacturing grew by 8.3 percent in real terms, and latest official estimates put the 2000/01 wheat harvest at 19.1 million tons, both somewhat higher than expected. Sugar production also is growing faster than expected, and real GDP growth (at factor cost) may reach close to 3.0 percent, slightly higher than programmed. Total exports for 2000/01 reached US$9.1 billion, an all-time high and an increase of 11 percent over last year in value terms, slightly better than programmed.

10. Net official reserves of the SBP on June 30, 2001 exceeded the program target, reaching US$1,677 million (but declined to US$1,608 million by July 9 mostly on account of debt service due). This strong performance, which was not expected to be achieved in the MEFP or the staff report, reflects a high level of foreign exchange purchases by the SBP in both interbank and kerb markets in the last week of June, early settlement of some long-term swaps in rupees and contracting of additional long-term swaps, as well as additional short term borrowing by the government. The depreciation of the Pakistani rupee against the U.S. dollar (interbank rate) rose to 22.9 percent for the year ending June 30, 2001; the spread between the interbank and kerb market rates was 4.3 percent on June 30, 2001. The fact that the rapid pace of building reserves in late June did not unsettle markets—which had been a major concern of the authorities and the staff—may in part reflect the better-than-expected export performance.

11. Monetary data for May 2001 indicate that, in the year through end-May 2001, broad money expanded by 7.8 percent and reserve money by 7 percent. The rupee currency-to-deposit ratio was stable during April–May at about 40 percent, contrary to the decline underlying the program projections. The authorities have indicated that NFA of the SBP reached PRs 40.2 billion (at program exchange rates) and NDA of the SBP PRs –24.2 billion; based on preliminary estimates of the value of the various adjusters the authorities are confident that the performance criteria on both NFA and on NDA of the SBP at end-June 2001 have been met with comfortable margins. Reflecting the indication that the NFA target has been met, the authorities no longer request a waiver of nonobservance for the performance criteria on NFA of the SBP at end-June, and a revised draft decision to this effect is attached.

12. Preliminary data on CBR revenue indicate that collection for the year 2000/01 reached PRs 393.4 billion, an increase of 13.5 percent over the preceding year, but PRs 23.6 billion (0.7 percent of GDP) short of the program target of PRs 417 billion, and still PRs 13.1 billion (0.4 percent of GDP) below the projections in the staff report. Revenue from direct and indirect domestic taxes remained below expectations by roughly similar magnitudes ; customs revenue was on target. Based on past experience, the final data is likely to be revised upwards, albeit by at most PRs 1–2 billion.

12. Data on other end-June 2001 quantitative performance criteria are not yet available.

Staff Appraisal

13. While the information above does not change the thrust of the staff appraisal, staff considers the shortfall in CBR revenues from already lowered expectations as highly disappointing. Staff therefore urges the government and the just-appointed new CBR management to redouble their efforts to strengthen tax administration, and to accelerate the streamlining of tax policies, including the speedy elimination of tax exemptions.

INTERNATIONAL MONETARY FUND

NEWS BRIEF

FOR IMMEDIATE RELEASE

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

IMF Completes Second Review Under Pakistan's Stand-By Arrangement

The Executive Board of the International Monetary Fund (IMF) today completed the second review under Pakistan's Stand-By Arrangement. As a result, Pakistan will be able to draw a further SDR 105 million (about US$131 million). Pakistan has so far drawn SDR 255 million (about US$324.6 million) under the Stand-By, which was first approved on November 29, 2000 (see Press Release No. 00/64).

The Executive Board also approved waivers for performance criteria on tax revenue collection and the elimination of interest subsidy element of the export finance scheme under the Arrangement.

Following the Board's discussion of Pakistan's program, Eduardo Aninat, Deputy Managing Director and Acting Chairman, issued the following statement:

"Pakistan's achievements under the program supported by the Stand-By Arrangement have been encouraging. The authorities have made a determined effort to implement the program, and most of the program targets have been achieved. Inflation has been better than expected, and the budget deficit remains in line with program assumptions. Economic activity was somewhat lower than expected because of severe drought, and this has contributed to lower-than-expected tax revenues and a weaker external balance. The implementation of important structural reforms has been well on track.

"To consolidate these achievements and build a solid foundation for sustainable high growth over the medium term, the authorities will need to pursue further macroeconomic adjustment and structural reform. The key challenge will be to implement the recently announced 2001/02 budget. The budget includes a package of direct and indirect tax reforms that will broaden the tax base, reduce distortions, strengthen incentives for investment, and reduce governance problems inherent to the current system. Together with planned improvements of tax administration, these reforms will help to boost collections, a key precondition for containing the fiscal deficit while increasing social and development spending.

"Another key challenge will be to achieve the targets for foreign exchange reserves, which will require good coordination of monetary and exchange rate policies and further progress toward a genuinely market-based exchange rate policy.

"Other reform priorities are to further improve governance in the management of public resources and the ongoing restructuring of public enterprises, and to strengthen the soundness of the financial system", Aninat said.