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

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

- the staff report for the Third Review Under the Stand-By Arrangement and Request for Waiver of Performance Criteria, prepared by a staff team of the IMF, following discussions that ended on **August 28, 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 September 12, 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 **September 26, 2001** updating information on recent economic developments.

- a News Brief summarizing the **views of the Executive Board as expressed during its September 26, 2001 discussion** of the staff report that completed the review.

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

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PAKISTAN

Third Review Under the Stand-By Arrangement and Request for Waiver of Performance Criterion

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

September 12, 2001

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Attachment

List of Acronyms

AsDB	Asian Development Bank
CBR	Central Board Revenue
DMFAS	Debt Management and Financial Analysis system
FATF	Financial Action Task Force
FCD	Foreign Currency Deposits
FDI	Foreign Direct Investment
FSAP	Financial Sector Assessment Program
GST	General Sales Tax
IDB	Islamic Development Bank
IFAD	International Fund for Agricultural Development
IFI	International Financial Institutions
I-PRSP	Interim Poverty Reduction Strategy paper
KESC	Karachi Electric Supply Company
MEFP	Memorandum on Economic and Financial Policies
NEPRA	National Electric Power Regulatory Authority
NBP	National Bank of Pakistan
NDA	Net Domestic Assets
NFA	Net Foreign Assets
OMCs	Oil Marketing Companies
PRGF	Poverty Reduction and Growth Facility
SAP	Social Action Program
SBP	State Bank of Pakistan
SMEFP	Supplementary Memorandum on Economic and Financial Policies
TMU	Technical Memorandum of Understanding
UBL	United Bank Limited
UNCTAD	United Nation Conference on Trade and Development
WAPDA	Water and Power Development Authority
WPI	Wholesale Price Index

I. Introduction and Background

1. The discussions for the third and last review under the Stand-By Arrangement were held in Islamabad and Karachi during August 15–28, 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 July 11, the Executive Board completed the second review and granted two waivers for the nonobservance of one quantitative and one structural performance criterion, and waivers of applicability for all other quantitative performance criteria for end-June 2001, which will be relevant for this review (EBS/01/101). In the attached letter dated September 12, 2001, the authorities request the completion of the third review under the Stand-By Arrangement and a waiver for the nonobservance of one structural performance criterion. The accompanying Supplementary Memorandum of Economic and Financial Policies (SMEFP) describes economic developments and policy implementation during the last quarter of FY 2000/01 and part of the first quarter of FY 2001/02 (fiscal year ending June 30).

2. In concluding the second review, Directors noted substantial progress in the implementation of the structural reforms, but expressed concerns about the repeated slippage in revenue performance, consequent cuts in development and social spending; and heavy foreign exchange intervention in the kerb market to meet the reserves' program targets. They singled out several conditions for a transition to a PRGF-supported program, including a clear strategy for dealing with the Supreme Court decision regarding transition to Islamic finance principles; improved tax collection and effective reorientation of public spending towards development and poverty-related expenditures; and better tracking of public expenditure.

3. Pakistan purchased the equivalent of SDR 360 million under the Stand-By Arrangement in three tranches. The last tranche of SDR 105 million will become available upon completion of the third review. As of end-July 2001, total Fund credit and loans outstanding to Pakistan amounted to SDR 1,305 million (126 percent of quota) (Appendix I).

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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 from the federal and provincial governments. Mr. Mirakhor and 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) and Ms. Chungu (MED assistant). Ms. Vishwanath and Messrs. Hasan and Mukhtar (all World Bank) participated in the work of the mission, which was assisted by Mr. Ghesquiere, the Fund's senior resident representative.

[2] See EBS/00/230.

II. Recent Developments

4. **On the political side, local governments have been elected in virtually all districts** and will gradually assume responsibility for the allocation of resources transferred from provincial budgets. The fiscal responsibilities of the local governments are governed by provincial laws, which include provisions that local governments may not borrow, and not hire without provincial approval. The government confirmed that elections for parliament will be held in October 2002.

5. **Economic developments over the last months of FY 2000/01 confirmed the negative impact of the drought on economic growth, but brought also better-than-expected inflation, external, and monetary outcomes** (Figures 1–3 and Table 1–5). With the exception of the target for Central Board Revenue (CBR) revenue (for which a waiver for nonobservance was granted under the second review), all quantitative performance criteria for end-June 2001 were observed (SMEFP, Table 1). The drought severely affected agricultural output, so that despite a stronger-than-expected recovery in the industrial sector, real GDP growth (at factor cost) in FY 2000/01 was limited to 2.7 percent. Reflecting prudent financial policies and still large food inventories, inflation as measured by the CPI slowed to 2.5 percent in the year through June 2001, and 4.4 percent for the annual average, better than programmed. This trend continued in July 2001, with the CPI increase year-on-year again at 2.5 percent. Strong export performance in May and June in the nontraditional sectors and sluggish imports resulted in a better-than-expected trade balance, which together with higher-than-projected workers' remittances limited the current account deficit (excluding grants) to 3.3 percent of GDP in 2000/01 compared with 3.6 percent in 1999/2000.

6. **Reserve targets and the performance criterion on net foreign assets (NFA) of the State Bank of Pakistan (SBP) for end-June 2001 were met with comfortable margins.** Since July, gross official reserves have been maintained broadly at targeted levels and seem on track to reach the indicative target of US$1,757 million by end-September 2001.[3] The average real effective exchange rate depreciated by 5.2 percent in 2000/01. After the sharp depreciation during 2000/01 (22.8 percent over twelve months), the interbank market exchange rate remained broadly stable during July–August 2001, with the premium on the kerb market in a daily range of 4–5 percent. Monthly kerb market purchases by the SBP averaged US$136 million during July–August, compared to US$180 million in FY 2001/02.

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[3] At the time of the previous review, continuous indicative floors for official reserves had also been set up to prevent a recurrent decline in the months that followed the test date. Official reserves fell slightly below the floors in August and early September, because the floors had been based on the end-June actual performance, which happened to be some US$200 million above the projected level, partly reflecting short-term borrowing that was repaid a few weeks later. This also explains why the projected accumulation of NFA by the SBP as of end-September (an indicative target) is unlikely to be met.

7. **The authorities met the fiscal deficit target for 2000/01 despite a disappointing revenue performance.** As reported by the staff at the conclusion of the second review, CBR revenue fell short of the already revised projections by 0.4 percent of GDP. The shortfall not only reflects mainly weak tax administration, but also reflects weaker GDP and import trends. Income tax collection suffered from an unexpected administrative mishap that prevented the auditing of a large number of taxpayers. In spite of the revenue shortfall, the budget deficit was contained at 5.2 percent of GDP (against a program objective of 5.3 percent and a deficit of 6.5 percent in 1999/2000) through expenditure restraint, mainly at the provincial level. Lower current and capital spending at the provincial levels resulted in part from the application of the revenue-sharing rules governing federal-provincial relations, and in part from deliberate expenditure restraints and better enforcement of accountability and governance standards. Related to such factors, social and poverty-related expenditures (as per provisional accounts) also fell short of the target but rose by 11 percent over the previous year, and probably higher since some as yet unclassified expenditure likely fell into this category. In addition, government net lending was reduced by unexpected early repayment of PRs 8 billion onlent debt by the telecom company. Military expenditure was contained at the programmed level. Ongoing auditing and reconciliation efforts are expected to further reduce the level of unclassified expenditure, most of which may be related to foreign-financed development projects where reconciliation is particularly cumbersome.

8. **Monetary tightening and abrupt changes in the composition of money demand in the last months of FY 2000/01 helped contain monetary aggregates well below program targets, without "unorthodox" means.** In June, monetary policy was tightened through open market operations and an increase in the repo rate. Six-month treasury bill rates rose by more than 1 percentage point, while demand for cash declined dramatically to the benefit of both demand and time deposits. Foreign currency deposits (FCDs) also registered a substantial increase. These factors contributed to the slowing down of reserve money growth to 3.3 percent in the year through end-June 2001, while helping the SBP to meet the performance criteria on its net domestic assets (NDA) at end-June with a comfortable margin, and without any exceptional operation. Broad money growth slowed to 7.1 percent in the year through June 2001, below the program target. The SBP is still investigating the reasons for the abrupt decline in the cash-to-deposit ratio in June; data for July 2001 which could indicate whether the change is sustained are not yet available. The 12-month growth of private credit slowed to 6.4 percent in June, from 8.7 percent in March, reflecting mostly the impact of high interest rates and weaker economic activity. As confidence in the economy and in the rupee was slowly being restored, as reflected in the building-up of foreign exchange reserves and stability of the exchange rate, with inflation under control and interest rates declining worldwide, the SBP has cautiously started to reverse the tight monetary stance. As a result, by mid-August 2001 the six-month treasury bill rate declined to 11.36 percent, 1.5 percent below the end-June rate; and downward pressure on government bond yields of longer maturities seems to indicate that some segments of the financial markets are anticipating further declines in interest rates. Since end-July 2001, the SBP has also tried to limit the day-to-day volatility of interest rates on the interbank market through more frequent open market operations, whenever warranted by market conditions.

9. **The implementation of the structural reform agenda through August 2001 was broadly on schedule; structural performance criteria for the period July–September were met with two exceptions** (a) the elimination of the interest subsidy element of the export finance scheme (a waiver for nonobservance had been granted under the second review); (b) and the delay in the promulgation of the income tax ordinance (Table 2, Attachment 1). The new income tax ordinance is to be promulgated in September 2001, about six weeks later than programmed, to allow more time for public scrutiny and comments.[4] The law will apply for income earned from July 1, 2002, although most tax policy changes were already incorporated in the last Finance law and apply since July 1, 2001. For these reasons, the authorities request a waiver for the nonobservance of the related performance criterion. The authorities have also taken several important steps towards the liberalization of petroleum products marketing and the privatization of major commercial banks and public enterprises, including the Water and Power Development Authority (WAPDA) (see SMEFP). Plans for downsizing the civil service at the federal and provincial levels have been adopted, as has the optional pay and pension package that had been announced in June, with effect from December 2001. On the fight against money-laundering activities, the SBP reminded the staff about current regulations for bank and nonbank financial institutions, which it considers to be in conformity with the Financial Action Task Force recommendations, including guidelines for the identification of bank accounts' holders.

III. Report on the Discussions

10. The discussions focused (a) on the implications of the tax shortfalls in June and July with a view to keeping the macroeconomic program for 2001/02 on track; and (b) initial discussions on the medium-term macroeconomic framework, structural reform agenda, and I-PRSP in view of formulating a program that could be supported under the PRGF.

A. Macroeconomic Policies for 2001/02

11. **The authorities shared the mission's concern about the repeated shortfalls in CBR revenue from target**, and agreed that the shortfalls in June/July implied that on current policies, the fiscal deficit (excluding grants) for 2001/02 was headed for a deficit of 5.2 percent of GDP rather than the targeted 4.9 percent. Given the weakening external environment, and the lower-than-programmed deficit achieved in 2000/01, the authorities' felt that the implied relaxation of fiscal policy should be at least partly accommodated, whereas new revenue measures could affect the credibility of the recently announced budget. In particular, they ruled out any changes in the income tax for the current fiscal year, because in a break with past practice the government would not seek to apply tax laws retroactively. The mission argued that revenue action was crucial to restore credibility of the budget targets, so as to tackle head on what clearly remains Pakistan's fiscal Achilles' heel (low revenue),

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[4]The draft was posted on the web in early July. Several professional associations formulated their views, including strong criticism of the inclusion of nonmonetary benefits as taxable income.

and to avoid restarting the cycle of cutting outlays which eventually could endanger high-priority development and social expenditure. Furthermore, continued fiscal adjustment was key to extracting Pakistan out of a debt trap that has perhaps been the biggest obstacle to growth and poverty reduction.

12. **In the end, the authorities adopted a package worth about PRs 12 billion (0.3 percent of GDP) that should bring the deficit back to 4.9 percent of GDP**, with three components each worth about 0.1 percent:

- a pass through of the expected CBR revenue shortfall to the provinces (through the automatic revenue-sharing mechanism), which would have to manage corresponding cuts in provincial outlays (or raise additional provincial revenue), but with a view to avoiding cuts in social sector outlays;
- cuts in federal nonpriority development expenditure, while also protecting social sector outlays; and
- an increase in diesel taxation effective early September 2001 by about 30 percent, translating into a retail price increase of about 3 percent on top of regular fortnightly adjustments to reflect movements in world prices and the exchange rate, as well as smaller adjustments in taxes on two other petroleum products (kerosene and JP-4).

The authorities shared the mission's concern that the last measure would have some adverse social implications, coming on top of the run up in energy costs over the last year, as well as possible gas and electricity price increases expected for the near future. At the same time, the authorities argued that higher diesel taxation had some strong structural merits, in that diesel was taxed far less than other petroleum products such as gasoline, which has created incentives for wealthier individuals to switch to diesel-powered cars; furthermore, diesel-powered lorries have been the heaviest road users, representing heavy costs to the environment. The increased taxation should thus also be seen as a road user charge and as an incentive to reduce adverse externalities.

13. **There was agreement that with the above measures fiscal policy should remain on track, and that on this basis the monetary and exchange rate policy set out in the last MEFP remained broadly appropriate**. The authorities noted in particular that several factors including the recent decline in the cash-to-deposit ratio, continued low inflation, a stable rupee/dollar exchange rate, and declining international interest rates had created some room for an easing of domestic interest rates. However, they concurred with the mission that further easing should be undertaken only if inflation and reserves targets remained on track and if the budget was implemented as programmed. They recognized that monetary policy needed to be vigilant, in particular, in view of the instability of the cash-to-deposit ratio, and needed to remain alert to any danger that the sharp depreciation of 2000/01 and the envisaged public wage increases would pass through into higher inflation.

14. The authorities are pursuing active steps to deepen the interbank foreign exchange market and reduce the importance of the kerb market. As a first step, nostro limits on domestic banks were abolished at end-August, removing a distortion that affected in particular forward premia and the hedging of foreign exchange exposure.[5] The authorities were confident that current exposure limits (net foreign exchange open positions are limited to 10 percent of paid in capital for any particular currency and for the aggregate position) would be sufficient to prevent banks from taking undue exchange risk. Provided the abolition of nostro limits went smoothly, requirement that interbank deals be backed by commercial transactions would be abolished as a next step. At the same time, the authorities were pursuing efforts to bring money changers more closely under prudential regulation and to encourage regular banks to become more active in channeling remittances and investments from Pakistani workers abroad back to Pakistan.[6]

15. **The authorities agreed with the mission that substantial risks to the current macroeconomic outlook remained**. Exogenous risks included the possibility of renewed drought, a risk that has risen recently with only limited rainfalls in August, and a further weakening of global demand. The latter was already severely affecting export unit values for textiles, and further weakening could deprive industrial growth of its main driving force. On the internal side, risks to the fiscal outlook included possible further shortfalls in CBR revenue from the revised targets, as well as additional drain on the budget from possibly larger-than-expected financial imbalances of WAPDA and KESC. The authorities confirmed their readiness to take appropriate measures to ensure the budget remained on track, and felt in particular that there may be room for further reducing development expenditure on less urgent projects.

B. The Structural Reform Agenda for 2001 and Beyond

16. **Governance issues remain a priority of Pakistan's program of structural reforms and major steps to improve governance are currently being prepared**. The revised draft I-PRSP explicitly reflects this priority, with the focus on four areas of reform: empowerment of people at the grass root level, civil service reforms, judicial reforms, and fiscal and

[5] The amount of foreign exchange lodged with correspondent banks abroad was limited to 20 percent of paid in capital.

[6] The authorities have provided the staff with further information on the modalities of their kerb market operations. According to the authorities, residents can purchase foreign exchange for all current international transactions in the interbank market; there are no current transactions that have to take place in the kerb market. Staff is reviewing relevant regulations in this regard. Purchases by the SBP from the kerb market are done through Gulf-based moneychanger who collect remittances from Pakistani workers in the Gulf and sell them to the SBP (transfer of U.S. dollars to banks in New York against crediting of money changers' accounts with SBP). Staff is discussing with the authorities the extent to which remittances are also permitted through the banking system at the interbank rate (for individuals or for money changers). This information will be required to determine whether Pakistan engages in multiple currency practices.

financial transparency. First steps involving reforms in tax administration and policy, expenditure monitoring, public enterprise restructuring and privatization, and improved transparency and quality of fiscal and other statistical data have been taken or are under way. Significant steps have been also made in the preparation of a major reform of the judicial system and the police, with assistance from the Asian Development Bank (AsDB).

17. **On tax reform**, the authorities indicated that they would promulgate in September the reformed income tax law prepared with LEG/FAD technical assistance, to apply for income earned from July 1, 2002. They provided the mission with a list of income tax exemptions to be phased out by July 2002. The mission promised to analyze the proposals carefully but indicated that at first glance the proposals seemed overly modest. The mission reiterated its concern that the exemption from withholding for holders of National Savings Schemes instruments up to a certain limit, while intended to protect relatively poor holders of such instruments who may be unable to reclaim withholding, introduced new possibilities of tax evasion and administrative complications. More generally, the mission stressed that reduction of exemptions was an essential part of reducing distortions and the scope for corruption in the tax system; and emphasized in this context the need for phasing out remaining non-standard GST exemptions. The authorities expect the passage of necessary amendments to the provincial agricultural income tax laws and regulations by early September, to allow filing to commence at end-September. While the authorities continue to implement the CBR short-term action plan, devised with FAD support earlier this year, they will formulate by end-October this year a multi-year action plan for fundamental CBR reform, based on the report of the task force released in April, and after reviewing additional recommendations from a FAD technical assistance mission which visited Pakistan in August 2001. Key recommendations of the latter focus on reorganization, large taxpayers, self-assessment, human resources and change management, and IT and physical infrastructure (Box 1).

18. **Regarding expenditure management and monitoring, the authorities pointed to considerable progress in accounting and reconciliation**, but cautioned that progress would be gradual because of administrative weaknesses, especially at the provincial level, and the preoccupation of provincial accounting staff with the devolution initiative. Regarding the mission's concern that last year's shortfalls in social sector expenditure may have been associated with a decline in social service delivery, the authorities stressed that all social sector spending at the federal level had been fully released without any cuts; the shortfalls reflected essentially limited absorptive capacity at the provincial level, as well as lower provincial resources (given the tax-sharing mechanisms). Furthermore, the authorities pointed to anecdotal evidence that basic schooling and health services had in fact improved, with lesser resources needed because of the reduction in waste and fraud (e.g., pervasive teacher absenteeism), growing private sector participation (private education is said to be Pakistan's fastest growing industry), and efficiency gains (e.g. using existing classes in the afternoon, or leasing schools in the afternoon to the private sector for schooling or specialized adult education programs). The mission recognized that such factors may be in play, noting

Box 1. Reforming the Central Board of Revenue

1. Weak tax revenue performance remains the Achilles' heel of fiscal consolidation efforts in Pakistan. Although CBR revenue rose from 10.9 percent of GDP in 1999/2000 to 11.3 percent of GDP in 2000/01, tax revenue has lagged behind expectations, reflecting mainly weak tax administration. While there has been some progress in addressing shortcomings related to auditing and enforcement in recent months in the context of implementing the short-term action plan, developed with FAD support earlier this year, fundamental weaknesses in tax administration are yet to be tackled.

2. The authorities acknowledge that the CBR will need to undergo fundamental reform to become more effective. The 2001/02 budget announced a revamping of the CBR, including organizational restructuring, putting in place a new and expanded self-assessment scheme, reducing personal contact between taxpayers and collectors, establishing simplified processes and revising the terms and conditions for employment of the CBR officials. The CBR reform will constitute a cornerstone of the structural reform agenda under the prospective PRGF-supported program.

3. With Fund/World Bank technical assistance, the authorities have already begun to formulate a strategy and an action plan for CBR reform. To foster ownership and participation of stakeholders in reforming the CBR, and improve its accountability vis-à-vis the public, Fund staff have suggested to establish a Supervisory Council (with 3 to 4 senior government officials, reporting directly to the President) to oversee CBR reform, and within the CBR, a Modernization Steering Committee and a Modernization Coordination Department to drive the reform process. The CBR has already appointed one senior staff as reform project leader. Within this institutional framework, CBR reform should focus on:

- **Reorganization.** The CBR should be transformed into a semi-autonomous body, with enhanced powers for recruitment, financial management, remuneration, training, and internal organization. Integrating sales, income, and excise tax operations (while leaving customs as a separate arm), the CBR would eventually be restructured along functional lines, including taxpayer services, operations (e.g., registration, payments and return processing), auditing, enforcement, and dispute resolution. By June of 2002, two "model offices" should be established to try and demonstrate the new organizational approaches.

- **Large taxpayers.** A national Large Taxpayer Office and a small number of functionally organized Large Taxpayer Units (LTUs) should be established to exercise full and close control over designated large taxpayers who pay the bulk of revenue (e.g., the top 100 taxpayers account for 30 percent of income tax collections, and less than 3,000 taxpayers account for 81 percent of sales tax revenue). One of the "model offices" to be established should be an LTU.

- **Self assessment**. While self assessment is already reasonably well established in sales tax operations, it is not yet universally applied and lacks key features in the administration of the income tax. Based on strengthened taxpayer services and initiatives to improve record-keeping by taxpayers, backed by strong audit, and on the basis of a much simpler income tax law that is currently being put in place, CBR reform should aim at introducing universal and modern self-assessment procedures for income from July 2002.

- **Human resources management**. One of two additional senior executives within the CBR should be put in charge of human resource management, revising recruitment policies (with greater emphasis on skills that match the CBR's needs), establishing incentive- and merit-based remuneration and promotion mechanisms (e.g., special allowances linked to the modernization program, revised reward systems, promotions based largely on merit), putting in place a training program, and preparing a program for a phased reduction of staff.

- **IT and accommodation**. The CBR is not sufficiently well equipped with IT and lacks proper management in this area. A second new senior CBR executive should be put in charge of IT and information systems, with a significantly enhanced budget. In addition, a comprehensive accommodation modernization plan should be prepared since many offices are currently well below acceptable standards and the existing network of offices is highly fragmented, impairing operational efficiency.

4. Revamping the CBR will require significant technical and financial assistance. FAD is committed to provide further technical assistance in the preparation and implementation of CBR reforms. The World Bank is also prepared to provide further technical assistance and may also consider financial support, and the U.K. (DFID) is willing to consider further technical assistance, provided that a credible CBR reform program is put in place.

however that such evidence would still support the argument that higher social expenditure could lead to large and rapid advances in improving social indicators. In any case, better quantitative data were needed to analyze developments in social outcomes. Encouragingly, as became clear in the discussion of a revised draft I-PRSP, the authorities have made good progress in identifying the key social outcomes that they want to monitor (e.g. school enrollment rates, vaccination ratios, and the like) and in setting up mechanisms to report on related public expenditure.

19. **In the financial sector**, the restructuring of the nationalized banks has progressed with the closure of hundreds of unprofitable branches and the completion of a first round of voluntary retirement/golden handshake programs. The latter did not quite meet with the expected enthusiasm but one first major bank is now being readied for privatization. The SBP has also amended its policy to allow banks to open and close branches on a commercial basis, and the ordinance facilitating the foreclosure of loan collaterals has been published. On a strategy regarding the Supreme Court ordered move to Islamic Finance principles by July 1, 2002, the authorities have reconfirmed that they would formulate an approach that would not endanger financial sector stability. In this context they were reviewing the experience in other countries with mandatory or optional Islamic financial systems to see what could be learned from such experiences. The mission stressed the importance of removing the uncertainties about the future institutional arrangements in the financial sector as soon as possible. In discussing the recent downturn of the Karachi stock market, staff pointed to similar developments elsewhere and urged the authorities to maintain a hands-off approach towards the stock market, and resist any pressures to prop up the market via public financial institutions' investment in listed companies. An FSAP mission is scheduled for October/November 2001.

20. **The authorities agreed with the importance of accelerating public enterprise reform**. Privatization of a few pilot firms (a nationalized bank, the telecom company, and government shares in various oil fields) is expected by end-2001, with numerous expressions of interest received mainly from financial groups operating in the Middle East. The restructuring of WAPDA continues, in close consultation with the World Bank, with the unbundling and corporatization of distribution and generation units to be completed by end-2001. Steady progress has been made in reducing theft and leakage. However, financial imbalances remain large and may grow further as current tariffs have not yet fully absorbed the backlog of cost increases over the last two years. Karachi Electric Supply Company (KESC) faces similar difficulties, but with much larger theft/leakage reflecting deep-rooted corruption and a difficult law and order situation in certain areas of Karachi. Consistent with the budget, KESC's current financial losses will have to be partly financed through bank borrowing (though guaranteed by the government). KESC has been put on a fast track toward privatization by mid-2002; at that point a major recapitalization will be required which will need to be taken into account in the next budget. In the context of discussing a preliminary draft tax regime for new energy sector investments, the mission urged the authorities to avoid the past practice of providing guarantees to foreign investors for minimum return on capital, protection, and prices, along with generous tax exemptions. Such privileges were at the root

of many current fiscal and structural problems and should be allowed to lapse as soon as the contracts allow. The authorities indicated that they would take up these issues in their forthcoming discussion with World Bank staff on energy policy.

21. **The authorities reiterated their strong interest in improving transparency and data quality**. In addition to requesting a FAD mission in late-2001 to review fiscal transparency and expenditure monitoring systems, they suggested to discuss with the forthcoming mission to prepare the data module of the ROSC, or a separate STA mission, the steps needed for a move towards the SDDS and to assess whether subscription in the near future would be feasible.

IV. Balance of Payments Outlook and External Financing Issues

22. **The external current account deficit (excluding official transfers) for 2001/02 is projected to decline to 3.2 percent of GDP**. Despite continued strong export volume growth, the trade deficit is projected to remain unchanged due to a slight deterioration in the terms of trade. The capital account balance is expected to deteriorate, largely because about US$700 million of the special U.S. dollar bonds (exchanged mainly by residents against frozen currency deposits in 1998) as well as a US$300 million U.A.E. deposit at the SBP are maturing (both are expected to be rolled over). Nonetheless the authorities expect a rise in foreign direct investment (FDI), mainly in the energy sector, to about US$600 million, and another US$500 million in privatization receipts. On the basis of international financial institutions' (IFI) financing indications, the external financing gap for October 2001–June 2002 is projected to be about US$2 billion, which would need to be covered by further IFI support as well as debt relief and other exceptional financing (Box 2).

23. **By 2003/04, the external current account (excluding official transfers) is projected to narrow to a deficit of 2.3 percent of GDP, assuming continued fiscal adjustment and structural reform**. Export volume growth is expected to be sustained over the coming years at about 7.5 percent a year on average as a result of structural reforms, the recent real depreciation of the exchange rate, and expected further gains in competitiveness. With an expected pick-up in investment, import volumes are projected to grow at about 7.2 percent a year on average, above real GDP growth. The capital account should improve as greater confidence takes hold. However, even assuming that under a PRGF-supported program relatively high levels of support from the World Bank and AsDB would be forthcoming, the financing gaps will remain large (about US$2 billion annually during 2002/03 and 2003/04), and will have to be closed by continuing exceptional financial support from multilateral and bilateral creditors, including additional debt rescheduling. Given the heavy debt burden (Box 3), the authorities are considering to seek a rescheduling of bilateral debts on concessional terms (Pakistan was granted nonconcessional Houston terms by the Paris Club in 1999). The authorities intend to also address the "hump" in debt payments in

Box 2. Closing the External Financing Gap, 2001/02

On the basis of the current IFI pipeline and debt relief agreed so far, the external financing gap would be fully covered during July to September 2001. Of the total projected gap for the remainder of fiscal year 2001/02 (October 2001-June 2001), US$600 million could come from rescheduling special U.S. dollar bonds falling due in 2001/02; other debt to the private sector is small and has already been rescheduled previously. About US$730 million could come from the rescheduling of maturities falling due to official bilateral creditors. The remainder of US$630 million would need to be covered from other resources, including the Fund.

	Oct. 2001–Jun. 2002	
	In millions of U.S. dollars	In percent of GDP
Financing gap	**1,960**	**3.3**
Rescheduling of Special U.S. bonds	600	1.0
Rescheduling of bilateral creditors' maturities (net of moratorium interest) 1/	731	1.2
Other 2/	629	1.1

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

2/ Including additional support from IFIs (including the Fund), and commercial borrowing.

Box 3. External Debt Sustainability (Continued)

1. Pakistan suffers from a heavy external debt burden. Based on preliminary data from a newly established debt data base, at end-June 2001, total external debt was estimated at 60 percent of GDP (most of which external public and publicly guaranteed debt) with a net present value (NPV) equivalent to 250 percent of exports of goods and services. In 2001/02 total debt service due is projected to absorb over 40 percent of exports. In the baseline scenario with no rescheduling, debt service payments are concentrated over the next five years, with a sharp "hump" equivalent to 6 percent of exports in 2005/06 (Chart 1) largely reflecting repayment of deposits with the SBP and the NBP.

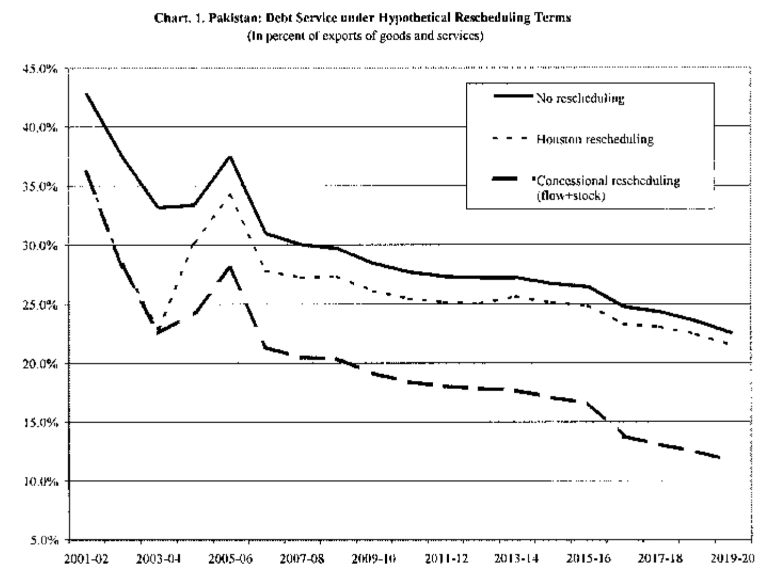
2. To achieve a sustainable debt position, Pakistan has adopted a debt management strategy that focuses on continued strong fiscal adjustment to limit public borrowing, boosting exports through sustained structural reforms, and seeking to obtain better terms for new borrowing or rescheduling.

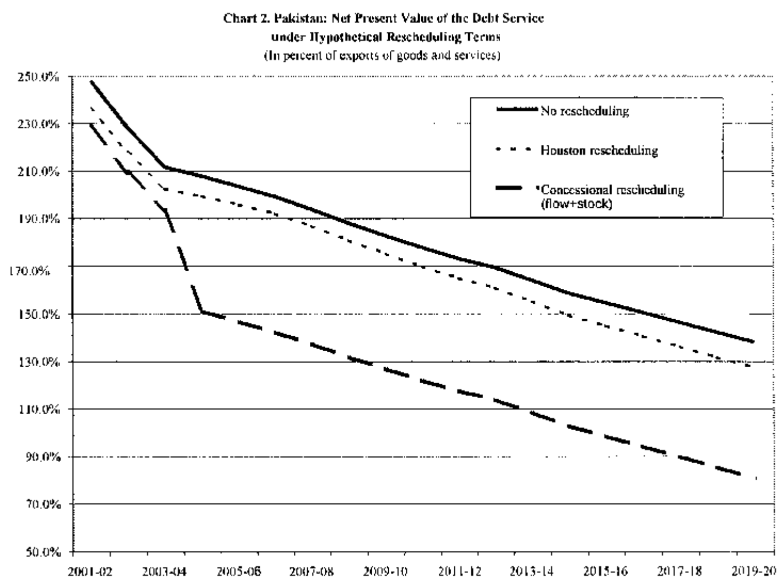
3. To illustrate the latter point long-term, alternative scenarios have been developed to highlight the implications of different terms of the rescheduling of bilateral debt under a possible three-year Fund arrangement. The three scenarios all assume average growth of exports in U.S. dollar terms at 6 percent, imports at 5.5 percent, maintenance of "normal" capital inflows at about the levels of 2001/02–2003/04 and achieving and then maintaining official reserves at about three months of imports. Residual financing needs are assumed to be met by borrowing at terms representing a mix between IDA and commercial terms. The scenarios differ only in their assumptions regarding rescheduling.

4. Both a traditional flow rescheduling on **Houston terms** and a rescheduling on **more concessional terms** [1/] would provide debt relief, on an annual average, of 8 percentage points of exports (and 1.5 percent of GDP) over the next three years compared with the **baseline** (no rescheduling). **Houston terms**, in the case of Pakistan, involves a relatively high element of concessionality since about two thirds of the debt is ODA debt, and would stabilize the debt service ratio at 25 percent in about 15 years, roughly the same as in the baseline (Chart 1), while **concessional rescheduling** would reduce the debt service ratio to 20 percent in seven years on a sustained basis. The latter would also provide a significant initial reduction in the NPV of debt of about 20 percentage points of exports compared with the baseline. The NPV of debt would, however, still be at 210 percent of exports at the end of the consolidation period (i.e., mid-2004), reflecting the fact that the amount of bilateral debt that can be rescheduled is only 20 percent of the total outstanding debt, declining to 150 percent of exports by 2005/06, while the NPV of debt under Houston terms would decline to 150 percent by 2014/15 only (Chart 2).

1/ Assuming a flow rescheduling of precut-off falling maturities of consolidation period (2001/02-2003/04) on concessional terms similar to Naples terms, followed by a reduction of 67 percent of the net present value of the remaining pre-cutoff debt stock. It should be noted that the Paris Club typically applies Naples terms only to IDA-only countries, a criterion Pakistan does not meet.

Box 3. External Debt Sustainability (Concluded)





2005/06. However, preliminary projections indicate that even under the most favorable assumption on the term of exceptional financing under a possible three-year arrangement, Pakistan's debt situation will remain difficult, making restoration of Pakistan's access to capital markets on reasonable terms a challenging task.

24. **Despite the risks to the projections, arising in particular from possibly higher oil prices, lower exports, 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 5.0 percent of total public and publicly-guaranteed debt in September 2001 (Table 8). Debt service obligations would peak at 3.2 percent of exports during the repayment period and would not exceed 15 percent of gross official reserves after 2002/03.

V. Staff Appraisal

25. **Economic performance during fiscal year 2000/01 as well as in recent months can be a source of satisfaction for the authorities.** Despite an unprecedented drought and a weakening external environment (including high oil prices), some positive growth in real per capita income was achieved, inflation was reduced even with a large depreciation of the currency, thereby boosting competitiveness, and external balances, and in particular official reserves, improved strongly. The outcome reflects largely strong macroeconomic management, including tight expenditure control, a broadening of the tax base, and prudent monetary policy. The determination of the authorities is exemplified in the more recent difficult tax increases on petroleum products and agricultural inputs, to keep the fiscal deficit on a downward path. Substantive and often painful structural reforms were also undertaken to move towards market-based relative prices, especially in the energy sector, and address long-standing governance and transparency issues. Overall, performance under the Stand-By Arrangement has been broadly satisfactory. However, as the authorities fully recognize, much more remains to be done in a number of policy areas, particularly in view of the very heavy external debt burden and the need to reduce poverty. The unfinished agenda, which the authorities wish to address in the context of a PRGF-supported program, includes the need to improve government revenue mobilization, reduce the drain on the budget from the weak financial position of public enterprise, step-up the implementation of a range of structural reforms, enhance transparency and governance, and thus improve the private sector investment climate. In this context, while this program is being prepared, it will be important to maintain the reform momentum over the coming months, including achieving the indicative targets through December discussed with the staff.

26. **The major shortcoming under the program was in tax collection, even though CBR tax proceeds grew faster than GDP**. The experience of 2000/01 underscores that reform of Pakistan's tax system must remain at the top of a reform agenda. Tax administration is still organized in a highly inefficient and segmented way, with income tax collection based on archaic procedures, often opaque legal provisions, and excessive

discretion for tax collectors. Tax policy—and again mainly in the income tax area—compounds the administrative weaknesses through widespread and difficult-to-administer exemptions, a still complex and distorted rate structure, and excessive use of withholding taxes. Reform needs to build on recent improvements in tax administration, such as increased focus on audit and arrears collection, and acceleration of dispute resolution. Serious income tax reform has finally started with the 2001/02 budget. The staff welcomes that the main reforms (reduced variance of rates, a higher threshold, and less reliance on distortive withholding) will be consolidated shortly in a new income tax law, which will also bring nonmonetary benefits into the tax net and introduce universal self-assessment.

27. **However, staff is disappointed by the pace at which income tax exemptions are being abolished**. The steps undertaken with the 2001/02 budget were modest, and while a further set of exemptions will be eliminated in the context of the forthcoming pay and pension reform (as some exempt allowances simply disappear), staff looks forward to elimination of a larger number of exemptions in the next budget. Staff also looks forward to a bold medium-term plan for a fundamental reform of the CBR, that would be a cornerstone of the program to be supported under the PRGF. **Another area where reform needs to accelerate is expenditure monitoring**. Reconciliation of especially provincial expenditure remains too slow, resulting in large amounts of expenditure remaining unclassified for too long, thus hampering proper expenditure management and prioritization.

28. **Staff is encouraged by the recent conduct of monetary and exchange rate policy**, which has helped to achieve the reserves target and contain any pass-through of the depreciation into inflation. Staff concurs that there seems to be some room for easing, but urges the authorities to proceed with caution, given the uncertainties especially of the structure of money demand, and to ensure that inflation and reserves targets remain on track. Staff also welcomes the development of a more active short-run role of the SBP in the money market and the formalization of the Karachi interbank money market which should allow a daily reading on the stance of monetary policy. Staff is encouraged by recent steps to better supervise the kerb market while deepening the interbank foreign exchange market, and looks forward to the early abolition of the commercial backing requirement. These steps should allow the rapid phasing out of the SBP's reliance on the kerb market to achieve reserves targets.

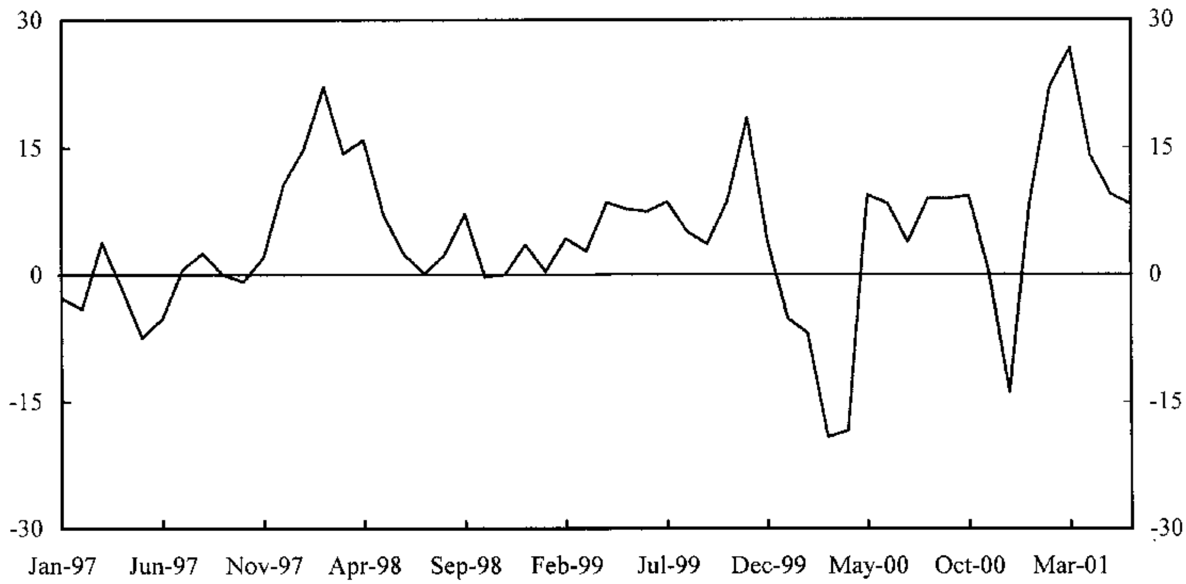
29. **Public enterprise reform remains a major element of the reform agenda**. Staff urges the authorities to make every effort to bring in the coming months a few major enterprise to the point of sale. While in light of developments in international equity markets this may not be the most favorable moment, it is important to signal to investors at home and abroad the firm determination of the government to withdraw from productive activities and allow the private sector to become the main engine of growth. Of more immediate short-term concern are the financial imbalances of KESC and WAPDA. Staff agrees that a sustainable adjustment strategy must focus on better collection and reduction of theft and leakage. At the same time tariffs must reflect the increased cost of furnace oil and other inputs and staff urges the authorities to review, in consultation with the World Bank, the need for tariff

adjustments. Otherwise, there is a risk that potentially large financial imbalances will be financed by growing arrears to suppliers and the budget, creating financial difficulties throughout the economy.

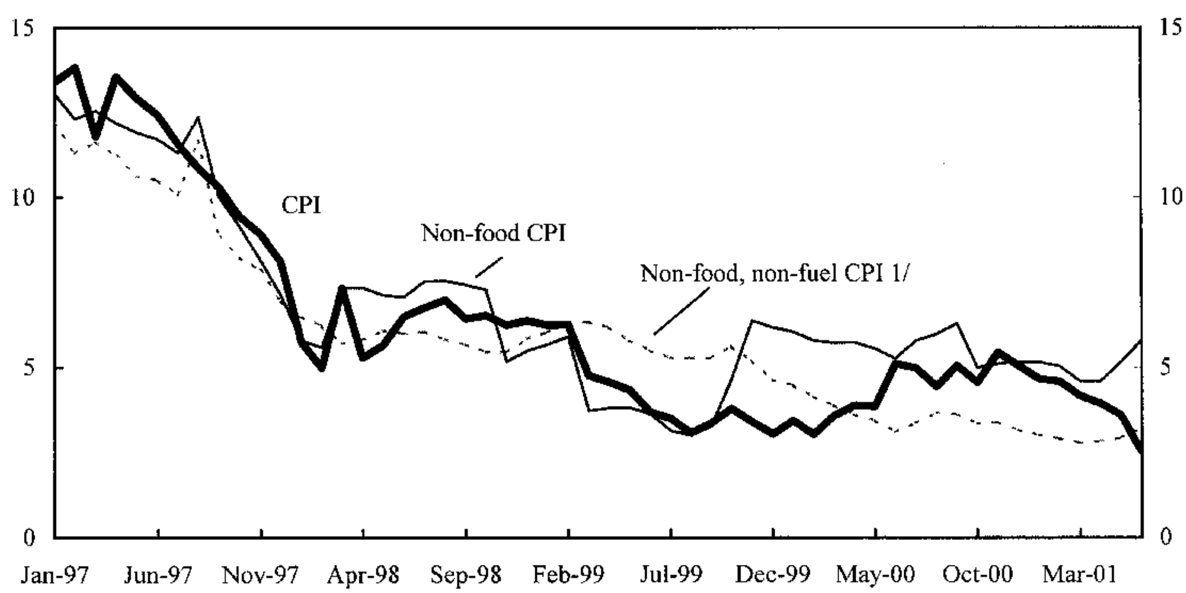
30. **Pakistan has a strong payment record vis-à-vis the Fund and capacity to repay the Fund.** However, the outlook is not without risk. The balance of payments remains vulnerable to higher oil prices as well as weaker demand for textile exports in the United States, Europe, and Asia. Both remittances and private capital flows may be affected by confidence factors, such as continued uncertainty regarding the move to Islamic Finance principles. Another risk relates to possible adjustment fatigue. For example, a large part of the media, and perhaps the public, perceives the adjustment process of the last two years as consisting mainly of price increases of basic commodities and utilities. Even though the authorities deserve credit for considerable transparency in publishing documents related to economic policy making, as well as substantial amounts of fiscal and monetary data, the preparation of a comprehensive poverty reduction strategy offers opportunities for broader discussion with civil society, which may help increase understanding for the constraints on economic policy and the rationale for the reforms. In the run-up to the parliamentary election in October 2002, populist pressures may also rise and resisting them may become more difficult. However, in a break from previous experience, Pakistan has over the last 10 months established a satisfactory track record of both prudent macroeconomic management, timely implementation of structural reform, and courageous steps when additional adjustment was needed. The flexible exchange rate regime should help mitigate any adverse impact of global turbulences. On this basis, the staff believes Pakistan deserves continued support by the Fund and recommends the granting of the requested waiver and conclusion of the third review.

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

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



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

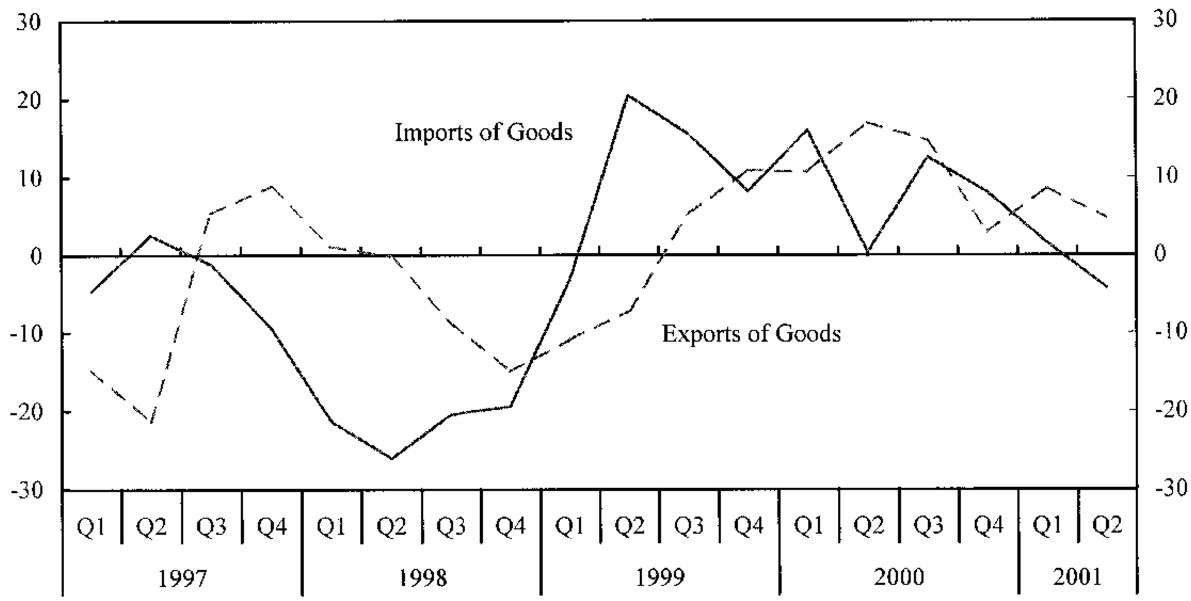


Source: Data provided by the Pakistan authorities.

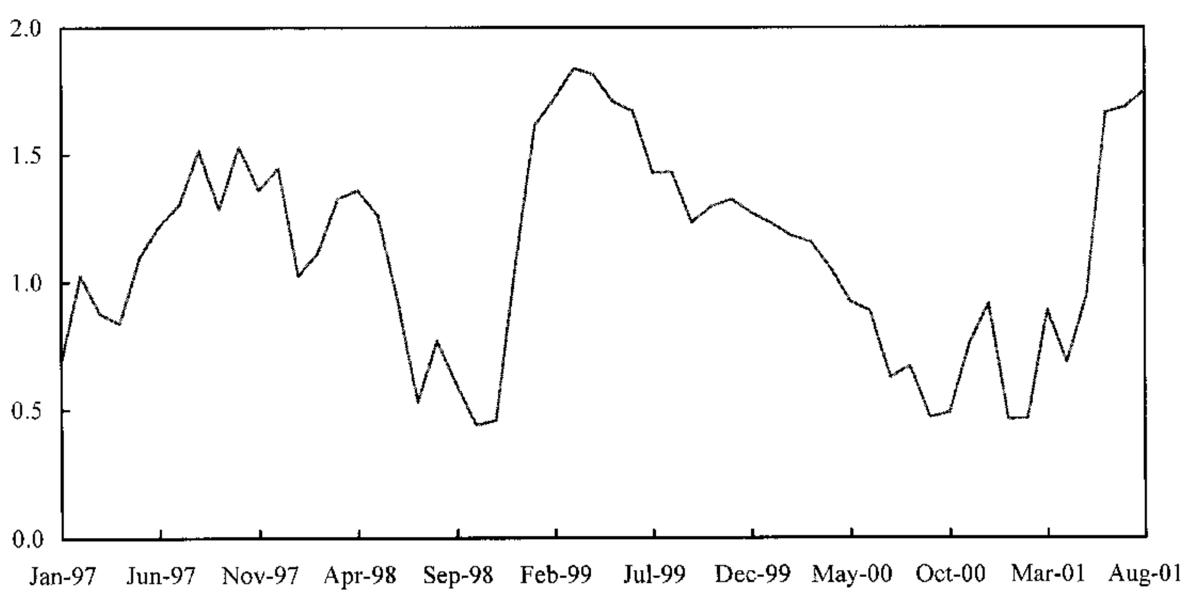
1/ This excludes the Food, Fuel & Lighting, and Transportation & Communications Groups.

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 - August 2001
(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.

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

Exports and Imports
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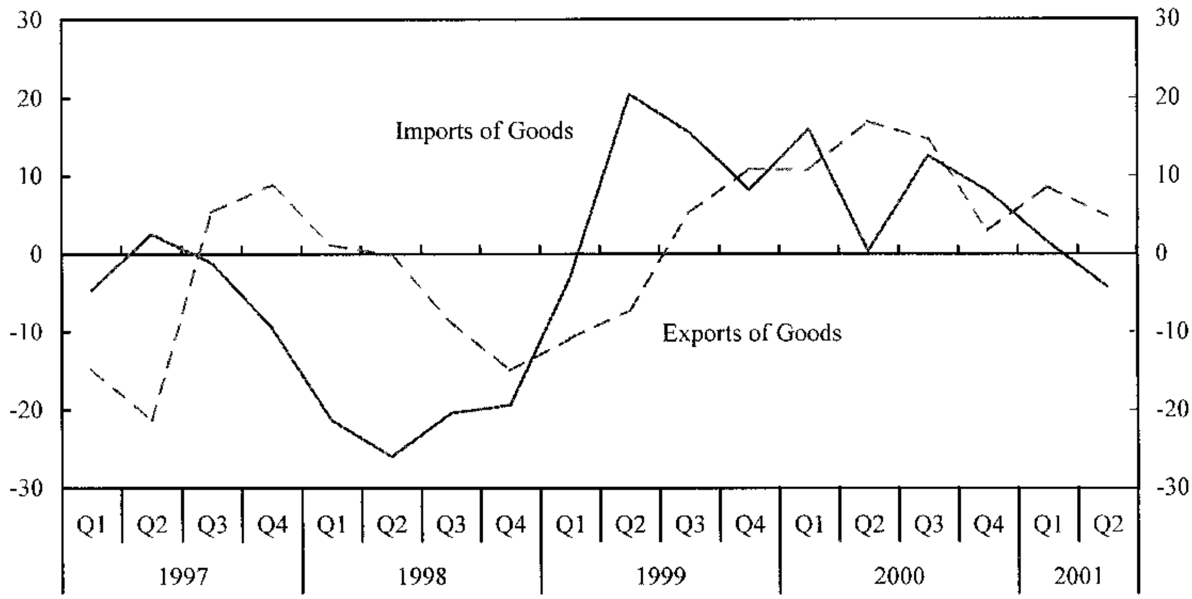
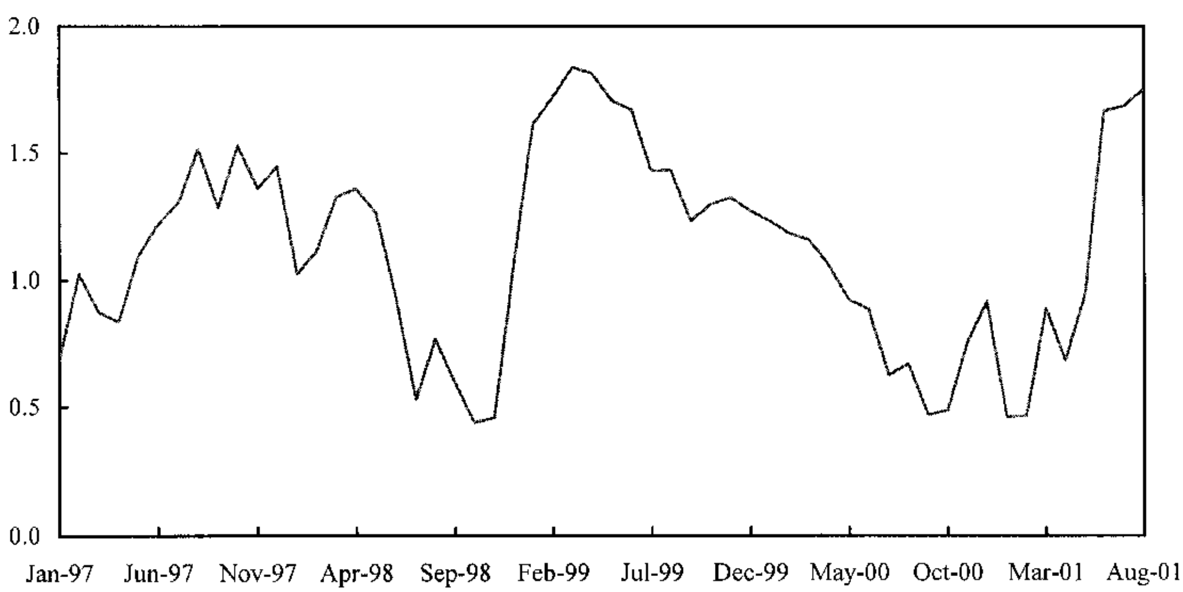


Gross Official Reserves, 1997 - August 2001
(In billions of U.S. dollars)



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.

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

	1998/99	1999/2000	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	2.7	4.0	4.5	5.0
Real GDP at market prices	3.7	4.4	4.3	3.4	4.2	4.5	5.0
Partner country demand	2.7	4.1	4.0	3.6	2.8	3.4	3.7
Consumer prices (p.a.)	5.7	3.6	5.0	4.4	5.0	5.0	4.9
Consumer prices (e.o.p.)	3.7	5.1	5.9	2.5	5.9	...	...
Rupees per U.S. dollar (p.a.)	17.0	3.0	11.7	12.8	11.3		
			(In percent of GDP)				
Savings and investment							
Gross national savings	11.9	13.5	13.9	12.8	13.6	14.0	14.4
Public 1/	-1.1	-2.2	-1.0	-1.6	-0.7	0.4	1.1
Private	13.0	15.7	14.9	14.4	14.3	13.6	13.3
Gross capital formation	15.6	15.6	15.5	14.7	15.4	16.0	16.5
Public 1/	5.0	4.3	4.5	3.5	4.0	4.1	4.2
Private	10.6	11.3	11.0	11.2	11.4	11.9	12.3
			(In percent of GDP)				
Public finances							
Budgetary revenue	16.2	16.5	16.3	15.7	16.9	17.4	17.7
Budgetary expenditure	22.2	23.0	21.5	21.0	21.8	21.3	21.0
Budgetary balance (excluding grants)	-6.0	-6.5	-5.3	-5.2	-4.9	-3.9	-3.3
Primary balance	1.3	1.1	1.5	1.5	1.9	2.5	2.8
Net public debt	91.2	86.2	94.3	92.6	88.7	87.4	83.2
Net domestic public debt	40.0	40.6	43.5	38.8	36.7	35.0	32.8
Implicit interest rate on public debt (percent) 2/	8.9	9.1	8.1	8.5	8.1	8.0	7.6
			(Annual changes in percent of initial stock of broad money)				
Monetary sector							
Net foreign assets	1.6	2.0	3.5	5.5	4.9	...	...
Net domestic assets	4.5	7.4	6.8	1.6	4.6	...	...
Of which : credit to the private sector	8.5	1.4	6.6	3.4	7.0	...	...
Of which : net credit to government	-3.9	3.1	-1.0	-3.4	-3.5	...	...
Broad money	6.2	9.4	10.3	7.1	9.5	...	...
6-month treasury bill rate (in percent, p.a.)	13.1	8.6	...	10.4	...	...	...
			(In percent of GDP)				
External sector							
Merchandise trade balance	-3.6	-2.3	-1.7	-2.1	-2.1	-2.0	-1.8
Merchandise exports	12.8	13.3	15.0	15.0	16.4	17.2	18.0
Merchandise imports	16.4	15.6	16.7	17.1	18.5	19.2	19.7
Current account excluding official transfers	-4.6	-3.6	-1.8	-3.3 3/	-3.2	-2.6	-2.3
Current account including official transfers	-3.6	-2.1	-1.6	-1.9 3/	-1.8	-2.0	-2.1
			(In percent of exports of goods and services)				
External public and publicly guaranteed debt	344.8	324.3	225.7	308.6	312.7	301.0	278.6
Debt service 4/	41.2	38.4	28.6	32.1	30.4	25.7	24.3
Implicit interest rate (in percent) 5/	3.6	4.0	5.1	3.9	3.8	3.3	3.4
Gross reserves (millions of U.S. dollars) 6/	1,672	908	1,636	1,681	2,314	2,811	3,511
In weeks of next years' imports (G and S)	7.7	3.9	6.6	7.0	8.8	10.0	11.6
In percent of short-term external debt 7/	40.1	21.6	84.8	51.1	62.2	75.8	104.0
Memorandum items:							
ICOR, three year moving average	4.5	4.7	3.5	4.5	4.3	3.4	3.2
Real effective exchange rate (percentage change)	-9.1	-0.5	-5.4	-5.2	-4.7	-2.4	-2.4
Terms of trade (percentage change)	4.1	-9.2	-3.0	-1.6	-1.4	2.0	2.3
Real per-capita GDP (percentage change)	1.3	2.1	2.0	1.1	1.8	2.2	2.7
GDP at market prices (PRs billion)	2,938	3,183	3,510	3,472	3,798	4,169	4,592

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

1/ Includes public sector enterprises throughout the projection period even though some of them may be (partially) privatized.

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

3/ Current account estimates for 2001/02 are not comparable with the program target because of a reclassification of part of private transfers into inflows of private capital.

4/ Including interest on short term debt.

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

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

7/ 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, 1999/2000–2003/04 (Continued)

	1999/2000	Est. 2000/01	Proj. 2001/02 Jul-Sep	2001/02	2002/03	2003/04
	(In millions of U.S. dollars)					
Current account (excluding official transfers)	-2,208	-1,946	-680	-1,860	-1,571	-1,477
Current account balance (including official transfers)	-1,282	-1,128	-473	-1,027	-1,239	-1,307
Trade balance	-1,411	-1,245	-383	-1,258	-1,199	-1,113
Exports f.o.b.	8,191	8,926	2,180	9,605	10,429	11,362
Imports f.o.b	-9,602	-10,171	-2,564	-10,863	-11,628	-12,475
Services (net)	-2,795	-3,130	-796	-3,103	-2,949	-3,019
Of which: interest payments	-1,676	-1,620	-430	-1,678	-1,431	-1,471
Private transfers (net)	1,997	2,429	500	2,502	2,577	2,654
Official transfers (net) 1/	926	818	207	833	332	170
Capital account	-2,610	-604	-373	-3,236	-1,799	-1,020
Public medium- and long-term capital	-1,452	-670	-294	-1,684	-1,578	-1,125
Project and nonproject loans	-664	-342	-253	-841	-748	-752
Disbursements	1,304	1,453	136	693	660	697
Amortization	-1,968	-1,795	-389	-1,534	-1,408	-1,449
Commercial banks and IDB	-170	-76	-45	-193	-182	-72
Other	-618	-252	4	-650	-648	-301
Public sector short-term (net)	-221	-5	-291	-700	69	-319
Private medium- and long-term	273	337	-22	174	458	718
Of which : FDI	471	322	70	600	744	817
Private short-term (including errors and omissions) 2/	-1,211	-266	234	-1,026	-748	-295
Overall balance (before debt relief)	-3,892	-1,732	-846	-4,263	-3,038	-2,327
Financing	3,892	1,732	846	4,263	3,038	2,327
Reserve assets (increase -)	208	-1,091	-170	-993	-908	-1,060
State Bank of Pakistan (including FE-25s)	379	-730	-103	-723	-600	-790
Deposit money banks	-171	-361	-68	-270	-308	-270
Use of Fund credit (net)	-280	85	-45	-195	-336	-406
Net exceptional Financing	3,965	2,738	1,061	3,491	2,332	2,100
Arrears (increase +)	343	-525	0	0	0	0
Rescheduling 3/	1,750	1,587	298	298	0	0
Rollover of foreign deposits with banking system 4/	1,872	1,676	300	1,312	900	800
Assumed program financing from IFIs	0	0	463	1,381	932	800
World Bank	0	0	145	640	525	400
AsDB	0	0	50	473	407	400
Others (including Fund)	0	0	268	268	0	0
Privatization reiceipts	0	0	0	500	500	500
Financing gap 5/	0	0	0	1,960	1,950	1,693
	(In percent of GDP)					
Current account (excluding official transfers)	-3.6	-3.3	...	-3.2	-2.6	-2.3
Current account balance (including official transfers)	-2.1	-1.9	...	-1.8	-2.0	-2.1
Trade balance	-2.3	-2.1	...	-2.1	-2.0	-1.8
Exports f.o.b.	13.3	15.0	...	16.4	17.2	18.0
Imports f.o.b.	-15.6	-17.1	...	-18.5	-19.2	-19.7

Table 2. Pakistan: Balance of Payments, 1999/2000–2003/04 (Concluded)

	1999/2000	Est. 2000/01	Proj. 2001/02 Jul-Sep	2001/02	2002/03	2003/04
	(Annual percent change)					
Exports f.o.b.	8.8	9.0	2.1	7.6	8.6	9.0
Imports f.o.b.	-0.1	5.9	-5.2	6.8	7.0	7.3
Export unit value	-3.3	-2.5	...	-1.5	1.6	2.4
Import unit value	6.4	-1.0	...	-0.2	-0.4	0.1
Export volume	12.5	11.8	...	9.3	6.9	6.5
Import volume	-6.2	7.0	...	7.0	7.5	7.2
Terms of trade	-9.2	-1.6	...	-1.4	2.0	2.3
	(In millions of U.S. dollars)					
Memorandum items:						
End-period gross official reserves 6/	908	1,680.5	1,760.5	2,314	2,811	3,511
(In weeks of imports of goods and nonfactor services)	3.9	7.0	6.7	8.8	10.0	11.6
SBP's purchases in the kerb market	1,600	2,157	...	...	...	...

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

1/ Includes a grant from Saudi Arabia in the form of oil that has been agreed through 2001/02.
2/ Includes repayment of FCDs held in NBFIs and banks (reschedulings shown as exceptional financing).
3/ Includes rescheduling of bilateral debt in 1999 and 2001, and rescheduling of commercial bank credit and Eurobonds in 1999.
4/ Includes rollover of FE-45 deposits with the banking system, of Kuwait's and U.A.E's deposits with the SBP, and Bank of China's deposits with the NBP.
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 2.
6/ Excluding new FCDs held with the SBP, and net of outstanding short-term foreign currency swap and forward contracts.

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

	Rev. Act. 1999/2000	Rev. Prog. 2000/01	Prel. Est. 2000/01	Budget 2001/02	Proj. 2001/02
	(In billions of Pakistani rupees)				
Revenue and grants	529.4	615.1	591.1	700.4	692.3
Revenue	525.4	570.4	546.4	649.9	640.8
Tax revenue	406.8	471.4	444.8	524.1	511.2
Federal	388.4	451.3	425.4	499.9	489.4
CBR Revenue	348.1	417.3	393.9	458.2	443.7
Direct tax	109.8	133.9	127.4	147.2	143.1
Federal excise duty	56.9	52.5	49.2	53.2	49.5
Sales tax	117.6	166.2	152.8	185.1	184.5
Customs duties	63.8	64.6	64.5	72.2	66.6
Petroleum surcharge	25.4	18.0	17.9	25.0	29.0
Gas surcharge	13.5	13.6	12.6	15.0	15.0
Other	1.4	2.5	1.0	1.7	1.7
Provincial	18.4	20.1	19.4	24.2	21.8
Nontax revenue	118.6	99.0	101.6	125.8	129.6
Federal	98.5	85.6	81.9	103.8	107.6
Provincial	20.1	13.4	19.7	22.0	22.0
Grants	4.0	44.7	44.7	50.5	51.5
Expenditure	733.6	756.1	728.5	836.4	828.8
Current expenditure	645.1	659.4	652.4	706.1	701.5
Federal	489.8	488.5	500.6	524.5	525.5
Interest payments	243.3	237.0	234.7	258.5	260.1
Domestic	198.4	185.0	183.5	197.4	197.9
Foreign	44.9	52.0	51.2	61.1	62.2
Defense 1/	150.8	157.5	157.3	162.8	162.6
Running of the civil government	47.9	52.1	50.6	57.4	57.6
Subsidies	20.4	14.0	14.7	14.5	13.7
Grants	11.8	26.6	24.0	19.3	22.8
Other	9.9	1.3	-0.4	12.0	8.8
Of which: bank restructuring				9.7	6.5
Unidentified	5.7	0.0	19.7	0.0	0.0
Provincial	155.3	171.0	151.8	181.7	176.0
Development expenditure and net lending	88.5	96.7	76.2	130.3	127.3
Public Sector Development Program	100.7	110.9	92.5	130.0	127.0
Federal 2/	64.4	68.2	69.6	100.0	97.0
Provincial	36.3	42.7	22.9	30.0	30.0
Net lending	-12.2	-14.3	-16.3	0.3	0.3
Budget balance (excluding grants)	-208.3	-185.7	-182.1	-186.5	-188.0
Budget balance (excluding grants and one-off expenditure) 3/	-208.3	-185.7	-182.1	-166.8	-171.5
Budget balance (including grants)	-204.3	-141.0	-137.4	-136.0	-136.5
Financing	204.3	141.0	137.4	136.0	136.5
External	70.2	77.3	80.5	62.7	52.8
Domestic	134.0	63.7	57.0	34.4	44.8
Bank	40.0	-14.5	-33.1	-26.8	-19.0
Nonbank	94.1	78.1	90.0	61.2	63.8
Privatization proceeds	0.0	0.0	0.0	38.8	38.9
Memorandum items:					
Primary balance	35.0	51.4	52.6	68.1	72.1
Social and poverty-related expenditure 4/	76.3	97.5	84.6	103.3	103.3

Table 3. Pakistan: Consolidated Government Budget, 1999/00–2001/02 (Concluded)

	Rev. Act. 1999/2000	Rev. Prog. 2000/01	Prel. Est. 2000/01	Budget 2001/02	Proj. 2001/02
		(In percent of GDP)			
Revenue and grants	16.6	17.5	17.0	18.4	18.2
Revenue	16.5	16.3	15.7	17.0	16.9
Tax revenue	12.8	13.4	12.8	13.7	13.5
Federal	12.2	12.9	12.3	13.1	12.9
CBR Revenue	10.9	11.9	11.3	12.0	11.7
Direct tax	3.4	3.8	3.7	3.9	3.8
Federal excise duty	1.8	1.5	1.4	1.4	1.3
Sales tax	3.7	4.7	4.4	4.9	4.9
Customs duties	2.0	1.8	1.9	1.9	1.8
Petroleum surcharge	0.8	0.5	0.5	0.7	0.8
Gas surcharge	0.4	0.4	0.4	0.4	0.4
Other	0.0	0.1	0.0	0.0	0.0
Provincial	0.6	0.6	0.6	0.6	0.6
Nontax revenue	3.7	2.8	2.9	3.3	3.4
Federal	3.1	2.4	2.4	2.7	2.8
Provincial	0.6	0.4	0.6	0.6	0.6
Grants	0.1	1.3	1.3	1.3	1.4
Expenditure	23.0	21.5	21.0	21.9	21.8
Current expenditure	20.3	18.8	18.8	18.5	18.5
Federal	15.4	13.9	14.4	13.7	13.8
Interest payments	7.6	6.8	6.8	6.8	6.8
Domestic	6.2	5.3	5.3	5.2	5.2
Foreign	1.4	1.5	1.5	1.6	1.6
Defense 1/	4.7	4.5	4.5	4.3	4.3
Running of the civil government	1.5	1.5	1.5	1.5	1.5
Subsidies	0.6	0.4	0.4	0.4	0.4
Grants	0.4	0.8	0.7	0.5	0.6
Other	0.3	0.0	0.0	0.3	0.2
Of which: bank restructuring				0.3	0.2
Unidentified	0.2	0.0	0.6	0.0	0.0
Provincial	4.9	4.9	4.4	4.8	4.6
Development expenditure and net lending	2.8	2.8	2.2	3.4	3.4
Public Sector Development Program	3.2	3.2	2.7	3.4	3.3
Federal 2/	2.0	1.9	2.0	2.6	2.6
Provincial	1.1	1.2	0.7	0.8	0.8
Net lending	-0.4	-0.4	-0.5	0.0	0.0
Budget balance (excluding grants)	-6.5	-5.3	-5.2	-4.9	-4.9
Budget balance (excluding grants and one-off expenditure) 3/	-6.5	-5.3	-5.2	-4.4	-4.5
Budget balance (including grants)	-6.4	-4.0	-4.0	-3.6	-3.6
Financing	6.4	4.0	4.0	3.6	3.6
External	2.2	2.2	2.3	1.6	1.4
Domestic	4.2	1.8	1.6	0.9	1.2
Bank	1.3	-0.4	-1.0	-0.7	-0.5
Nonbank	3.0	2.2	2.6	1.6	1.7
Privatization proceeds	0.0	0.0	0.0	1.0	1.0
Memorandum items:					
Primary balance	1.1	1.5	1.5	1.8	1.9
Social and poverty-related expenditure 4/	2.4	2.8	2.4	2.7	2.7
GDP (in PRs billions)	3,183	3,510	3,472	3,815	3,798

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

1/ Military pensions are included in defense expenditure.
2/ In 2001/02, includes PRs 10 billion and PRs 3 billion of spending related to drought and fiscal devolution, respectively.
3/ In 2001/02, projections include one-off expenditure of PRs 10 billion for drought and PRs 6.4 billion for bank restructuring.
4/ 2001/02 budget data as reported in EBS/01/101 were subsequently revised to PRs 103.3 billion.

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

				Jun.			Proj.		
				Prog. 1/	Act. 1/	Rev. Base 2/	Sep.	Dec.	Jun.
	1997/98	1998/99	1999/2000	2000/01	2000/01	2000/01	2001/02	2001/02	2001/02
	(End-of-period stocks in billions of Pakistan rupees)								
Net foreign assets	-90.1	-70.7	-43.9	5.5	33.4	27.3	24.8	48.6	102.6
Net domestic assets	1,296.4	1,351.3	1,443.6	1,539.4	1,466.2	1,499.4	1,491.0	1,568.8	1,569.5
Net claims on government	597.5	551.4	629.6	615.2	582.3	582.3	577.7	553.0	528.3
Of which:									
Net bank borrowing	552.4	505.9	545.8	531.4	512.9	512.9	520.3	507.6	493.9
Commodity operations	63.7	67.3	107.4	107.4	94.9	94.9	82.9	70.9	58.9
Net claims on nongovernment	697.5	816.7	842.8	947.8	911.9	911.9	908.1	1,010.6	1,036.1
Of which:									
Private sector	632.0	734.7	753.2	845.2	801.4	801.4	800.5	896.1	907.5
Privatization account	-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	-25.9	-20.7	-25.1	8.1	8.1	8.1	8.1
Total liquidity (broad money)	1,206.3	1,280.5	1,399.7	1,544.9	1,499.5	1,526.6	1,515.7	1,617.3	1,672.2
Of which:									
Rupee liquidity	927.8	1,131.9	1,288.2	...	1,371.9	1,371.9	1,359.7	1,459.0	1,509.4
	(Changes in percent of stock of broad money at the beginning of the fiscal year)								
Net foreign assets	-2.7	1.6	2.0	3.5	5.5	...	-0.2	1.4	4.9
Net domestic assets	17.3	4.5	7.4	6.8	1.6	...	-0.6	4.5	4.6
Of which:									
Net bank borrowing by govt.	4.5	-3.9	3.1	-1.0	-3.4	...	-0.3	-1.9	-3.5
Net claims on private sector	8.1	8.5	1.4	6.6	3.4	...	-0.1	6.2	7.0
	(Changes over 12 months; in percent)								
Broad money	14.5	6.2	9.4	10.4	7.1	...	...	...	9.5
Net claims on private sector	13.7	16.2	2.5	12.2	6.4	...	...	...	13.2
Memorandum item:									
Program exchange rate	...	...	51.79	59.66	59.66	63.98	63.98	63.98	63.98

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

1/ At indicative program exchange rates.

2/ At end-June 2001 exchange rate.

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

	1997/98	1998/99	999/2000 1/	Prog. 1/ 2000/01	Act. 1/ 2000/01	.ev. Base 2/ 2000/01	Proj. 2/ Sep. 2001/02	Dec. 2001/02	Jun. 2001/02
	(End-of-period stocks in billions of Pakistan rupees)								
Net foreign assets	-48.6	-42.5	-55.1	-13.5	-13.0	-24.4	-32.2	-16.3	17.1
Net domestic assets	418.1	440.4	552.9	538.6	527.1	557.6	565.4	592.4	567.3
Net claims on government	223.7	257.8	391.0	389.2	357.5	357.5	363.8	389.3	361.2
Of which:									
Budgetary support	242.2	279.6	414.6	412.8	383.1	383.1	389.3	414.9	385.7
Claims on nongovernment	40.8	56.1	51.2	40.7	40.1	40.1	40.1	40.1	40.1
Claims on scheduled banks	158.5	187.2	193.4	199.4	198.0	198.0	199.5	201.0	204.0
Other items, net	-2.0	-57.7	-79.8	-87.8	-65.6	-35.0	-35.0	-35.0	-35.0
Reserve money	369.5	398.0	497.8	525.0	514.1	533.2	533.2	576.2	584.4
Of which:									
Banks' reserves	71.4	85.2	114.7	92.3	108.2	128.6	121.0	132.1	139.9
Currency	291.7	306.6	375.1	423.7	394.6	394.6	400.9	432.8	433.3
	(Changes in percent of stock of reserve money at the beginning of the fiscal year)								
Net foreign assets	-10.8	1.7	-3.3	8.3	8.5	...	-1.5	1.5	7.8
Net domestic assets	17.3	6.0	28.4	-2.9	-5.2	...	1.5	6.5	1.8
Of which:									
Budgetary support	-1.3	10.1	33.9	-0.4	-6.7	...	1.2	6.0	0.7
	(Changes over 12 months; in percent)								
Reserve money	6.5	7.7	25.1	5.5	3.3	...	...	...	9.6
Currency	11.3	5.1	22.4	13.0	5.2	...	...	...	9.8
Memorandum item:									
Program exchange rate	...	...	51.79	59.66	59.66	63.98	63.98	63.98	63.98

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

1/ At indicative program exchange rates.

2/ At end-June 2001 exchange rates with reserve money including reserves on FCDs.

Table 6. Pakistan: Summary Accounts of Seven Key Public Sector Enterprises, 1996/97–2001/02

(In millions of Pakistan Rupees)

	1997/98	1998/99	Prel. 1999/2000	Prog. 2000/01	Prel. Est. 2000/01	Proj 2001/02
Net operating surplus 1/	-2,263	28,032	22,514	33,604	14,140	6,468
WAPDA	-7,993	19,023	7,176	4,878	-15,091	-26,373
KESC	-6,970	-7,482	-12,916	-7,964	-15,975	-14,814
PTCL	12,407	17,567	21,421	23,266	25,194	28,206
OGDC	3,875	3,948	9,646	9,850	18,717	16,981
SNGPL	-250	-222	158	645	698	1,427
SSGCL	-1,156	-1,030	-774	1,014	-471	323
Railways	-2,177	-3,772	-2,197	1,915	1,068	719
Gross savings 2/	28,536	57,741	49,079	61,195	42,411	40,855
WAPDA	9,625	35,049	21,287	19,973	91	-5,649
KESC	-4,822	-4,756	-10,095	-4,510	-13,064	-11,651
PTCL	14,348	19,802	22,725	24,131	26,273	29,118
OGDC	6,690	5,922	11,592	11,286	20,865	19,809
SNGPL	2,466	2,695	2,997	3,541	3,672	4,681
SSGCL	2,406	2,802	2,770	4,859	3,506	3,829
Railways	-2,177	-3,772	-2,197	1,915	1,068	719
Gross capital expenditure	53,401	41,329	48,975	74,272	51,210	84,669
WAPDA	19,706	17,391	24,654	33,899	23,833	25,000
KESC	6,278	2,386	2,451	4,442	4,442	3,550
PTCL	12,828	11,776	14,633	15,500	11,500	16,500
OGDC	5,187	2,707	2,910	9,985	5,173	15,894
SNGPL	4,487	2,466	2,280	4,096	2,250	10,554
SSGCL	2,697	1,215	979	3,150	1,555	6,802
Railways	2,219	3,388	1,069	3,200	2,457	6,369
Overall balance 3/	-44,190	-3,437	-22,080	-36,112	-32,564	-68,849
WAPDA	-21,220	7,106	-15,095	-26,399	-36,302	-43,511
KESC	-13,248	-9,868	-15,367	-12,406	-20,417	-18,364
PTCL	1,520	8,026	8,092	7,766	14,773	12,618
OGDC	-700	770	5,496	190	12,057	-45
SNGPL	-4,102	-2,049	-1,753	-3,189	-1,217	-8,744
SSGCL	-2,045	-262	-187	-789	-70	-5,152
Railways	-4,395	-7,160	-3,266	-1,285	-1,388	-5,650
Net operating surplus	-0.1	1.0	0.7	0.9	0.4	0.2
Of which: WAPDA	-0.3	0.6	0.2	0.1	-0.4	-0.7
Gross savings	1.1	2.0	1.5	1.7	1.2	1.1
Of which: WAPDA	0.4	1.2	0.7	0.6	0.0	-0.1
Capital expenditure	2.0	1.4	1.5	2.1	1.5	2.2
Of which: WAPDA	0.7	0.6	0.8	1.0	0.7	0.7
Overall balance	-1.7	-0.1	-0.7	-1.0	-0.9	-1.8
Of which: WAPDA	-0.8	0.2	-0.5	-0.7	-1.0	-1.1

Source: Pakistan authorities; and Fund staff estimates.

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

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

3/ Total revenue minus total expenditure.

Table 7. Pakistan: Summary of Public External Debt and Debt Service, 1998/99–2003/04

	1998/99	1999/2000	Est. 2000/01	Proj. 2001/02	2002/03	2003/04
	(In millions of U.S. dollars)					
Total public and publicly guaranteed external debt	30,482	31,054	31,692	34,625	35,953	36,059
Medium- and Long-term debt	26,609	27,306	28,440	31,659	33,238	34,046
Project and nonproject aid	23,101	23,834	23,884	25,269	25,543	25,733
Commercial banks and IDB	730	560	1,100	1,079	897	842
Other 1/	2,778	2,912	3,456	5,311	6,797	7,471
Short-term Debt (by initial maturity)	2,049	2,253	1,694	1,354	1,423	1,104
Commercial banks and IDB	583	671	511	494	735	735
FEBCs and DBCs	196	147	122	99	77	58
Deposits of nonresidents with the SBP	1,270	1,435	1,061	761	611	311
Fund credit and loans 2/	1,825	1,496	1,558	1,611	1,293	909
Service of medium- and long-term						
Public and publicly guaranteed debt	3,546	3,586	3,239	3,307	3,031	3,111
Of which: to the Fund	191	347	254	252	414	467
Amortization	2,569	2,452	2,072	2,100	1,926	1,909
Of which: to the Fund	147	287	194	195	336	406
Interest 1/	977	1,133	1,167	1,207	1,105	1,202
Of which: to the Fund	44	60	60	57	78	62
Interest on public and publicly guaranteed short-term debt	96	94	61	57	44	36
	(In percent of GDP)					
Total public and publicly guaranteed external debt	52.0	50.4	53.2	59.1	59.4	57.0
Long-term	45.4	44.3	47.7	54.1	54.9	53.8
Short-term	3.5	3.7	2.8	2.3	2.4	1.7
Fund credit and loans	3.1	2.4	2.6	2.8	2.1	1.4
Service of medium- and long-term public and publicly guar	6.1	5.8	5.4	5.6	5.0	4.9
Amortization	4.4	4.0	3.5	3.6	3.2	3.0
Interest	1.7	1.8	2.0	2.1	1.8	1.9
Interest on public and publicly guaranteed short-term debt	0.2	0.2	0.1	0.1	0.1	0.1
	(In percentage of exports of goods and nonfactor services)					
Total public and publicly guaranteed external debt	344.8	324.3	308.6	312.7	301.0	278.6
Of which: Fund credits and loans	20.6	15.6	15.2	14.5	10.8	7.0
Service of medium- and long-term public and publicly guar	40.1	37.4	31.5	29.9	25.4	24.0
Of which: to the Fund	2.2	3.6	2.5	2.3	3.5	3.6
Amortization	29.1	25.6	20.2	19.0	16.1	14.7
Of which: to the Fund	1.7	3.0	1.9	1.8	2.8	3.1
Interest	11.1	11.8	11.4	10.9	9.3	9.3
Of which: to the Fund	0.5	0.6	0.6	0.5	0.7	0.5

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 (for the projection period) the financing gap.
2/ Include use of Fund resources under the current Stand-By Arrangement.

Table 8. Pakistan: Indicators of Fund Credit, 2000/01–2007/08 1/

	Est. 2000/01	Proj. 2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08
Outstanding Fund Credit								
In millions of SDRs	1,203	1,266	1,014	712	502	353	281	223
In millions of U.S. dollars	1,558	1,611	1,293	909	642	452	360	286
In percent of:								
Quota	116.4	122.5	98.1	68.9	48.5	34.1	27.2	21.6
GDP	2.6	2.8	2.1	1.4	1.0	0.6	0.5	0.4
Exports 2/	12.7	12.3	9.2	6.0	4.6	3.2	2.6	2.1
Public and publicly guaranteed debt	4.9	4.7	3.6	2.5	1.6	1.0	0.7	0.5
Debt service to the Fund								
In millions of SDRs	237	191	289	329	229	160	80	64
In millions of U.S. dollars	312	252	414	467	453	370	130	90
In percent of:								
Exports 2/	2.4	1.9	2.8	3.0	3.2	2.7	0.9	0.6
Gross official reserves	18.6	10.9	14.7	13.3	11.3	8.6	2.8	1.9

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

1/ Under the assumptions of the program, assuming disbursement of the last tranche under the Stand-By arrangement.
2/ Exports of goods and services and workers' remittances.

Table 9. Pakistan: Indicators of External Vulnerability 1999/2000–2001/02

	1999/2000	2000/01	(Early Sep.) Latest 2001/02	Rev. Proj. 2001/02
Financial indicators				
Net public debt (in percent of GDP)	91.6	92.6		88.7
Broad money (12-month percentage change)	9.4	7.1		9.5
Private sector credit (12-month percentage change)	1.4	3.4		7.0
180-day treasury bill yield (in percent)	8.6	10.4		. . .
180-day treasury bill yield, real (in percent)	5.1	6.0		. . .
Karachi Stock Exchange index				
End-of-period	1,521	1,366	1,241	. . .
Period average	1,514	1,436	1,242	. . .
External Indicators				
Exports (annual percentage changes, in U.S. dollars)	8.8	9.0		7.6
Imports (annual percentage changes, in U.S. dollars)	-0.1	5.9		6.8
Terms of trade (12-month percentage changes)	-9.2	-1.6		-1.4
Current account balance (excluding official transfers in percent of GDP)	-3.6	-3.3		-3.2
Gross Official Reserves (in millions of U.S. dollars) 1/ 2/	908	1,681	1,727	2,314
In weeks of imports of goods and services	3.9	7.0	6.6	8.8
In percent of broad money	3.4	7.1	7.3	8.8
In percent of short-term external debt 3/	21.6	51.1		62.2
Total external debt (in millions of U.S. dollars)	35,635	37,426		38,935
In percent of exports of goods and services 4/	307.1	293.8		286.2
Actual debt service 5/ (in percent of exports of goods and services 4/)	17.5	9.2		25.2
Exchange rate (Rupees per U.S. dollar, period average)	51.6	58.3	64.0	. . .
Real exchange rate (annual percentage changes)	-0.5	-5.2	. . .	. . .

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 on medium- and long-term debt of the following year (including payments on debt that was rescheduled).
4/ Including workers' remittances.
5/ Scheduled debt service minus rescheduled debt service plus debt service on previously rescheduled debt.

Pakistan: Fund Relations
As of July 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	1,951.97	188.8
Reserve position in Fund	0.11	0.0

III. SDR Department:	SDR Million	%Allocation
Net cumulative allocation	169.99	100.0
Holdings	13.25	7.8

IV. Outstanding Purchases and Loans:	SDR Million	%Quota
Stand-By arrangements	386.79	37.4
Extended arrangements	178.89	17.3
Contingency and Compensatory	352.70	34.1
SAF arrangements	10.93	1.1
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	360.00
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			
	07/31/2001	2001	2002	2003	2004	2005
Principal	0.0	58.5	201.8	407.2	330.5	124.5
Charges/Interest	0.0	23.0	43.3	33.2	18.8	10.4
Total	0.0	81.5	245.1	440.4	349.3	134.9

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**

Prior to mid-1998, Pakistan implemented a fixed exchange rate system with periodic step devaluation to compensate for the inflation differential with major trading partners. On July 21, 1998, a dual exchange system was introduced consisting of a fixed official exchange rate at PRs 46 per US$1 and a floating interbank market exchange rate (FIBR). Under this system, all authorized transactions were effectively conducted at the so-called "composite rate" which was the weighted average of the FIBR and the official exchange rate. In addition, since May 28, 1998, withdrawals from foreign currency accounts have only been allowed in rupees (at the official exchange rate). An advance import deposit of 30 percent was introduced on July 12, 1998; it was subsequently reduced to 20 percent on January 9, 1999 and to 10 percent on January 24, 1999, and was eliminated on February 24, 1999. On May 19, 1999, the official exchange rate was eliminated and the exchange rate system unified, with all international transactions conducted at the FIBR. As of July 31, 2001 the FIBR was PRs 64.03 per U.S. dollar.

VIII. **Last Article IV Consultation**

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

IX. **Safeguards Assessments**:

Under the Fund's safeguards assessment policy, the State Bank of Pakistan (SBP) is subject to a full Stage One safeguards assessment with respect to the Stand By arrangement approved on November 29, 2000 which is scheduled to expire on September 30, 2001.

A Stage One safeguards assessment of the State Bank of Pakistan was completed on 10/26/2000. The assessment concluded that high risks may exist in the area of external audit mechanism, financial reporting and internal control, and recommended a Stage Two (on-site) assessment. The Stage Two (on-site) assessment was completed on 02/13/2001 and staff's findings and recommendations were reported to Fund management and to the authorities.

X. **ROSCs**

Fiscal Transparency Module	11/28/2000	SM/00/264

XI. Recent Technical Assistance

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

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

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

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

XII. Resident Representative

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

September 12, 2001

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

Dear Mr. Köhler:

Based on discussions with Fund staff in late August 2001 for the third review under the Stand-By Arrangement, the attached Supplementary Memorandum on Economic and Financial Policies (SMEFP) reviews economic developments and policy implementation in fiscal year 2000/01 (July 2000–June 2001) and during July–August 2001, and discusses a few measures to be taken in the coming weeks to ensure the program for 2001/02 remains on track. As you know, we are discussing with Fund staff a three-year program to be supported under the PRGF, and with negotiations well advanced, expect to provide you soon with a Memorandum on Economic and Financial Policies (MEFP) for the next three year.

On the outcome for the structural performance criteria through end-June 2001 we had already reported in our letter dated June 27, 2001. All structural performance criteria for July–September were observed, except that passage of the revised income tax law has been delayed to early September 2001 to allow more public debate and scrutiny of the published draft, and the elimination of the export credit subsidy (for which a waiver of nonobservance was granted in July). With one exception, all quantitative performance criteria for end-June 2001 were met with comfortable margins. The performance criterion on Central Board of Revenue (CBR) revenue was missed, as already anticipated in our June letter, but by a larger-than-expected margin as explained in the attached memorandum. To ensure that the 2001/02 deficit will be achieved, we have implemented additional fiscal measures as outlined in the attached SMEFP, along with measures designed to deepen the interbank foreign exchange market. This will allow to gradually reduce reliance on the kerb market purchases to strengthen official reserves. On this basis, we request a waiver for the nonobservance of the structural performance criterion on passage of a reformed income tax law by end-July 2001. On the basis of performance and policies set out in the attached memorandum, the government requests the completion of the third 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	s
Shaukat Aziz Minister of Finance and Economic Affairs	Ishrat Husain Governor State Bank of Pakistan

Attachment:
Supplementary Memorandum of Economic and Financial Policies

PAKISTAN

Supplementary Memorandum of Economic and Financial Policies for the Third Review Under the Stand-By Arrangement

I. Developments During FY 2000/01 and the First Quarter of FY 2001/02

1. **Macroeconomic performance in 2000/01 suffered from an unprecedented drought, a weakening external environment, and higher oil prices.** As detailed in our earlier memoranda, rainfed agriculture was most severely affected, and the need for additional petroleum imports to substitute for hydropower weakened already vulnerable external balances. Preliminary estimates put real GDP (at factor cost) growth in FY 2000/01 at 2.7 percent, slightly better than the program target of 2.6 percent. We expect some slowdown of industrial growth for 2001/02 given weakening foreign demand, but despite poor rainfalls in August (after good rains in June/July), some recovery of agricultural output. Accordingly, the economy is so far on track to realize the targeted real GDP growth of around 4 percent for 2001/02. Reflecting prudent financial policies and favorable food supply conditions, inflation as measured by the CPI slowed to 2.5 percent in the year through June 2001, and 4.4 percent for the annual average, better than programmed. This trend continued in July 2001, with the CPI increase year-on-year again at 2.5 percent. With the exception of the target for Central Board of Revenue (CBR) revenue, as discussed below, all quantitative performance criteria for end-June 2001 were observed (Table 1).

2. **External balances for FY 2000/01 were somewhat stronger than programmed.** The external current account deficit (excluding grants) declined to 3.3 percent of GDP, compared to 3.6 percent the preceding year. The trade balance turned out better than projected, reflecting largely lower imports, while workers' remittances (including through the kerb market) were higher than projected. Exports grew by 9 percent, reflecting strong growth in nontraditional exports, such as petroleum products, pharmaceuticals, chemicals, and leather goods. Cotton manufacture exports stagnated due to lower unit values, reflecting a softening of world demand, whereas volumes increased as programmed. Import growth was contained at 6 percent, reflecting weaker domestic demand and external financing constraints.

3. **Reserves targets and the performance criterion on net foreign assets (NFA) of the State Bank of Pakistan (SBP) for end-June 2001 were met with comfortable margins**. Gross official reserves (excluding FE-25 foreign currency deposits and short-term swaps and forwards) were maintained close to or above the projected end-June level, and are on track to meet the target (US$1,757 million) by end-September. However, given the timing of debt service payments and of foreign exchange inflows it will not be possible to observe daily the indicative continuous floor as set out in our June letter. The interbank market exchange rate remained broadly stable during July–August 2001, with the premium on the kerb market also stable in a daily range of 4–5 percent. Kerb market purchases by the SBP were reduced to US$88.5 million during July, compared to US$266.3 million during June.

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 FY 2000/01 amounted to 5.2 percent of GDP, lower than programmed.** Unexpectedly large shortfalls in tax revenues from programmed levels were compensated by expenditure restraint. The revenue shortfalls on CBR taxes were mostly in income and sales tax collections as well as gas surcharges. The shortfalls on CBR taxes reflect a variety of factors, such as perhaps overly ambitious targets, weaker-than-expected growth, and excessive focus on the tax survey and documentation drive at the detriment of audit and collection enforcement earlier in the fiscal year. Despite release at the federal level of all budgeted appropriations for social and poverty-related expenditures at the beginning of the year, as envisaged in the program, such outlays fell short of program objectives by PRs 13 billion (as per provisional accounts) mainly due to limited absorption capacity. Nonetheless, such outlays rose by 11 percent (somewhat faster than GDP) over the last year and probably more as some of the expenditure that has yet to be classified (reconciliation is typically completed by end-September) may fall in this category. Military expenditure was contained at the programmed level. In addition, government net lending was reduced by the unexpected early repayment of PRs 8 billion onlent debt by the telecom company. Lower current and especially capital spending at the provincial levels resulted from deliberate expenditure restraint and better enforcement of accountability and governance standards. In the circumstances, the end-June performance criterion on CBR revenue was breached with a larger margin (0.7 percent of GDP) than was anticipated in our June letter. However, the performance criterion on the fiscal deficit was observed with a comfortable margin (0.2 percent of GDP). The performance criterion on net bank borrowing was also met comfortably, as both external and domestic nonbank financing turned out somewhat higher than expected. The unfavorable tax revenue trends continued in July, despite an encouraging performance of sales tax, with CBR revenue falling again short of the target, making it unlikely that the end-September indicative target would be met. More comprehensive budgetary data for July are not yet available although continued compression especially of provincial expenditures is likely to have occurred.

5. **Monetary policy remained tight to keep inflation on target.** A sharp tightening of monetary policy (six-month treasury bill rates were raised to 12.9 percent in late June) helped achieve the reserve target and helped slow reserve money growth to 3.4 percent in the year through end-June 2001, well below the program target. The performance criterion on central bank net domestic assets (NDA) at end-June was met with a comfortable margin, and without any exceptional operation. Broad money growth slowed to 7.1 percent in the year through June 2001, below the program target, reflecting a sharp reversal of the previously observed shift to cash. We are analyzing the reasons for this change in money demand, which does however reflect a return closer to the historically observed levels of the cash/deposit ratio from the unusually high levels observed through much of 2000. Private credit growth slowed to 6.4 percent over the year, reflecting mostly the impact of high interest rates. By contrast,

the growth of NFA of both commercial banks and the SBP was much larger than expected. With inflation well under control, and reserves targets for September within reach, we have cautiously started to reduce interest rates, but stand ready to reverse these steps if needed.

6. **Structural reforms are broadly on track**. The structural performance criteria for the period April 2001- July 1, 2001 were all observed, with the exception of the elimination of the interest subsidy on export finance (Table 2). The latter was nonetheless substantially implemented through a sharp increase in the export credit rate (to 13 percent), which, however, fell slightly short of the programmed level as the relevant benchmark rate (the six-month treasury bill rate) rose to exceptionally high levels in late June. The auction rate on six-month treasury bill subsequently declined rapidly, to 11.4 percent in early August and thus below the export finance rate by a margin exceeding 1.5 percentage points, thus fully eliminating any subsidy as defined in the TMU. The structural performance criteria for the period July–September 2001 have also been met, with the exception of the passage of a new income tax law (see below). **Most structural benchmarks for the period April–August 2001** have also been met, with a few qualifications as indicated in Table 2.

7. The new income tax law will be promulgated in early September 2001, somewhat later than programmed, to allow more time for public scrutiny and comment (the draft was posted on the web in early July and triggered a lively debate and a host of suggestions from the public and especially various professional associations). The new law, elaborated with Fund technical assistance, will considerably streamline and clarify income tax rules, generalize self-assessment with clearly specified record-keeping rules, remove the ambiguities of current regulations, include the taxation of nonmonetary benefits as a principle, and incorporate all the substantive reform elements that were already made effective July 1, 2001 under the current budget law as described in our June letter. The law will apply to income earned from July 1, 2002. At that time a further reduction in exemptions will be phased in.

8. **Moves towards market liberalization** have continued with the liberalization of petroleum imports in June 2001. Registered oil marketing companies (OMCs) are free to import any petroleum product. The OMC since June 2001 jointly determine every fortnight, subject to monitoring by the Ministry of Petroleum, 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 depots, and other domestic costs as well as taxes and duties. Retail prices are free up to a fixed margin over ex-depot prices to allow for differences in transport costs between retail outlets and the depots.

9. **The government has continued its program to streamline, restructure and corporatize public enterprises, and prepare several important enterprises for privatization.** Market-friendly regulatory frameworks encouraging competition in the telecom and energy sector are being put in place. Progress has been made in reforming WAPDA through creation of autonomous distribution and generation entities (which would eventually be privatized) and the new corporate entities are fully functional. KESC has been put on a fast track towards privatization by end-June 2002, but continues to face very large

collection shortfalls, theft and leakage of electricity, and financial distress; privatization will eventually require a major recapitalization operation by the government. The federal government will continue to ensure that a few key federal and provincial priority connections (such as hospitals and schools) remain current on their electricity bills. For all other agencies, WAPDA and KESC will apply normal commercial practice of switching off supply if bills are not settled.

10. **To strengthen the financial sector's soundness,** restructuring of the three nationalized banks has continued with the closure of 450 branches by end-July; and two of the three banks have completed major voluntary early retirement programs, although the staff reductions achieved cover only 60.8 percent of UBL and 31.3 percent of Habib Bank's respective initial targets. Both banks are being prepared for privatization, with UBL expected to be brought to the point of sale before year-end; recently cabinet also authorized the sale of a 5–10 percent share of the National Bank of Pakistan (NBP). The insolvent National Development Finance Corporation has been put in liquidation and assets will be transferred to the NBP. Finally, in close consultation with the World Bank, the SBP has approved a liberal policy regarding branch openings or closures for scheduled banks. The SBP has also stepped up its efforts to combat money laundering. Prudential regulations have been put in place, in line with the recommendations of FATF, to prevent criminal use of banking channels for the purpose of money laundering and other unlawful trade. An additional regulation directs the banks to make all reasonable efforts to determine the identity of the account holders. Regarding the issue of Islamic Finance, the Supreme Court has extended the deadline for the transition to July 1, 2002. Under any circumstances, all foreign and existing domestic debt and loan contracts will be honored.

11. In the context of preparing for the launching of our poverty reduction strategy, we have made progress in developing a system of improved monitoring of pro-poor and social spending, specifying coverage, frequency of reports, along with monitoring of intermediate outputs. We expect the system to start reporting quarterly data with a four-month lag for a first set of key expenditure categories by end-October 2001; other categories as well as more disaggregated data below the sector head level will become available only later. We have also made progress in building a debt database and management system, and we expect to sign before end-November the contract with UNCTAD for full implementation of the upgraded DMFAS system.

12. **Devolution of the delivery of relevant government services to local government has started in earnest.** Elections to the various local government councils were completed in July/August, and local government laws have been promulgated by all provinces. The elected Nazims are now in place. The primary objective of the process is to politically and economically empower the people at the grassroot level. The process has been carefully designed to avoid fiscal irresponsibility and to ensure accountability. The laws explicitly do not allow local governments to incur any debt.

13. The Cabinet approved in March, 2001 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) over the next four years. Redundant staff are being 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 some surplus staff. Similar plans are being prepared at the provincial levels. In collaboration with the World Bank, we have started to undertake a further in-depth evaluation of the pay and pension system, including additional actuarial analysis and on this basis will design a strategy for long-term pension reform.

II. Adjustment and Reform Program 2001–2004

14. We have initiated discussions with Fund staff on a three-year program to be supported under the PRGF, and expect shortly to finalize the discussions with a view to bring a request to the Fund's Executive Board. In this context we will report in detail about financial and economic policies for the coming years. A new draft I-PRSP has been prepared in August, based on broad consultation within Pakistan, donors, and discussions with the staff of the Fund, the World Bank, and the Asian Development Bank (AsDB). It will be posted on the web in September to invite broader public debate. We have also organized consultations with each province on both the content and their role in implementing the strategy and in tracking results.

15. For the remaining period under the Stand-By Arrangement, we will pursue efforts on deepening the interbank foreign exchange market to facilitate the phasing out of the SBP's kerb market purchases; and have implemented additional revenue and expenditure measures to offset recent revenue slippages in order to ensure that the 2001/02 fiscal deficit target is met without compromising social sector or essential development expenditure; and further improve expenditure data reconciliation. The measures included an increase in diesel taxation by PRs 0.50 per litre effective September 1, 2001; cuts in nonpriority federal development expenditure to be managed by the federal government and the provinces. We expect the indicative financial program targets for end-September to be achieved, except for CBR revenue (as discussed) and possibly the NFA target, and intend to complete the actions listed in Table 3 prior to the Board meeting on the third review under the Stand-By Arrangement. To address continued large financial imbalances, WAPDA and KESC will continue to implement restructuring programs with support from the World Bank and the AsDB. In addition, we expect WAPDA and KESC to move the regulatory authority in the electricity sector (NEPRA) to authorize further adjustment of electricity tariffs. In September 2001, gas consumer prices will be adjusted as envisaged under the six-monthly adjustment mechanism. We will also review the experience with the 20 percent GST rate on selected inputs in March 2002. Finally, we plan to lift the commercial backing constraint for foreign exchange interbank transactions, while strengthening our supervision over money changers to better monitor transactions in the kerb market.

III. External Financing Issues

16. **External financing needs for 2001/02 and onwards remain large**. Continuing support from multilateral and bilateral creditors and private sector will be essential. At the same time, preliminary indications from ongoing work on a debt sustainability analysis indicate that financing at largely non-concessional terms, while addressing immediate liquidity needs, keeps Pakistan's long-term external outlook unsustainable, with most debt indicators worse than for many countries supported under the HIPC initiative. Given the need to reduce a debt overhang that deters domestic and foreign investment and implies a burden on public finance that depresses much-needed spending on development and poverty reduction, we are therefore seeking to shift financing for the coming years towards more concessional terms. In particular, in the context of the discussions on a PRGF-supported program, we will seek a multiyear rescheduling from Paris Club creditors at terms more concessional than traditional Houston terms, and will limit as far as possible any non-concessional borrowing.

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. 2001			End-Jun. 2001		
		Prog.	Adj.	Act.	Mod. Prog.	Adj.	Act.	Prog.	Adj.	Act.
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	34.8	42.1
Net domestic assets of the SBP 2/	552.9	-26.3	-22.1	-41.1	8.0	8.2	-8.1	-14.3	-7.6	-25.3
Overall budget deficit	206.4	103.8	103.8	77.9	152.8	152.8	144.5	185.7		182.1
Of which : net bank borrowing 3/	40.0	6.4	21.1	-9.4	19.9	34.8	13.0	-14.5	-15.5	-33.0
CBR revenue	346.6	189.9	189.9	182.0	279.3	279.3	276.7	417.3		393.9
Credit to the seven major public enterprises 4/	44.5	6.5	0.0	-9.4	9.5	9.5	-14.2	11.5	11.5	7.4
Accumulation of budgetary arrears to WAPDA		0.0	0.0	-3.7	0.0	0.0	-3.4	0.0	0.0	-6.5
		(In millions of U.S. dollars)								
Contracting of short-term public and publicly guaranteed external debt 5/	657	800		264	800		474	800		754
Contracting of nonconcessional medium- and long-term public and publicly guaranteed external debt 5/		2,000		533	2,500		688	3,000		1138
Of which: External debt with an initial maturity of over one year and up to five years 5/		1,000		0	1,500		0	1,500		100
Accumulation of external payments arrears (continuous performance criterion during the program period)		0		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	87.7	22.6
Federal tax revenue 7/	386.8	207.5	207.5	195.5	302.1		300.6	451.3		424.3
Social and poverty-related spending 8/	76.3	48.5	48.5	35.2	77.9		73.1	97.5		84.6
Memorandum items:										
Net external budget financing 9/	73.6	71.5		43.6	87.0		61.7	77.3		80.5
Net foreign assets of the SBP (level; PRs bln)	-55.1	-63.3		-52.9	-46.4		-57.3	-13.5		-13.0
Net domestic assets of the SBP (level; PRs bln)	552.9	526.6		511.8	560.8		544.9	538.6		527.5
		(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		811	790		774
Program financing		1,690		1,301	1,997		1,693	2,550		2565
BOP support loans 10/		570		212	567		316	918		933
Debt rescheduling		1,120		1,089	1,430		1,377	1,632		1632
Stock of foreign exchange swaps of the SBP	756	717		798	717		753	717		721
Of which: short-term	104	65		256	0		0	0		0
Forward exchange contracts of the SBP	0	23		27	23		10	23		0
External financing counted as SBP liability		117		76	220		96	207		51

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 as of September 10, 2001
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, and June 15, 2001.
Ban on introduction of new GST exemptions and fixed-tax schemes under the GST.	Continuous during the program period.	Met through August 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 February 2001, May 2001, and August 2001.
GST extension to urea fertilizer and pesticides.	By end-March 2001.	Met.
GST extension to all other agricultural inputs.	By September 1, 2001.	Met.
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.	Not met. Promulgation pending.
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.	Met.
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.	Met.
The reduction of the maximum customs tariff to 30 percent and the number of tariff slabs to four.	July 1, 2001.	Met.
The elimination of interest subsidy element of the export finance scheme.	July 1, 2001.	Not met. Measure substantially taken
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.	Met.

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

Measures	Timing	Status as of September 10, 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.	Met.
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.	Not met. Submission to cabinet and promulgation 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).	Partially met. Reconciliation processes established and partial reconciliation achieved covering data through June 2001.
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.

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

Measures	Timing	Status as of September 10, 2001
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.	Met.
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.	Met.
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.	Report provided in early July 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.	Delay expected due to delay in FSAP mission now expected for October.
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	Not met. Implementing regulations became effective in NWFP and Punjab provinces in July/August 2001, but remain yet to be issued in Balochistan and Sindh.

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

Measures	**Timing**	**Status as of September 10, 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.	Partially met, with restructuring plan approved at the federal level.
Deregulation of diesel prices.	Mid-September 2001	Partially met, prices adjusted fort-nightly to reflect movements in world prices.

Table 3. Pakistan: Prior Actions

- Eliminate nostro limits on scheduled banks' foreign exchange holdings with correspondent banks.
- Official reserves (TMU–definition) to reach at least US$1,631 million by September 13.
- Promulgate the reformed Income Tax Ordinance to take effect for income earned from July 1, 2002, as described in paragraph 7.
- Promulgate amendments to the agricultural income tax ordinance and notify regulations in all four provinces.

Statement by the IMF Staff Representative
September 26, 2001

1. This statement summarizes information which has become available since the staff report (EBS/01/161) was circulated to the Executive Board on September 12, 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/01/161) have been implemented. In particular:

- Net reserves of the State Bank of Pakistan (SBP) reached US$1,726 on September 13, 2001, compared to a target of US$1,631 million. Reserves stood at US$1,679 million on September 24, 2001.

- Nostro limits on commercial banks' foreign exchange holdings with correspondent banks were eliminated effective August 31, 2001 (SBP's foreign exchange circular No. 11).

- A reformed income tax law was promulgated on September 13, 2001, to apply for income earned from July 1, 2002 as described in paragraph 7 of the supplementary MEFP (EBS/01/161, Attachment I).

- In all four provinces amendments to the agricultural income tax were passed, and accompanying rules and regulations notified, providing clearer and uniform definitions and specifying important rules (e.g., deductible costs for computing net agricultural income) to be applied equally in all provinces. Accordingly, filing for agricultural income taxes can commence end-September this year as envisaged under the program.

Recent Economic Developments

3. Inflation data for August indicate that the CPI increased 3.4 percent over the year ending August (from 2.5 percent in July), reflecting mainly an increase in the price of various food items. However, core inflation (excluding food and energy) slowed, and the average annual CPI declined from 4.2 percent through July to 4.1 percent in August. The wholesale price index decelerated to 6.0 percent in the year to August, compared to 6.5 percent in the year through July 2001. Preliminary trade data indicate an improvement in the trade balance in July–August 2001 by US$63 million compared to the same period a year earlier, as exports stagnated while imports recorded a small decline. Worker's remittances in July were at about the same level as a year earlier, while net foreign investment recorded an inflow of US$18 million compared to an outflow of US$15 million in the same period a year earlier.

4. Financial markets have been under pressure since early September reflecting global capital market developments as well as domestic uncertainties arising from the merger of the failed National Finance and Development Corporation (NFDC), a publicly owned development finance institution, with the state-owned National Bank of Pakistan (NBP) in the context of a World Bank supported banking sector reform. As a first step toward the merger, on August 30, 2001, the Ministry of Finance declared a 180 day moratorium on all NFDC operations, including deposit withdrawals. The moratorium triggered sharp withdrawals from National Savings Scheme (NSS) instruments until the SBP clarified that NSS holdings were not affected by the merger, and eased the freeze on NDFC deposits.[1] The situation has since stabilized. The terrorist attack on New York and Washington on September 11 triggered further pressures, in particular on the Karachi stock market. The main stock market index fell by 12 percent between September 11 and September 24, 2001, bringing the cumulative decline to 19 percent from end-June 2001. Pakistan's stock exchanges had been closed during September 15–23. The exchange rate of the Pakistani rupee against the U.S. dollar was broadly stable during July–September; the spread in the kerb market also remained stable at about 4–5 percent. Kerb market purchases by the SBP reached US$374 million during the period July 1–September 24, 2001 (compared to US$596 million in the quarter ending June 30, 2001).

5. Preliminary data on CBR revenue indicate that collection for July–August 2001 reached PRs 46.5 billion, a decrease of 2 percent over the corresponding period last year, broadly as expected under the program. The average annual growth rate for the year through August thus slowed to 10.3 percent, from 13.5 percent through June. To a large extent the slowdown reflects clearance of a large backlog of refunds (mainly for GST and customs) which should result in higher net collections in the months to come.

Impact of Terrorist Attacks on New York and Washington

6. Recent events have changed the outlook for Pakistan's economy. Export growth is likely to be lower than projected in the staff report, both because of the expected further weakening of the external environment and greater concerns about the domestic socio-political situation, which may affect freight and insurance premia as well as trade finance. In addition, the envisaged privatization program and the expected improvement in FDI flows may materialize at a pace slower than initially expected. As a result, growth is likely to be lower than projected and external imbalances larger. Lower tax revenue, rising inflows of Afghan refugees, and potentially greater domestic security concerns could exacerbate budgetary pressures.

7. In the context of the forthcoming discussions of a successor arrangement to be supported under the PRGF, staff will work with the authorities to quantify the above

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[1]The SBP announced on September 6 that NDFC depositors were allowed to withdraw the balance of their accounts up to PRs 250,000 on September 6, and will be allowed to withdraw another PRs 250,000 from NDFC deposits, starting mid-October.

implications, which however will remain subject to an unusually large degree of uncertainty. The authorities have already indicated that they will seek additional international support, including the lifting of bilateral sanctions, elimination of quotas on Pakistan's textile exports in industrial countries, and greater financial assistance, including more concessional debt relief from bilateral creditors.[2]

Staff Appraisal

8. The information above does not change the thrust of the staff appraisal. However, the socio-political as well as the economic-financial fallout from the recent terrorist attacks on the U.S. has clearly increased the risks to Pakistan's economic outlook. Staff is concerned in particular about a possible further weakening of export opportunities, and greater difficulties in implementing the planned privatization program on time and attracting FDI inflows. As a result, staff believes that the implementation of the stabilization policies and structural reforms outlined in the MEFP has become even more important, and that international assistance for the program will need to be larger than anticipated even a few weeks ago. The staff looks forward to working with the authorities in formulating a new three-year program that could be supported under the PRGF.

[2] The U.S. has in recent days lifted the sanctions imposed in relation to the nuclear tests in 1998; other kinds of sanctions are also under review.

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 Last Review Under Pakistan's Stand-By Arrangement, Approves US$135 Million Disbursement

The Executive Board of the International Monetary Fund (IMF) today completed the third and last review under Pakistan's Stand-By Arrangement, which was approved in November 2000 to support the country's economic reforms through September 2001 (see Press Release No. 00/64).

The completion of the final review will enable Pakistan to draw SDR 105 million (about US$135 million). This will bring total disbursements under the IMF-supported program to SDR 465 million (about US$600 million). To complete the review, the Executive Board approved a waiver for the non-observance of a performance criterion under the arrangement required due to a six-week delay in promulgation of a new income tax law.

After the Executive Board's discussion of Pakistan's economic 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 commendable. Despite adverse weather conditions, real per capita GDP rose, inflation has been lower than expected, and external balances and official reserves have improved in line with program targets. The implementation of structural reforms has been broadly on track. While tax revenue collection was weaker than expected, the budget deficit was kept within the targeted level.

"To consolidate these achievements and build a solid foundation for sustainable high growth over the medium term, particularly in light of the heightened uncertainty following recent events, the authorities will need to pursue further macroeconomic adjustment and structural reforms. A first challenge will be to hold the course on the 2001/02 budget, despite continued weaknesses in tax revenue collection in recent months and a weaker-than-expected global environment. Recent measures to raise fuel taxation and reduce non-priority spending should help contain the fiscal deficit, while allowing for higher social and poverty-related spending. At the same time, the broadening of the tax base and a fundamental reform of tax administration are urgently needed.

"Another key challenge will be to further build foreign exchange reserves, which will require good coordination of monetary and exchange rate policies, while further liberalizing the foreign exchange interbank market to reduce the importance of the kerb market.

"Other reform priorities are to improve governance and transparency in the management of public resources, particularly in the context of the ongoing devolution of fiscal responsibilities to the newly elected local governments; the ongoing restructuring and privatization of public enterprises; and the strengthening of the financial system," Mr. Aninat said.