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Pakistan: Second Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility and Request for Waiver of Performance Criterion—Staff Report; Staff Statement; News Brief on the Executive Board Discussion; and Statement by the Executive Director for Pakistan

In the context of the Second Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility and Request for Waiver of Performance Criterion, the following documents have been released and are included in this package:

- the staff report for the second review under the three-year arrangement under the Poverty Reduction and Growth Facility, prepared by a staff team of the IMF, following discussions that ended on **May 15, 2002** with the officials of Pakistan on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on June 18, 2002.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff statement of **July 3, 2002** updating information on recent economic developments.

- a News Brief summarizing the **views of the Executive Board as expressed during its July 3, 2002 discussion** of the staff report that completed the review.

- a statement by the Executive Director for Pakistan.

The documents listed below have been separately released.

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

*May also be included in Staff Report.

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PAKISTAN

Second Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility 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

June 18, 2002

- Discussions for the second review under the Poverty Reduction Growth Facility (PRGF) arrangement were held in Islamabad and Karachi from May 3–15, 2002. The staff team consisted of Mr. Enders (Head), Ms. Fichera, Mr. Joly, and Ms. Milasiute (all MED); Mr. Taube (FAD); Mr. Sobolev (PDR); and Ms. Gittens (staff assistant, MED). The mission was assisted by Mr. Ghesquiere (Senior Resident Representative). Staff from the World Bank's resident mission participated in some of the discussions.

- The mission held meetings with Finance Minister Shaukat Aziz, the Governor of the State Bank of Pakistan (SBP) Ishrat Husain, the Secretary General Finance and Secretary Finance, and other senior officials dealing with economic and financial matters. Mr. Ahmed (OED) participated in the discussions.

- The Managing Director, the First Deputy Managing Director, and Mr. Aninat met Minister Aziz and Governor Husain during the Spring Meetings.

- In the last Executive Board discussion (EBS/02/43), Directors commended the authorities for their overall economic management in a difficult context and for holding the course on structural reform. They noted that growth prospects had to be scaled down, but that external balances and inflation had improved more than programmed, and that the budget deficit target was being achieved. However, Directors expressed disappointment at the low level of Interim Poverty Reduction Strategy Paper (I-PRSP) expenditures, the difficulty to contain net credit to public enterprises, and the continued weakness in Central Board of Revenue (CBR) tax revenue collection. Looking ahead, they urged the authorities to firmly implement their reform agenda, stressing in particular the need for a sustained shift in public expenditure toward human development and poverty alleviation, the vigorous pursuit of revenue-enhancing measures, the restructuring and privatization of public enterprises, and continued progress in governance and transparency.

- The principal authors of this report are Klaus Enders, Valeria Fichera, and Hervé Joly, with inputs by Günther Taube, Yuri Sobolev, and Alina Milasiute.

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Appendices

Attachment

List of Acronyms

AFMF	Accountable Fiscal Management Framework
AGPR	Auditor General Pakistan Revenue
AsDB	Asian Development Bank
CBR	Central Board of Revenue
CIRRs	Commercial Interest Reference Rates
DFID	Department for International Development
FSAP	Financial Sector Assessment Program
I-PRSP	Interim Poverty Reduction Strategy Paper
IFIs	International Financial Institutions
KESC	Karachi Electric Supply Corporation
LTU	Large Taxpayer Unit
MEFP	Memorandum of Economic and Financial Policies
NAM	New Accounting Model
NBFI	Nonbank Financial Institutions
NBP	National Bank of Pakistan
NDA	Net Domestic Assets
NEPRA	National Electric Power Regulatory Authority
NFA	Net Foreign Assets
NSS	National Saving Schemes
NWFP	North West Frontier Province
PASSCO	Pakistan Agricultural Storage and Services Corporation
PIA	Pakistan International Airlines
PIFRA	Pakistan Improvement of Financial Reporting and Accounting
PPL	Pakistan Petroleum Limited
PRGF	Poverty Reduction and Growth Facility
PRSP	Poverty Reduction Strategy Paper
PSDP	Public Sector Development Program
PTCL	Pakistan Telecommunications Company Limited
ROSC	Report on the Observance of Standards and Codes
SBP	State Bank of Pakistan
TMU	Technical Memorandum of Understanding
UBL	United Bank Limited
WAPDA	Water and Power Development Authority

Executive Summary

Developments in the first months of 2002 indicate further progress toward the program's macroeconomic objectives. However, tax revenue collected by the Central Board of Revenue (CBR), as well as social sector spending, were again lower than targeted through March, reflecting mostly lower-than-programmed imports and start-up problems of the recently elected local governments. Nonetheless, social spending rose in the quarter to March compared to the preceding quarter, and tax revenue performance improved in March and April, indicating that a turnaround for both aggregates may finally be under way. Inflation remained (slightly) lower than expected, and strong private capital inflows and remittances helped in maintaining a high level of official reserves and a stable Pakistani rupee per U.S. dollar exchange rate. A rise in exports and imports during March–April 2002 points to an incipient recovery of the real economy. However, more recently intensifying regional tensions have cast a large shadow over the hoped-for recovery of business confidence.

Progress on the structural front was broadly in line with the program, in particular in the area of tax administration, fiscal transparency, and privatization. Financial improvement plans for the two public power utilities are being implemented to contain their drain on the budget. A temporary reduction of petroleum product tax rates and a suspension of automatic adjustments of electricity tariffs for international oil price changes during April–May were lifted in the second half of May.

All but one of the performance criteria for end-March 2002 were met. The authorities request a waiver for the nonobservance of the (modified) performance criterion on CBR revenue.

The authorities have formulated a reform package for FY 2002/03 that should deliver tangible progress toward the Interim Poverty Reduction Strategy (I-PRSP) objectives. The broad mix of macroeconomic policies remains unchanged. Monetary policy will target low inflation within a flexible exchange rate system. Fiscal policy will aim to reduce the public debt overhang while enhancing the effectiveness of expenditure in stimulating growth and reducing poverty. A package of tax measures, and the expected continued recovery of production and trade, should deliver a sizable improvement in tax revenue. A financial improvement plan for the Water and Power Development Authority (WAPDA) aims to eliminate WAPDA's drain on the budget in FY 2002/03, and help reduce the fiscal deficit for FY 2002/03 to 4.4 percent of GDP. The budget also incorporates a pronounced shift in public expenditure toward human development, complemented by a broad range of governance reforms to ensure a better monitoring of spending and outcomes, better accountability of public enterprises, tax administration reform, and judicial and police reforms. The main risk to the program is a further aggravation of regional tension that could derail the expected recovery of trade and investment, jeopardize the fiscal targets and/or the planned shift of resources to human development, and weaken the ability of the government to implement politically difficult reforms.

I. Introduction and Background

1. On December 6, 2001, the Executive Board approved Pakistan's request for a three-year arrangement under the Poverty Reduction and Growth Facility (PRGF) with access of 100 percent of quota (SDR 1.03 billion). The first disbursement of SDR 86.2 million took place in late December 2001. The first review was concluded by the Executive Board on March 26, 2002 and a second disbursement of SDR 86.1 million took place in early April.[1] The 2002 Article IV consultation with Pakistan is planned to take place by September 2002, concurrently with the third review of the three-year arrangement under the PRGF. Planned Financial Sector Assessment Program (FSAP) missions have once again been postponed due to security concerns, and thus staff will not be able to discuss the findings of FSAP missions during the next Article IV consultation. As of April 30, 2002, total Fund credit and loans outstanding to Pakistan amounted to SDR 1,450 million (140.2 percent of quota).

2. In the attached letter dated June 18, 2002, and the attached Memorandum of Economic and Financial Policies (MEFP) (Attachment I), the government of Pakistan requests completion of the second review under the PRGF arrangement and a waiver for the nonobservance of the quantitative performance criterion regarding CBR revenue for end-March 2002. A third disbursement (SDR 86.1 million) is conditional on the completion of the second review and observance of end-March performance criteria.

II. Performance Under the Program from January–April 2002

3. **The regional security situation has remained tense**. Large military forces are deployed along Pakistan's eastern border and tension with India has been rising in recent weeks.[2] Isolated terrorist acts have targeted foreigners, as well as religious minorities. Domestic opposition to certain reform measures, notably the recent removal of the GST exemption on pharmaceuticals, remains vocal. A referendum was held on April 30; according to Pakistan's Election Commission, a majority of those voting supported continuation of the reform agenda and extension of General Musharraf's presidency by five years. Parliamentary elections are to be held in October 2002.

4. **Economic developments in the period to April showed signs of improvement,** despite the difficult security situation. Macroeconomic and structural policies have been implemented broadly in line with program expectations. All structural and quantitative performance criteria for end-March 2002, except on CBR revenue, were met.

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[1] The relevant Executive Board paper is EBS/02/43. Pakistan's relations with the Fund and the World Bank are described, respectively, in Appendix I and Appendix II.

[2] Following a terrorist attack on India's parliament in December 2001, India and Pakistan mobilized large numbers of troops along the borders. Tensions intensified further in April–May, but most recently have abated somewhat.

5. **Real sector developments are consistent with the GDP growth rate reaching 3.3 percent for the year ending in June (Figure 1 and Table 1).** Official crop estimates have been marginally revised as detailed in the MEFP (para. 2), indicating that growth in agriculture will be slightly below projections. Monthly developments in large scale manufacturing activity, as measured by the quantum index of manufacturing, have been rather irregular. However, the latest data available—a 3.2 percent increase in production during July 2001–March 2002 over the same period last fiscal year—remain in line with the program target, and anecdotal signs of a recovery of external demand became apparent in March and April.

6. **Inflation has picked up slightly since December, as expected under the program.** The consumer price index (CPI) increased by 3.3 percent in the year through March 2002, mostly due to higher energy, transportation, and food prices. Energy prices were affected by higher international oil prices and by an 8.5 percent increase in household gas tariff in March.[3] The food price increase essentially reflects the return to more normal levels of the prices of some basic food staples, which had recorded sharp falls during the second half of 2001. Annual average inflation is now expected to end up slightly below the 3 percent projected under the program.

7. **The balance of payments position has continued to improve, while the Pakistani rupee per U.S. dollar exchange rate remained virtually stable (Figures 2, 3, and 6, and Table 2).** As detailed in the MEFP (para. 3), following a large decline in trade activity in February, both exports and imports rebounded in March and April, and the rebound is expected to continue in the fourth quarter. The most recent data are in line with revised program projections of zero growth in exports and a 4 percent decline in imports in U.S. dollar terms for the year. Positive developments in the services account, reflecting higher-than-originally estimated payments for services to the coalition against terrorism, together with strong private remittances, have led to a downward revision for the projected current account deficit (excluding official transfers) to 1.3 percent of GDP. The inflow of private capital has continued at a strong pace, contrary to earlier expectations. Net exceptional financing flows remain in line with expectations,[4] and the expected improvements in the current and capital accounts will be fully reflected in higher reserve accumulation. As of end-May, gross official reserves had reached US$3.7 billion, and the program target for end-June will likely be exceeded substantially.

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[3] To protect low-income households, the tariff for the lowest consumer segment was left unchanged. However, the World Bank is of the view that this slab has an unnecessarily high threshold, which should be reduced to improve targeting to needy households.

[4] Higher-than-expected World Bank disbursements and rollover of foreign deposits offset shortfalls in Asian Development Bank (AsDB) disbursements, the latter reflecting delays in certain agricultural policy reforms and the privatization of Karachi Electric Supply Corporation (KESC).

8. **Despite a cumulative shortfall in CBR revenue in the nine months through March from the modified program target, the fiscal deficit target for end-March was met with a substantial margin (Figure 5 and Table 3).** A slower-than-anticipated recovery in imports during the quarter through March explains most of the shortfall in CBR revenue of about 0.2 percent of GDP (see Box 1). However, in line with other signs of economic recovery, CBR tax collection registered a significant pick-up in March and April, growing by 6 percent and 17 percent, respectively, compared with the same months last year. Despite these improvements, reaching the June target will be difficult, especially if regional tensions do not abate. Higher-than-expected nontax revenue and expenditure restraint more than offset the shortfall in CBR revenue through March. The good nontax revenue performance primarily reflected larger payments for services to the coalition against terrorism, related to the ongoing military operations in Afghanistan. Because dividends from public corporations and State Bank of Pakistan (SBP) profit transfers were also higher than expected, nontax revenue for the nine months to March ended up about PRs 6 billion above projections, despite a shortfall in interest payments from WAPDA. Budgetary spending through March remained 1.4 percent of GDP below program projections, despite a decline in the stock of government payment arrears to WAPDA. On the federal level, this reflected mostly low defense expenditure (through March, 63 percent of the projected annual total was spent; the stand-off related costs appear to have been mostly financed by using existing stocks) and lower domestic interest payments. Current provincial spending was also below the program target, even though third quarter development spending and pro-poor outlays (I-PRSP expenditure) rose by 9 percent and 42 percent over the second quarter, respectively, as the operational capacity of local governments improved. Nonetheless, I-PRSP expenditure remained about PRs 16 billion below the amount targeted for the nine months to March.[5] Looking at the sectoral composition, the most noticeable increase in the quarter to March is in current education outlays. While defense expenditures are expected to pick up sharply in the last quarter of this fiscal year, barring exceptional developments, the authorities seem on track toward meeting the June deficit target (5.7 percent of GDP), while allowing for a further acceleration of social and poverty reduction expenditure.[6]

9. **Monetary data to March point to slowing reserve money growth, while broad money growth accelerated further (Figure 6, and Tables 4 and 5).** Following an accommodative monetary stance in late 2001 aimed at limiting the impact of the post-September 11 shock, the SBP more recently moved to a more aggressive sterilization of foreign exchange inflows, achieving a sharp slowdown in the year-on-year growth of reserve

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[5] A more disaggregated classification indicates that I-PRSP spending picked up strongly at the federal level, in Sindh and in the North West Frontier Province (NWFP), while it remained even below last year's level in Punjab.

[6] Operations relating to the recapitalization of KESC and settlement of banks' excess payments of tax on unrealized profits through 2000 (see below) are excluded from the deficit as defined for program monitoring purposes. Including these operations, the deficit in FY 2001/02 is expected to reach about 7.1 percent of GDP.

Box 1. Central Board of Revenue Tax Revenue and Administration Reform

Central Board of Revenue (CBR) tax revenue performance remains a main weakness in Pakistan's public finances. Following a good start in the first two months of the fiscal year, CBR tax collection slipped significantly after September 11, reflecting the impact of exogenous shocks and a refund policy adjustment. In contrast to previous years, however, there has generally been no visible slackening in tax administration efforts. Nonetheless, CBR revenue targets had to be revised downwards during the first program review, and reaching the revised targets for this fiscal year may prove challenging (Table 3).

Exogenous shocks. In the aftermath of September 11, adverse shocks to Pakistan's economy as well as favorable trends such as low inflation and exchange rate appreciation due to large capital inflows have been stronger than expected. In combination, these factors have affected key tax bases, most importantly imports. For example, while overall imports (in Pakistani rupee terms) rose by 23 percent in July and August 2001 compared with the same months a year earlier, these growth rates fell to 8.5 percent during September–December 2001, and turned negative (-7.3 percent) in January–March 2002. Although this trend was anticipated in the original program as well as during the first review, its severity was underestimated. For example, a small positive growth rate for imports (2 percent, in rupee terms) for January–March 2002 was assumed under the revised program.

On the domestic side, activity indicators (e.g., the quantum index for large-scale manufacturing) have performed broadly in line with expectations, but lower-than-projected overall inflation and prices in key manufacturing sectors (e.g., textiles, steel) have affected the domestic sales tax base. These factors have also adversely impacted on income tax collections, through the withholding tax on contracts. In addition, income tax collection has suffered from lower imports through the withholding tax on imports, and the stronger-than-expected decline in interest rates through the withholding tax on interest income from securities.

Refund policy adjustment. Shortly after September 11, the government decided to clear the backlog of sales tax and customs refunds faster than previously envisaged, in a bid to help exporters cope with the substantial disruptions in external trade. This basically sound governance measure achieved its objective, as the stock of pending refunds for both taxes was reduced significantly by end-January 2002. However, the measure also triggered a large increase in refund applications and payments that were out of line with underlying trends in trade and prices. (see EBS/02/43, para. 9). It also became clear that there is a need for stricter enforcement of existing refund rules, and to revise them with the objective to reduce the incidence of incorrect claims and payments The staff estimates that the CBR tax revenue base for this year would need to be adjusted upwards by PRs 15 billion (0.4 percent of GDP) due to one-off revenue losses as a result of unusually high refunds.

Tax administration. In contrast to previous years, tax administration this fiscal year has generally not been disrupted by ad hoc measures and slippages. Under a new Board of members, the CBR has followed through with the implementation of a short-term action plan, devised in the latter half of last fiscal year with FAD technical assistance. The plan focused on standard tax administration practices such as intensive follow up on large arrears cases and improved auditing (see EBS/01/39). For example, the number of sales tax audits increased sharply, reflecting the appointment of about 350 new auditors; during July–March this fiscal year, over 15,000 audits were completed compared with less than 4,000 during the same period last fiscal year.

In addition, following a slow start, which in part reflected disruptions in the aftermath of September 11, the implementation of the CBR reform project has gathered pace in recent months (see EBS/01/161, Box 1). Five new CBR members have taken up their assignments in March and April 2002, focusing on audit, taxpayer education and facilitation, tax analysis, human resources, and IT. The implementation of key measures agreed under the program is proceeding generally as planned, including the establishment of the pilot Large Taxpayer Unit (LTU) in Karachi. The Fund and the World Bank are providing technical assistance to this project.

money, from 14.3 percent in December 2001 to 5.8 percent in March 2002.[7] This was supported by a decline in commercial banks' foreign currency deposits with the SBP, following the elimination of incentives to deposit increments to frozen foreign exchange deposits (FE-31) with the SBP (the incentive was the provision of forward cover). Reflecting tighter monetary conditions, treasury bill rates in recent months stabilized at about 6.5 percent, following a sharp slide in the second half of 2001. However, presumably reflecting lags in the impact of the recent contraction of banks' reserves on credit and broader monetary aggregates, domestic liquidity continued to increase at a faster-than-envisaged pace (13.8 percent in the year through March, against 11.8 percent in December 2001). Developments through April indicate a further acceleration of broad money growth to 15.4 percent year-on-year, while reserve money grew by 10.5 percent. Whether relatively high broad money growth should be a source of concern remains unclear, as the combination of low inflation, a stable exchange rate and a comfortable reserve position may well have raised money demand. The appropriateness of the recent monetary stance would also seem to be supported by the fact that even in late May, when tension on the eastern border escalated, private capital inflows continued and the exchange rate did not suffer any major pressure, even though a moderate correction occurred in the stock market. The weak growth of private sector credit (2.3 percent in the year through March) reflects the weak investment climate, relatively high bank lending rates, but perhaps also the injection of liquidity through the reduction in outstanding tax refunds.

10. **Revisions of banks' data on credit to public enterprises show that the related December 2001 and March 2002 performance criteria were both met.** The Ministry of Finance and the SBP undertook a comprehensive exercise to investigate what appeared to be large growth in credit to minor public sector corporations in the quarter to December 2001, which had supposedly caused the nonobservance of the relevant December performance criterion. For the investigation, the SBP requested all scheduled banks to identify the enterprises classified as public corporations. The banks' list was compared with the records of the Ministry of Finance listing all corporations where the government owned a direct majority equity stake. It emerged that banks were still including in their list about 90 corporations which were not public enterprises on the basis of the program definition. Some of them had been privatized over the last 15 years, a few had been liquidated and their debt had been taken over by the government and a few large ones operating in the oil and gas sector were not majority owned by the government. The revised list is now composed of 53 duly identified enterprises, on the basis of which the program performance criterion on net credit to public enterprises is to be monitored. Based on this reclassification, PRs 10 billion (0.3 percent of GDP) of credit to public enterprises as of June 2001 was reallocated to credit to private sector (PRs 3 billion) and to net claims on the government (PRs 7 billion). On this

[7] To make the aggregates comparable, reserve money stocks have been corrected for the impact of the exceptional operations conducted by the State Bank of Pakistan (SBP) in December 2000 and March 2001, and the 20 percent cash reserve requirement on new foreign currency deposits introduced in April 2001. Without these corrections, reserve money growth slowed from 29 percent in the year through December 2001 to 17 percent in the year through March 2002.

basis the flow of net credit to public enterprises through December 2001, as well as March 2002, remained below the program ceiling (MEFP, Table 1).

11. **Structural reforms have been broadly on track (as detailed in the MEFP, Table 2), except for some temporary slippages during April which were all reversed by end-May**. In March, the authorities eliminated the GST exemption on fertilizers at both wholesale and retail stages, while extending the standard GST penalty regime to the retail sector. Implementation of a market-based gas-pricing framework was initiated (MEFP, para. 7). However, the increase in gas prices and the elimination of GST exemptions for pharmaceuticals (excluding life-saving drugs) caused considerable socio-political tension ahead of the April 30 presidential referendum. This led the government to delay, for a few weeks, the electricity tariff increase (approved by the National Electric Power Regulatory Authority (NEPRA) in February) in application of the fuel adjustment clause, and to lower petroleum taxation. The delayed tariff adjustment was fully implemented in mid-May, and petroleum taxation fully restored by June 1, 2002.

12. **A few privatization operations were successfully concluded**. In early March, the government proceeded with the sale of a 90 percent stake in Pak-Saudi Fertilizer to a domestic company, and finalized the sale of government interests in six oil and gas fields. At the request of the three consortia that have expressed interest in acquiring United Bank Limited (UBL), the bank's board in May released audited accounts for 2001, and the bidding for UBL is expected for early June. The process toward the privatization of the Karachi Electric Supply Corporation (KESC) advanced with the recapitalization of the company, followed by some equity write-off to offset several years of accumulated losses. KESC has also filed a petition for a tariff increase and for approval of a multi-year tariff schedule with NEPRA. Expressions of interest to purchase KESC have so far been received by two large international energy companies. The privatization of the telecommunication company (Pakistan Telecommunications Company Limited (PTCL)) has encountered delays. Despite two extensions of the deadline for submitting expressions of interest, only three bidder consortia came forward, probably reflecting the current difficult financial situation of most international telecommunication companies. The authorities consider that the potential bidders do not (yet) fully comply with the technical and financial requirements and will need to take some actions before qualifying for bidding.

III. Report on the Discussions

13. Pakistan's economic strategy, as laid out in its I-PRSP, aims to lay the foundation for higher sustainable growth and to reduce poverty, through fiscal adjustment to bring debt to sustainable levels, and a wide range of governance reforms to stimulate private sector growth and improve social service delivery. Against the background of a gradual economic recovery since March, the policy discussions focused on the budget for FY 2002/03 and the related tax and other structural measures, notably steps to improve the financial situation of WAPDA, and other governance reforms. The recent isolated terrorist attacks against foreigners and rising tension with India have sharply increased the risks to the economic outlook. The projections discussed below assume that tensions will not escalate any further and will wind

down by late 2002. Further escalation, however, could jeopardize the entire poverty reduction strategy.

A. Macroeconomic Framework and Budget for FY 2002/03

14. **In line with recent trends, real GDP growth (at factor cost) is expected to accelerate to about 4.5 percent for FY 2002/03, with inflation remaining moderate.** Economic activity should further accelerate, especially in manufacturing, supported by the ongoing economic recovery in Pakistan's main trading partners and as certain post-September 11 effects begin to dissipate, such as the fall in export orders. Growth in the agricultural sector is expected to remain somewhat below potential, since continued water scarcity will constrain the yields of water-intensive crops and has already led to a decrease in sown areas for sugarcane and cotton. The inflation objective of 4 percent is consistent with recent price developments and the Fund's World Economic Outlook (WEO) price assumptions for international oil prices.

15. **The balance of payments position is expected to remain strong in FY 2002/03, despite the subsiding of exceptional factors**. Nonetheless, the trade balance is projected to worsen slightly on account of a significant recovery of imports due to higher domestic growth, notwithstanding a pick up in exports. Worker remittances are expected to come down closer to traditional levels, after the post-September 11 spike. On this basis, the current account deficit, excluding official transfers, should widen to 2.3 percent of GDP in FY 2002/03. Official transfers are also expected to decrease from an exceptionally high level in FY 2001/02. A tapering-off of private capital inflows is projected, on the assumption that the surge in FY 2001/02 was a one-off portfolio adjustment, possibly triggered by increased scrutiny by host countries of Pakistani balances held abroad. Nonetheless, the capital account is expected to improve further, reflecting lower net public short-term outflows following large repayments of trade credits and of frozen nonresident foreign currency accounts in FY 2001/02. Net exceptional financing is expected to be somewhat lower than this fiscal year (see below). Overall, gross official reserves are expected to increase by another US$0.7 billion to at least US$4.2 billion at end-June 2003, equivalent to about four months of imports of goods and nonfactor services.

16. **The fiscal framework for FY 2002/03 aims to further reduce the public debt overhang, while protecting social expenditure**. The consolidated deficit will be contained at 4.4 percent of GDP, despite a strong increase in social- and poverty-related expenditure.[8] The projections are based on a sizable increase in CBR tax revenue through the implementation of a tax policy package that aims at further broadening the base and simplifying the tax system, and further expenditure restructuring in favor of social sectors and poverty alleviation, including freezing nominal defense expenditure (see below). Another critical step is a structural electricity tariff increase by mid-July to enable WAPDA to make

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[8] It is likely that the planned privatization of KESC will require additional capitalization outlays. The financial program would allow for adjusting the deficit target for up to PRs 11 billion on this account (see TMU).

all scheduled debt-service payments to the budget. To protect the fiscal deficit target in case of unforeseen events, including higher defense expenditure should tensions intensify, the authorities plan to take contingency measures such as reducing nonpriority expenditure or raising petroleum taxes, while protecting I-PRSP outlays.

17. **The authorities are committed to implementing a significant tax policy reform package with the next budget**. Key measures of this plan include (a) the elimination of the sales tax exemptions on edible oils and vegetable ghee (PRs 4 billion or 0.1 percent of GDP); (b) the abolition of two minor withholding taxes under the income tax (estimated revenue loss of PRs 1.2 billion); (c) a further increase in the threshold for the income tax from PRs 60,000 to PRs 80,000 (with a revenue loss of PR 4.5 billion that also factors in the impact of the increase in the threshold from PRs 40,000 to PRs 60,000 that became effective this fiscal year); (d) the reduction in the maximum tariff rate from 30 percent to 25 percent (with a revenue loss of PRs 2.6 billion); (e) the elimination of 55 (out of about 170) income tax exemptions (adding PRs 1 billion in revenue); (f) the implementation, effective July 1, of revised duty drawback coefficients (with a revenue gain of PRs 4 billion); and (g) the elimination of six minor excise taxes and an increase in rates of other excise taxes to ensure revenue neutrality. This plan should help make the tax system less distorted and more transparent, provided no new tax exemption or extension of preferential tax treatment are granted. The authorities are also considering steps, beyond the extension of withholding tax on interest income on all National Saving Schemes (NSS) investments beyond PRs 150,000, to further harmonize the taxation of income from various financial services and instruments, in the context of a planned Asian Development Bank (AsDB) loan in support of capital market development (see also Box 2).

18. **Tax revenue performance should improve on account of tax policy and administration reforms**. The revenue impact of the various tax policy reforms described above should boost revenue collection next fiscal year by about PRs 6 billion (0.15 percent of GDP).[9] Improvements in tax administration, including at the provincial level, are expected to add another 0.25 percent of GDP to revenue. An additional 0.4 percent of GDP improvement is a base effect reflecting the one-off impact in FY 2001/02 of the decision to clear the backlog of tax refunds.

19. **The budget involves a major rationalization of expenditure, to make additional room for social and development spending**. Defense expenditures are projected to remain broadly constant in nominal terms, thus maintaining the high levels of the current year

[9] The authorities also intend to maintain, for FY 2002/03, the special GST rate of 20 percent on certain inputs as incentive for traders to register under the GST to receive credit for sales tax payments. The authorities have estimated that this measure added about PRs 2 billion this year in revenue, and reported that the measure has encouraged a higher level of GST registration without causing an increased incidence of excess GST credits. Staff emphasized the potential drawbacks from this measure, which should be considered strictly temporary and phased out as soon as feasible.

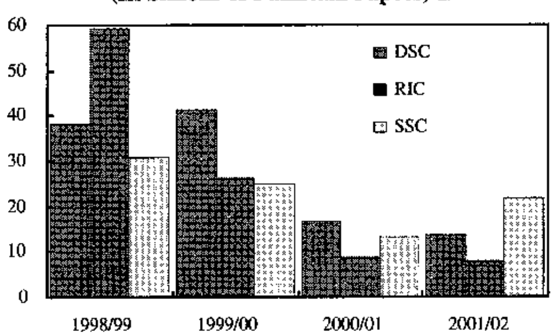
Box 2. National Savings Schemes

National Savings Schemes (NSS) are on-tap domestic debt instruments geared towards small retail investors and administered by the federal government's Central Directorate of National Savings (CDNS). Currently, there are six available long-term schemes with maturities ranging from 3 to 10 years. Given high NSS interest rates that exceed the rates of other government securities, the share of NSS borrowing in domestic debt has been constantly increasing (from 33 percent in 1996/97 to 46 percent in 2000/01).

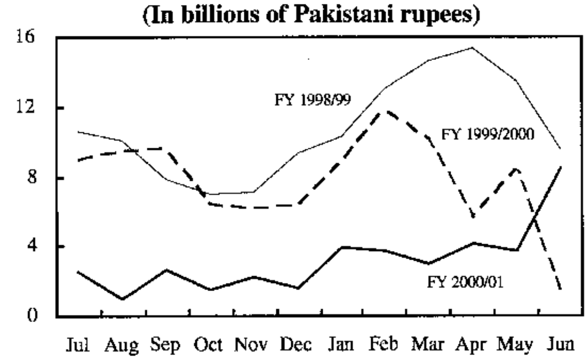
Recent Developments

- Measures were taken to remove preferential NSS tax treatment and unify it across all instruments and investors. Starting with 2001/02, all new NSS issuances became subject to an income-adjustable withholding tax of 10 percent beyond a threshold of PRs 300,000 for aggregate investments (to be reduced by half in July, 2002). These measures make NSS taxation equivalent to that of Term Finance Certificates (TFC) and Pakistan Investment Bonds (PIB) in terms of tax rate and income tax adjustability, but still involve preference compared to treasury bills (withholding tax at 30 percent) and equity (not income tax adjustable).
- A general ban against institutional investors (in addition to an already existing ban on bank and DFIs' investment) was issued in March 2000. Interest rates on all instruments were reduced in 1999 and are, since the year 2000, generally linked to the rates of comparable PIBs. As a result, the net mobilization of the three most popular instruments (Defense Savings Certificate (DSC), Regular Income Certificate (RIC), and Special Savings Certificate (SSC)) has been falling for the past two fiscal years.
- So far, CDNS processes documentation and manages records manually which precludes the development of more refined statistical data, as well as more flexible debt management. A project for computerization of National Savings Organization (NSO) offices' records was initiated this year, with pilot computerization of Islamabad-Rawalpindi regions to be completed in 2003.

Annual Net Mobilization for DSC, RIC, and SSC
(In billions of Pakistani rupees) 1/



Monthly Net Mobilization of Main NSS Schemes
(In billions of Pakistani rupees)



Remaining Distortions and Reform Issues

- The effective maturity of NSS instruments can vary substantially: after a lock-in period, investors can encash early with little penalty in most cases. For example, the early encashment rate for Defense Savings Certificates is around 50 percent. Only one scheme—Regular Income Certificates—has recently imposed a penalty on principal. Other schemes allow early encashment at a small interest rate penalty: 0.13 percent for Special Savings Certificates, 0.5 percent on average per year for Defense Saving Certificates.
- Since NSS rates are revised biannually, using the average of the past six months auction yield rates of the comparable PIBs, there is a substantial lag in reflecting bond market changes. Moreover, the yield curve is insufficiently taken into account especially in the case of three-year Special Savings Certificate, leading to market distortions.

Although steps were taken to make NSS more market-based and less costly, further reforms, especially of the NSS interest rate structure, are necessary. Major importance will need to be placed on devising an efficient mechanism through which NSS interest rates could be aligned more closely with the market yield curve. Incentives for early encashment should be minimized, either by introducing stiffer penalties on principal for other instruments than Regular Income Certificates or increasing interest rate penalties.

[1] For 2001/02—cumulative through March only.

(which reflect nearly 10 months of exceptionally intense military presence at either western or eastern borders, or both) under the assumption that tensions on both borders do not intensify and do not last beyond end-December 2002.[10] Another critical element is lower support (net lending) to WAPDA. Pro-poor expenditure restructuring will also benefit from a lower domestic interest bill, while the share of social and poverty alleviation spending in the Public Sector Development Program (PSDP) is expected to rise. The FY 2002/03 budget will shift considerable additional resources to provinces and local governments to allow higher social spending. To avoid further budget fragmentation while improving expenditure management and control, the authorities and the staff concurred that it would be useful for local governments to prepare and monitor unified budgets (i.e., combine in one budget expenditure made from own revenue with those devolved from the federal and provincial levels) while integrating audit functions at the local government levels for all revenue and expenditure. The financial program would furthermore allow additional I-PRSP expenditure for up to 0.5 percent of GDP (and thus a deficit, excluding grants, of 4.9 percent of GDP), to the extent that cash budgetary grants plus debt stock cancellation or debt swaps[11] exceed the assumed baseline of PRs 10 billion.

20. **Monetary policy will remain cautious in order to meet the inflation objective**. In view of a possible sustained increase in money demand, the authorities have set the annual targets for broad money and reserve money growth slightly above the projected nominal GDP growth. In light of the fiscal targets, this would allow for a significant increase in credit to the private sector. Given the uncertainty whether recent developments provide sufficiently firm evidence of a sustained shift in money demand, the authorities concurred on the need to closely monitor inflation developments and prospects, and to stand ready to respond to any reemergence of inflationary pressures by stepping up liquidity absorption. The authorities will continue their flexible exchange rate policy and calibrate foreign exchange purchases so as to meet the reserves target. Credible exchange rate flexibility will be all the more important given the various exogenous risks, including the risks of a change in investors' sentiment leading to pressures for private capital outflows. While technical work toward the planned move to an inflation-targeting framework has yet to gain momentum, an important first step will be the planned amendments to the SBP act so as to increase the central bank's independence, in line with the February 2001 Safeguards Assessments recommendations.

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[10] Abstracting from these exceptional outlays for this and the next fiscal year, the underlying trend would be defense outlays that are broadly constant in real terms.

[11] The cancellation of debt principal (including through swaps) would be recorded as increased amortization in external financing, and an offsetting capital grant above the line, consistent with GFS. To the extent additional I-PRSP expenditure are not financed by excess cash grants, increased domestic financing would be required.

B. Key Structural Issues

21. The authorities have formulated a **structural reform agenda through end-2002 that focuses on a broad range of governance issues**, in particular in the areas of tax administration, fiscal and I-PRSP monitoring and transparency, privatization, and accountability in the public enterprise sector (MEFP, paras. 14–19).

Tax administration

22. **The comprehensive tax administration reform designed in the last two years, in consultation with FAD and the World Bank, is gathering momentum (MEFP, para. 14).** The thrust of the reform is to reorganize CBR business procedures around the functional integration across taxes, establishing arm's length in dealing with taxpayers through computerization and self-assessment, and strengthen the incentive system and personnel management to increase efficiency and reduce corruption. Among the next steps, the Large Taxpayer Unit (LTU) in Karachi is expected to commence operations on July 1, 2002, followed by a pilot modern income tax office for small and medium taxpayers in Lahore by end-October 2002. Business procedures, human resources management, and automation are being enhanced with the support of World Bank-financed consultants. Further technical assistance from FAD is likely to be requested in the areas of the LTU, customs administration, and in revising sales tax and customs refunds rules and procedures to reduce the incidence of incorrect claims and payments. As a corollary to the new Income Tax Ordinance, universal self-assessment will be implemented for all taxpayers and income earned from July 1, 2002 onwards. In preparation, new bookkeeping rules have been prepared, a taxpayer education campaign is under way to promote their use, and the audit process is being further strengthened to avoid that the reform leads to underreporting of income. A streamlined income and sales tax appeals and dispute resolution process will also become effective on July 1, 2002.

I-PRSP implementation, public expenditure management, and fiscal transparency

23. **The authorities are working closely with the World Bank, the U.K. Department for International Development (DFID), and other donors to improve monitoring of I-PRSP expenditure, intermediate social indicators, and final outcomes**. The recently established I-PRSP secretariat will institutionalize the monitoring of I-PRSP implementation and progress in preparing the full Poverty Reduction Strategy Paper (PRSP). Baseline data and a monitoring framework for intermediate poverty indicators are being developed with DFID and World Bank support, to be ready by end-2002. The authorities will already earlier start reporting quarterly on three intermediate outcome indicators, as well as on various social safety net indicators. A World Bank-supported public procurement reform as well as other measures aimed at improving governance, such as the reform of the police and the judiciary under an AsDB-supported program, should further increase the productivity of public expenditure and reduce rent-seeking. The authorities are studying recent Transparency International (TI) recommendations for further initiatives in this area.

24. **On fiscal transparency and data quality, the authorities remain committed to implementing measures in line with the Accountable Fiscal Management Framework (AFMF).**[12] As a first step toward the adoption of the GFS-consistent New Accounting Model (NAM) at all levels of government, the 2003/04 budget call will be made on the basis of the NAM, in parallel with the old accounting model, for the federal government and the North West Frontier Province (NWFP). Two World Bank-financed provincial structural adjustment loans aim to support, inter alia, enhanced fiscal transparency at the provincial level (MEFP, para. 15). Transparency will also be increased at the federal level by explicitly including in the budget, starting in FY 2003/04, the subsidy to fertilizer producers implicit in below-market feedstock gas prices.

25. **Pension reforms have remained behind expectations.** The authorities indicated that, due to difficulties in obtaining actuarial expertise, the establishment of a contributory pension scheme for new recruits in the civil service and the preparation of a third phase public pension reform package would be delayed. The authorities now hope to establish an actuary cell in the Ministry of Finance by end-2002 and push ahead with the preparation of a contributory pension system for new civil service entrants, with support from the World Bank.

Poverty impact analysis

26. The poverty impact of recent reforms, such as the elimination of the sales tax exemption on pharmaceuticals (excluding life-saving drugs) and the increase in gas prices, has likely been limited because of relatively low consumption and, in the case of gas, limited connectivity of poor households.[13] However, the planned increase in electricity tariffs and the elimination of the sales tax exemption for vegetable ghee could affect poor households more significantly because of larger shares in consumer baskets, and, in the case of electricity, more widespread connectivity.[14] The staff has therefore urged the authorities to combine the implementation of these measures with appropriately targeted measures for poor households, while protecting the lowest electricity consumer segment as much as possible from the planned price rise. More generally, with Fund staff involvement, the World Bank is currently undertaking an assessment of the impact of energy sector price rises on the poor and vulnerable.[15]

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[12] See Box 2 in EBS/02/43 for a detailed description.

[13] According to a recent World Bank estimate, only 11 percent of poor households use gas. Also, as indicated above, the tariff for the lowest consumer slab was left unchanged when gas prices were raised in March.

[14] The World Bank has estimated that 52 percent of poor households are connected to the electricity grid.

[15] This assessment is supported by a poverty and social impact analysis undertaken by DFID, which has selected Pakistan as one of several country pilot studies. This analysis focuses primarily on the energy sector, and concentrates on NWFP. The World Bank is furthermore completing a comprehensive poverty assessment.

Privatization and public enterprise reform

27. **The authorities remain determined to implement their privatization agenda, and have scheduled major operations for this summer**. KESC's financial restructuring and the complementary regulatory reform needed to attract investors are on schedule for bringing the power utility to the point of sale by end-July 2002.[16] The authorities also plan to sell their stakes in Pak-Arab Fertilizers, Pakistan State Oil (the country's largest oil marketing company), the Oil and Gas Development Company Limited (a large oil and gas producer), and Habib Bank over the summer/early fall. While the authorities are confident that there is strong interest for the oil/gas-related enterprises, they are concerned that the weak financial position of the international telecom sector, along with security concerns, could weaken investors' interest for PTCL and KESC, and complicate the work of the financial advisors and the planned investor road shows.

28. **The authorities have started to implement the medium-term financial improvement plan for WAPDA discussed with the World Bank (MEFP, para. 17)**. This plan calls for another structural tariff increase by mid-July, improvements in billing and collection, and reduction of leakage and theft (see Box 3). To ensure implementation and enhance WAPDA's accountability, the authorities will translate the plan into quarterly performance targets and determine which institution, following the breakup of WAPDA into 13 separate power generation, transmission, and distribution companies, will be held responsible for monitoring and reporting on the results. The planned monitoring, in close collaboration with the World Bank, will involve quarterly published progress reports on implementation starting in November 30, 2002 for the quarter July–September 2002. Better public information on the financial constraints facing WAPDA, the trade-offs involved, and actual performance should help in increasing public understanding for the rationale of the reform, while enhancing accountability of WAPDA's management.

Financial sector and exchange system reform

29. As detailed in the MEFP (para. 19), **banking sector reform and the modernization of prudential regulation are moving ahead**. The authorities confirmed that they will pursue an evolutionary approach to introducing Islamic Finance, as set out in the November 2001 MEFP, and are seeking approval of this approach from the Supreme Court, in light of the earlier judgment mandating a move to Islamic Finance by end-June 2002. The Supreme Court has started hearings on the issue in early June. The recently chartered first purely Islamic Bank has been brought under SBP prudential supervision. The authorities expressed disappointment about repeated delays in the planned IMF/World Bank FSAP mission (which reflect security considerations), indicating that they were looking forward to its advice, especially in the following areas (a) anti-money laundering rules and the fight against terrorism financing; (b) further modernization of the prudential framework, including for

[16] In this context, the government will likely have to settle additional KESC debts outstanding at the time of privatization, which may reach up to PRs 11 billion.

Box 3. The Water and Power Development Authority's Financial Improvement Plan

Water and Power Development Authority (WAPDA) is one of Pakistan's two public sector power utilities (the other is Karachi Electric Supply Corporation). It was created in 1958 for the development and use of water and power resources. WAPDA's Power Wing (henceforth referred to as WAPDA) is a vertically integrated electric power utility supplying the entire country, except the Karachi area which is serviced by Karachi Electric Supply Corporation (KESC). WAPDA owns 11 thermal power generation stations, with a total capacity of about 5,000 MW, approximately equivalent to its total installed hydropower capacity.

WAPDA's financial performance has been shaky over the past years and has sharply deteriorated in FY 2001/02. This year's cash shortfall is expected to be close to PRs 30 billion (about 0.8 percent of GDP) and will eventually be borne, to a large extent, by the budget in the form of deferred debt service payments. According to the World Bank,[1/] this poor financial performance is attributable to (a) weak bill collection, including from the public sector; (b) high levels of transmission and distribution losses (about 25 percent of units generated or purchased), due to theft and leakage; (c) inadequate tariff adjustments, which did not reflect increased fuel prices in 1999–2000; (d) increasing purchases from independent power producers, including payments for large unused generation capacity; and (e) the decline in the share of (cheaper) hydro power generation as a result of the current drought.

Over the past decade, the government has tried to comprehensively reform WAPDA to increase its efficiency through competition, accountability, managerial autonomy, and market incentives. The reform process gained momentum from 1998 on with (a) a financial restructuring entailing tariff increases in 1998–99 and a large debt-for-equity conversion of WAPDA's debt service liabilities to the government; (b) the appointment of a new management team entrusted with the responsibility of improving governance and efficiency; (c) the launching of a corporatization process, with the unbundling of WAPDA in one transmission, eight distribution, and three generation companies; and (d) an improved regulatory framework, with in particular the adoption of a formula-based tariff adjustment for fuel costs. These measures were, however, implemented rather slowly and sometimes not consistently.

Recent developments led the authorities to devise, with the assistance of the World Bank, a Financial Improvement Plan (FIP) for the period 2002–2004 whose ultimate goal is to restore WAPDA's financial viability. The main elements of this strategy are (a) a substantial structural tariff increase (below) by July 2002; (b) full and timely implementation of the fuel adjustment clause; (c) limiting progression of WAPDA's administrative expenses; (d) a reduction in technical and nontechnical losses by 1.5 percentage point each year; (e) improvements in billing and collection, so as to contain the amount of receivables from all consumers (including government entities); and (f) the coming on line of the major Ghazi Barotha hydropower project in FY 2003/04. Under the FIP, WAPDA's deferred debt service liabilities to the government would be converted into equity in FY 2002/03. The government would also settle KESC's arrears to WAPDA and make sure that all other public sector dues be cleared during FY 2002/03.

Under these assumptions, and also based on oil prices at their December 2001 level, implementation of the FIP would allow WAPDA to service all its debt to the government and to do without any budgetary support. The overall financing gap would be brought down to about PRs 5 billion in FY 2002/03 (and possibly covered by bank borrowing), and an overall net cash surplus is expected for FY 2003/04.

One central element of the FIP is a structural tariff increase, which would yield about PRs 23 billion on a full year basis. WAPDA has filed a petition with NEPRA requesting a PRs 0.88 per kWh increase. On May 15, 2002 NEPRA allowed an interim average tariff increase of PRs 0.08 per kWh as well as the implementation of the formula-based fuel cost adjustment which had been delayed since April 1 (an additional PRs 0.045 per kWh increase). Public hearings on the petition took place in late June 2002, and a decision is expected to be announced in July 2002.

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[1] See, for instance, Report No. 23847—PAK on the second Structural Adjustment Credit.

Islamic banking; and (c) phasing out of the remaining directed credit and special refinancing schemes (agriculture, domestically produced equipment goods, and exports). The mission emphasized the need to move ahead on all these areas even without an FSAP, and in close consultation with the Fund. The authorities intend to eliminate soon administrative restrictions on the setting of interest rates on foreign currency deposits, and further link the interbank foreign exchange market to the "free" market, reducing the need of the SBP to purchase reserves from large money changers in the Gulf.

Other structural reforms

30. The mission expressed disappointment at the slower-than-expected disengagement of the government from agricultural commodity trading. Although the private sector has been slow in taking over this activity, the government's current role entails significant costs to the budget, either directly through subsidies to the commodity trading boards, or indirectly through guarantees on bank loans by these boards that might eventually be called. The recent incentive package to stimulate private sector marketing and storage, while perhaps needed to overcome private sector hesitation, should be made strictly time-bound, an occasion of the next review of the package.

IV. Statistical Issues

31. The staff urged the authorities to devote sufficient resources to fulfill earlier commitments to improve the quality and dissemination of statistics. The project to revise and change the base year of national accounts appears broadly on track, with the notable exception that new producer price indices have not yet been published. The authorities still aim at publishing the new version of the national accounts in September 2002. Administrative capacity constraints delayed the implementation of the planned steps toward improvement in statistical data dissemination outlined in the March 2002 MEFP, but the authorities are committed to implement them by June 30, 2002. An institutional reform plan for the statistical system should be ready by mid-2002, aiming to merge the main statistics producers to improve coordination and to strengthen the autonomy of the statistical system, which is currently perceived by the public as insufficiently protected from political pressures. Significant progress has been made in the area of external debt data management (DMFAS), including the completion of implementing data on a loan-by-loan basis, and increased capacity to project future debt service.

V. External Financing of the Program

32. In line with the revised balance of payments projections, the program for the current fiscal year and next appears fully financed (Table 6). Net exceptional financing in FY 2002/03 is projected to decrease to about US$3.3 billion, mainly reflecting lower rollover of foreign deposits with the banking system. Net exceptional financing in the form of rescheduled debt payments and program financing from the International Financial Institutions (IFIs) would be roughly stable at US$2.6 billion. The authorities reported that they have not yet finalized bilateral agreements with the Paris Club creditors and that they

were studying options to secure comparable treatment from other creditors. They expect US$100 million of exceptional financing from the private sector in FY 2002/03, possibly through restructuring of loans from the foreign branches of the nationalized banks. On the basis of the current balance of payments projections for FY 2002/03, and in particular given the much higher official reserve levels for June 2003 than originally programmed, the authorities concurred with the staff that there was no need at this stage to consider an augmentation of access under the PRGF. However, augmentation could still be discussed in the future, in the event of major deviations from the program path due to exogenous shocks.

VI. Program Monitoring

33. Proposed prior actions, quantitative and structural performance criteria and indicative targets, and structural benchmarks are specified in the MEFP (see also Box 4). A revised TMU updates various definitions and strengthens reporting requirements, and will apply effective from July 1, 2002, the beginning of the new fiscal year. In view of the uncertainties surrounding Pakistan's economic outlook, the program will continue to be monitored through quarterly reviews. The third review is expected to take place by end-September 2002.

VII. Staff Appraisal

34. **The authorities deserve credit for consolidating gains in macroeconomic stability in a difficult economic and political environment, while pursuing substantive structural reform.** Barring an escalation of regional tension, prospects for achieving the real growth target for FY 2001/02 under the program appear good, the rate of inflation remains slightly lower than expected, and external balances are improving far more than programmed. This outcome reflects prudent public expenditure policies and favorable exogenous factors that helped in containing the budget deficit; a monetary and exchange rate policy mix well geared toward the inflation and reserves objectives; and strong external support. Progress in reforming tax administration and in privatization has been encouraging. **Disappointments include notably continued below-target performance in tax collection and social spending, while defense outlays were increased in response to regional tensions.** So far, low social spending largely reflects start-up problems of the recently established district and municipal governments, while tax shortfalls reflect lower-than-expected imports and only limited gains from CBR administrative reform. Encouragingly, both revenue and social spending have improved in recent months, indicating that tax performance may finally be turning around and that local governments are overcoming their teething problems. Nonetheless, addressing these two issues must be at the core of policies for the next year. Another disappointment is the temporary lowering of petroleum taxes and delays in the automatic fuel cost adjustment of electricity tariffs during April/early May. The staff recognizes the difficult socio-political circumstances during the run-up to the presidential referendum in late April that motivated these decisions, but these measures may have re-politicized the setting of petroleum and electricity prices and weakened the credibility of the commitment to let market forces operate freely, which had been an important achievement of reforms in recent years.

Box 4. Structural Conditionality [1]

1. Coverage of structural conditionality in the PRGF program for FY 2002/03

Most of structural conditionality for FY 2001/02 has been met so far. Structural conditionality for FY 2002/03 is detailed in Table 2 of the MEFP. The focus remains on tax policy and tax administration reforms, public expenditure management reforms and fiscal transparency, all considered essential to the success of the government's growth and poverty reduction strategy. Particular emphasis is also given to public enterprise monitoring, because improving the financial situation of some of them, particularly WAPDA, is critical for achieving the targets for public finances. For similar reasons, the privatization of KESC, which is being pursued in the context of an energy sector reform program supported by the AsDB, is a structural performance criterion. Failure to privatize KESC could undermine medium-term fiscal consolidation. The program includes other measures to further liberalize the financial system and to strengthen central bank autonomy in line with the Safeguards Assessment recommendations.

2. Status of structural conditionality from earlier programs

Virtually all structural measures included in the Stand-By Arrangement, which expired in September 2001, were implemented. A benchmark on the establishment of best practice anti-money laundering rules was missed because of a postponement in the scheduled FSAP mission, that was expected to provide technical advice. The benchmark on the reconciliation of provincial expenditure was only partially met because of limited institutional capacity in managing both the devolution initiative and revising accounting procedures to include the newly created district administrations. The structural reform program in the PRGF program include a series of steps to improve expenditure reconciliation over the program period.

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

World Bank program lending for FY 2001/02, as for the previous fiscal year, was delivered under a one-tranche Structural Adjustment Credit. Disbursement was conditional on: (a) accelerating power sector reforms with a view to restore the sector's financial viability; (b) revamping the tax administration system to improve governance and increase revenues; (c) improving the policy framework in the oil and gas sectors to attract domestic and foreign investment; (d) improving the effectiveness in the delivery of social services through civil service reforms, and enhanced transparency and accountability in the use of public resources; (e) accelerating the implementation of the Education Sector Reforms Action Plan and the National Health Policy; and (f) establishing monitoring and evaluation systems to assess progress in the implementation of the Poverty Reduction Strategy. Conditionality related to the restructuring of three nationalized banks is part of a banking sector project loan approved in October 2001. Fiscal transparency at the provincial level should be enhanced through two provincial structural adjustment loans currently under discussion.

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

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[1] Updated from EBS/02/43.

35. **Building on the progress in stabilization, the authorities have formulated a policy package for FY 2002/03 that further deepens reforms critical for Pakistan's growth and poverty reduction objectives**. Provided the package is implemented with determination, the staff would see it as a major step toward achieving the central objectives under Pakistan's I-PRSP, notably a strong **turnaround in public debt dynamics**, a meaningful **shift in public expenditure toward human development**, and substantive progress in **tackling a host of governance issues**, especially in the area of tax administration, expenditure control, public service delivery, and management of the public enterprise sector.

36. **On the macroeconomic side, staff welcomes the planned policy mix of a continued flexible exchange rate, a tight monetary policy geared toward maintaining low inflation, and strong fiscal adjustment**. The planned budget for FY 2002/03 should leave ample room for private sector credit, provided public wheat and cotton procurement is reduced as planned, and public enterprise credit remains under tight control. The budget needs to include a set of safety net measures to help shield the real incomes of poor and low-income households from the impact of the planned electricity tariff increase and elimination of GST exemptions. The monetary authorities will have to keep developments under close watch, given the uncertainty as to whether the recent decline in velocity is a temporary or sustained phenomenon, while sustaining a strong pace of interbank purchasing of foreign exchange to meet the reserves objectives. The recent appreciation of the Pakistani rupee may not represent a move toward a sustainable equilibrium, and while respecting the market-determination of the exchange rate, the authorities may want to use the timing and amount of purchases to remind market participants that the authorities are not underwriting any particular level or range of the exchange rate. With the rising tensions in the regions, a sudden loss of confidence cannot be ruled out, and while some use of reserves could be reasonable, the burden of the adjustment would have to be carried by a mix of tighter financial policies and exchange rate adjustment.

37. **Achieving the planned fiscal adjustment will require strong political willingness to enforce tax collection**. Staff urges the authorities to implement fully and on time the planned steps toward establishing a broader tax base and reducing the scope for rent-seeking, such as the elimination of various tax exemptions, the introduction of universal self-assessment for income tax, and the launching of pilot offices to test modern tax administration. As the disappointing performance of the agricultural income tax underscores, beyond that legal and regulatory reform forceful implementation at the field level is required. Staff also urges the authorities to further strengthen the sales tax and customs duty refund system in consultation with World Bank and Fund staff, in order to reduce room for discretion and fraud. Meeting the revenue target for FY 2002/03 will depend heavily on the expected recovery of growth and imports. Should these not materialize, the authorities will have to take timely contingency measures on the revenue side, notably accelerating the harmonization of petroleum taxation.

38. **The other pillar of the planned fiscal adjustment is meaningful reform of WAPDA and KESC, to stop the drain from these two companies on the budget**. Staff urges the authorities to press ahead with the privatization of KESC, and put the complementary reforms in place to provide investors with sufficient regulatory certainty. Given the socio-political and security-related uncertainties, the authorities may also need to be ready to prepare a contingency plan in case no credible investors were to bid for KESC. A structural electricity tariff increase to absorb the fuel cost run-up during 1999–2000 is also urgently needed, as acknowledged in WAPDA's and KESC's tariff filings. Such a measure will undoubtedly face stiff domestic political resistance and will constitute an important test of the government's willingness to stick to unpopular but necessary measures. To some extent, the public will rightly see the increase as paying for limited progress in eliminating theft and leakage and ensuring full bill collection—which in turn may be partly related to insufficient support by law enforcement agencies, for example in the tribal areas. It is, in the staff's view, imperative that the financial improvement plan agreed with the World Bank be monitored quarterly with performance reports to be published, and that WAPDA and its successor entities be clearly held accountable for performance. It will also be key to design the planned significant tariff increase in a manner consistent with the government's poverty alleviation objectives. Beyond the power sector, accountability of public enterprises needs to be improved more generally, and staff welcomes the authorities' commitment to reinforce monitoring of credit to all public enterprises and monitor the implementation of restructuring strategies for major enterprises.

39. **To address the country's huge "social gap", much greater priority needs to be given to human development**. The key building block to ensure that money for human development is spent responsibly is now in place, with elected local governments in charge of setting priorities and monitoring the use of funds. The planned FY 2002/03 budget rightly calls for a strong increase in public spending on human development. Resource allocation between the federal level, provinces, and districts will need to be further redesigned to protect key social spending, with World Bank loans tied to provincial adjustment programs acting as useful catalyst. With higher spending on social services, ensuring greater efficiency has become even more important. Staff welcomes therefore progress toward establishing better monitoring of spending and related intermediate outcomes in consultation with DFID and other donors.

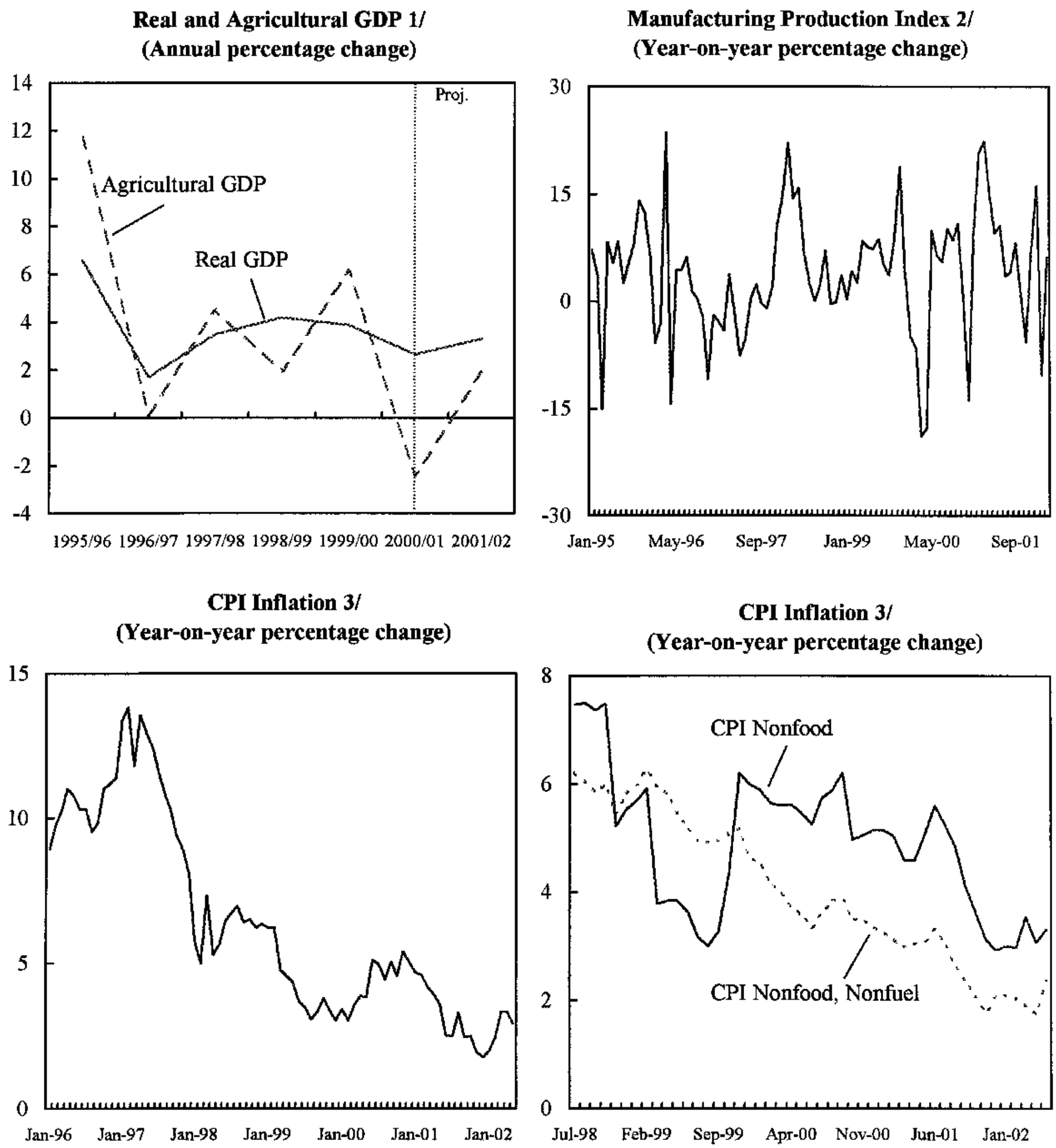
40. **The staff welcomes Pakistan's progress in improving governance, transparency, and data quality in public finances**. Improvements in the reconciliation of public expenditure at both the federal and provincial levels are encouraging, but most importantly the authorities need to ensure that the operations of the new local governments are clearly accounted for. The staff urges the government to implement FAD recommendations on introducing an accountable fiscal monitoring framework, and embody its key elements in a fiscal responsibility law as the standard of governance in this area. Staff looks forward to completion of the work on new National Accounts and Producer Price series later in the year, and some modest first steps toward meeting higher data dissemination standards. Finally, staff welcomes the authorities' commitment to promulgate by October 2002 amendments to

the SBP act that will strengthen central bank autonomy, in particular in the area of reserve management, as recommended under the recent Safeguards Assessments exercise.

41. **The risks to Pakistan's economic reform program have strongly risen in recent weeks, mostly because of the increasingly tense stand off with India and isolated terrorist attacks**. A further escalation of tension into large-scale hostilities would likely compromise any prospect of implementing the reform program. Even if contained at current levels, recent security-related developments present significant risks for the ability to maintain control over defense spending and achieve the planned pro-poor expenditure restructuring. The incipient recovery of business confidence and export demand, and thereby the achievement of already ambitious growth and revenue targets, would also be at risk. In addition, security concerns may weaken the government's ability to implement some of the more difficult reforms related to the pursuit of fiscal adjustment and utility reform, especially in light of a changing political environment, as Pakistan edges closer to parliamentary elections. Third, administrative capacity remains constrained and reforms that are not of immediate urgency may be in danger of being delayed.

42. **Barring an escalation of current tensions with India into military conflict, and in view of Pakistan's track record over the last two years, staff remains confident that the government will be able to hold the program broadly on course**. Over the past two years, the government has established a solid record in adhering to the fiscal deficit targets and implementing its structural reform program. Strong reserves and a flexible exchange rate should help cushion the impact of limited additional shocks. The commitment to adopt, as prior action, a federal budget for FY 2002/03 consistent with the financial framework under the PRGF program, along with other key structural measures, minimizes uncertainty. The process of quarterly reviews provides additional assurance that an adequate response to unforeseen events will be developed quickly. Given that the cause of the revenue shortfalls through March was largely exogenous; that a number of tax measures were taken during April–June to strengthen revenue; and the fact that the deviation was minor as all other macroeconomic targets have been achieved, staff recommends the granting of the requested waiver to allow completion of the second review under the PRGF arrangement.

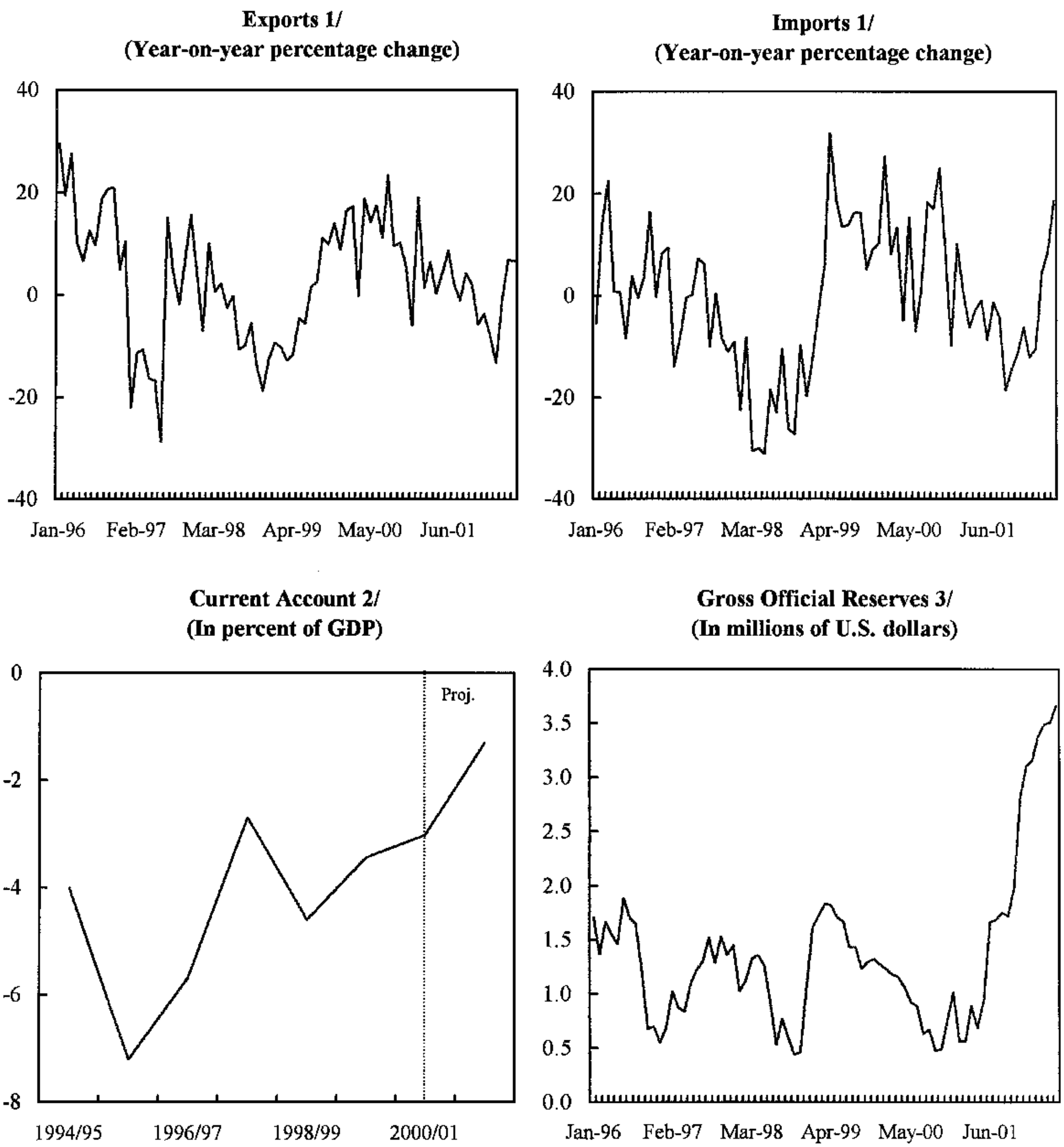
Figure 1. Pakistan: Output and Inflation, 1995/96–2001/02



Source: Data provided by the Pakistani authorities.

1/ Last observation: projection for 2001/02.
2/ Last observation: March 2002.
3/ Last observation: May 2002.

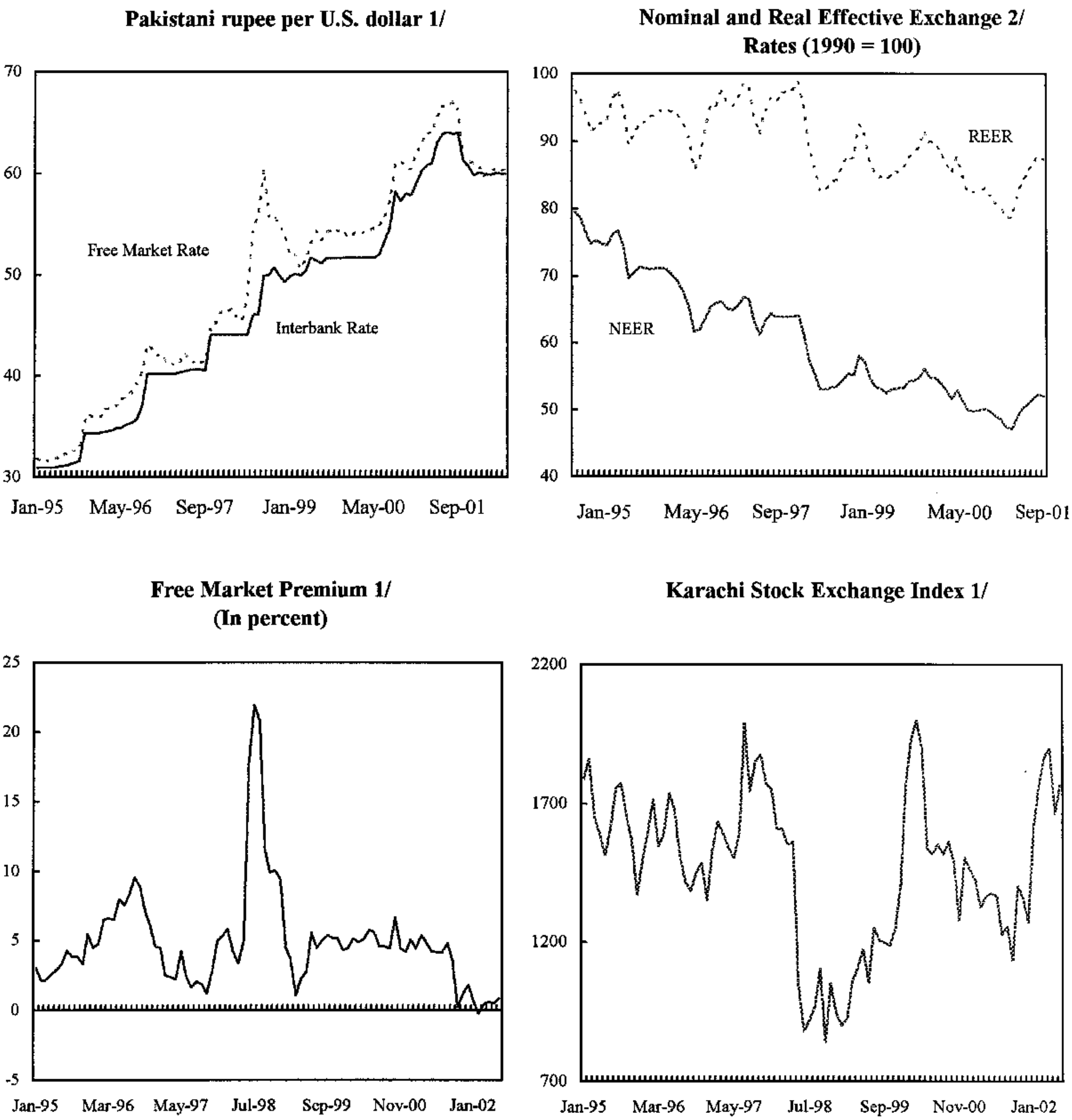
Figure 2. Pakistan: External Sector Developments, 1994/95–2001/02



Source: Data provided by the Pakistani authorities.

1/ Customs basis. Last observation: May 2002.
2/ Excluding official transfers. Last observation: projection for 2001/02.
3/ Excluding gold, short-term swap, and forward commitments. Last observation: May 2002.

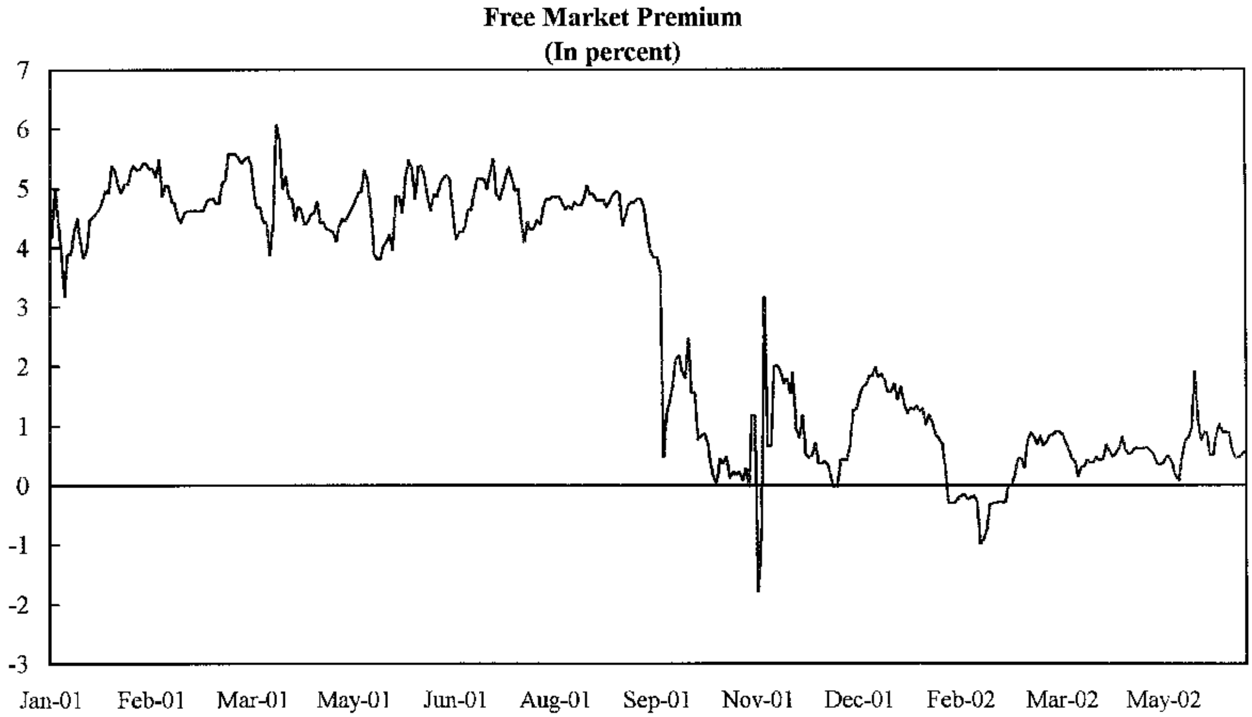
Figure 3. Pakistan: Exchange Rate and Stock Market Developments, 1995–2002

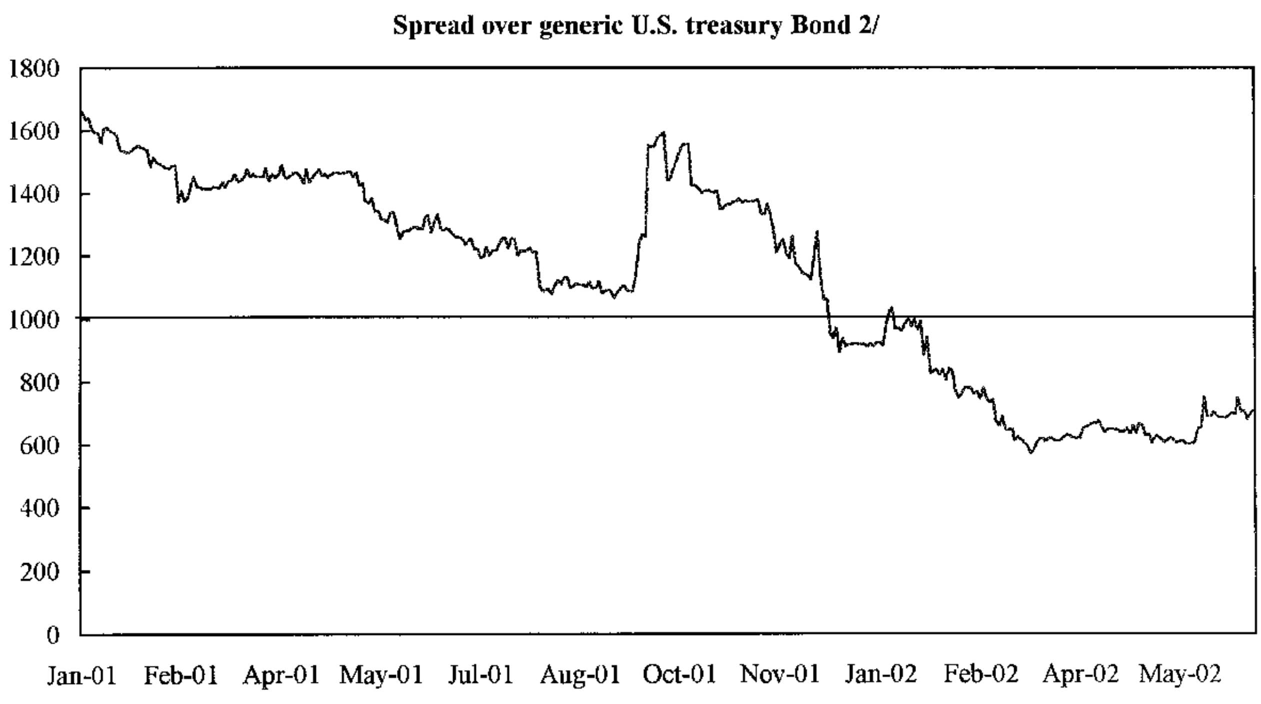


Source: Data provided by Pakistani authorities; and Fund staff estimates.

1/ Last observation: June 14, 2002.
2/ Last observation: March 2002.

Figure 4. Pakistan: Recent Financial Market Developments 2001–2002 1/



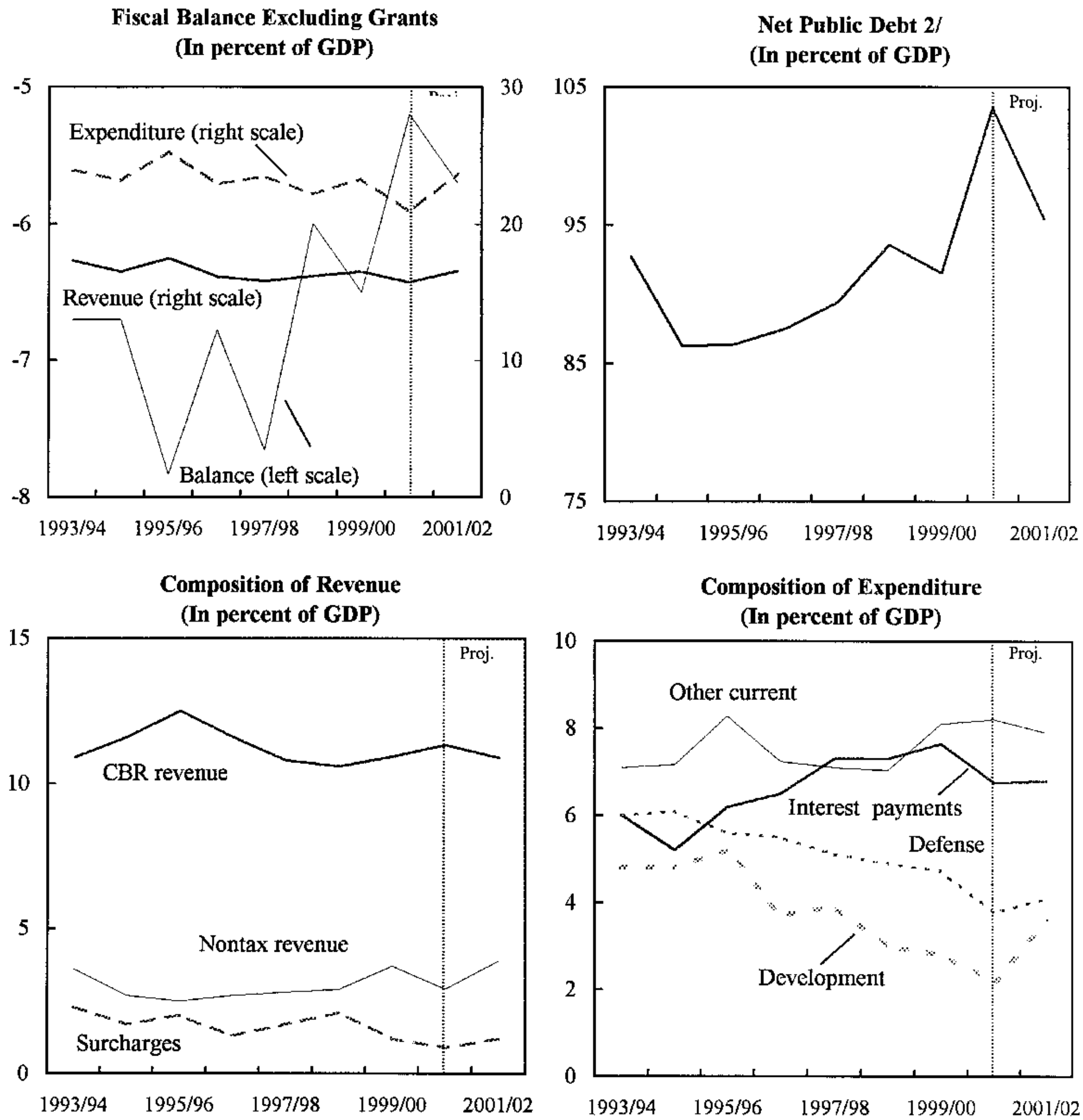


Source: Data provided by Pakistani authorities; and Datastream.

1/ Last observation: June 14, 2002.

2/ Calculated for Pakistan Islamic Republic 10 percent bond maturing on December 13, 2005.

Figure 5. Pakistan: Fiscal Developments, 1993/94–2001/02 1/

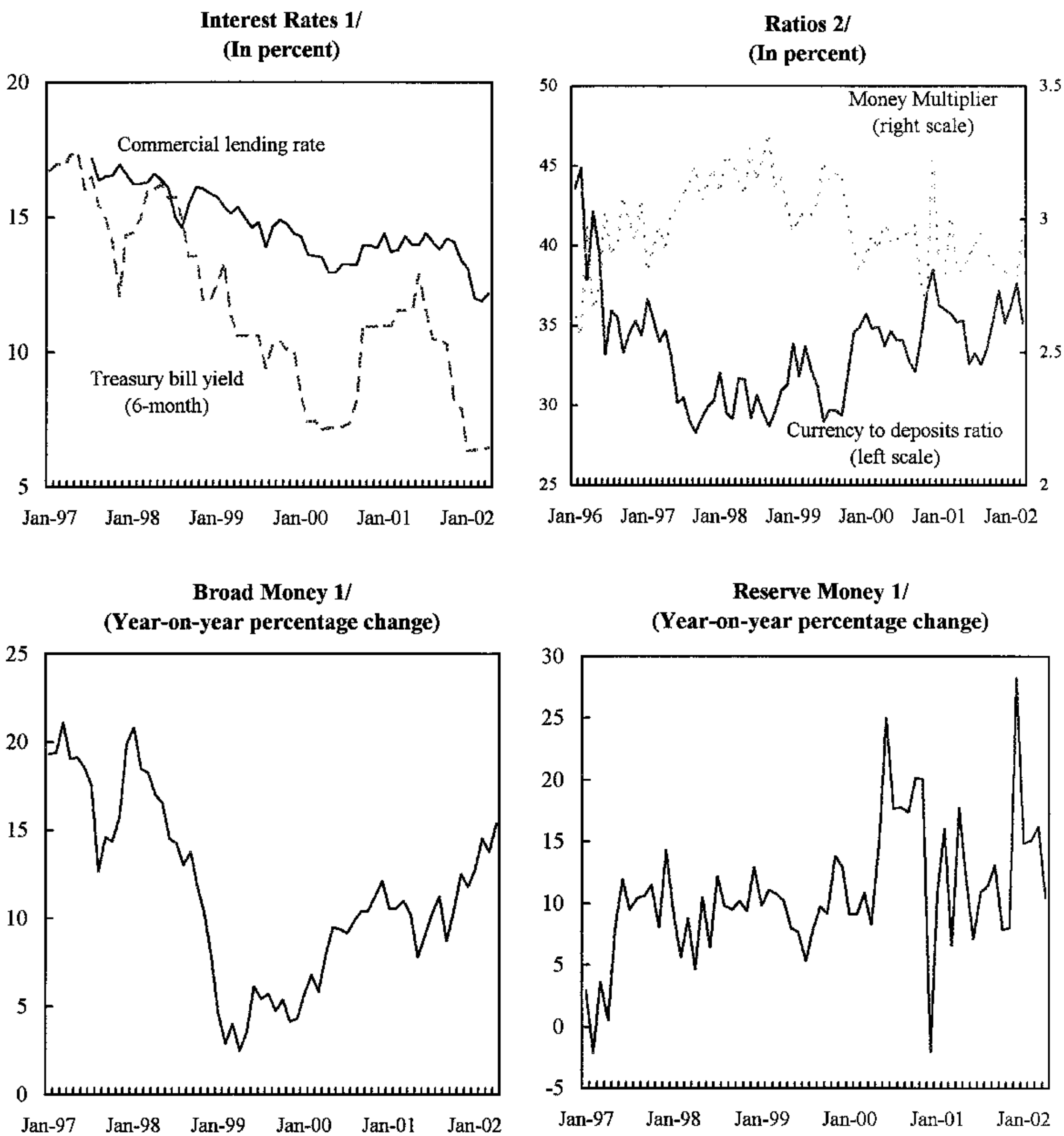


Source: Data provided by the Pakistani authorities.

1/ Last observation: projection for 2001/02.

2/ Net public debt is the sum of net domestic government debt and external public- and publicly-guaranteed debt.

Figure 6. Pakistan: Monetary Developments, 1996–2002



Source: Data provided by the Pakistani authorities.

1/ Last observation: April 2002.
2/ Last observation: March 2002.

Table 1. Pakistan: Selected Economic and Financial Indicators, 1999/2000–2003/04 (Continued)

	1999/2000	2000/01	Prog. 2001/02	Rev. Proj. 2001/02	Proj. 2002/03	2003/04
	(Annual changes in percent)					
Output and prices						
Real GDP at factor costs	3.9	2.7	3.3	3.3	4.5	5.0
Real GDP at market prices	4.4	3.4	3.4	3.3	5.0	5.3
Partner country demand	4.0	3.2	1.5	1.5	2.5	3.8
Consumer prices (p.a.)	3.6	4.4	3.0	2.7	3.9	4.0
Consumer prices (end-of-period)	5.1	2.5	3.5	3.5	4.0	4.0
Pakistani rupees per U.S. dollar (p.a.)	3.0	12.8	...	...	...	...
	(In percent of GDP)					
Savings and investment						
Gross national savings	13.7	13.0	15.4	16.2	16.0	15.8
Government	-3.6	-1.7	0.2	0.2	0.4	1.0
Nongovernment 1/	17.3	14.8	15.2	16.0	15.6	14.8
Gross capital formation	15.6	14.7	15.2	15.2	16.8	17.6
Government	3.2	2.7	3.4	3.4	3.6	3.8
Nongovernment 1/	12.4	12.0	11.8	11.8	13.2	13.8
	(In percent of GDP)					
Public finances						
Budgetary revenue (excluding grants)	16.5	15.7	16.9	16.6	17.2	17.4
Budgetary expenditure 2/	23.0	20.9	22.7	22.3	21.7	20.8
Budgetary balance (excluding grants) 2/	-6.5	-5.2	-5.7	-5.7	-4.4	-3.5
Primary balance (excluding grants)	1.1	1.6	1.2	1.1	2.1	2.5
Net public debt 3/	91.6	103.5	94.1	95.5	90.5	84.6
Net domestic government debt 4/	42.9	43.3	41.8	44.1	40.6	37.5
Implicit interest rate on public debt (in percent) 5/	8.8	8.1	7.3	7.0	7.5	7.2
	(Annual changes in percent of initial stock of broad money)					
Monetary sector 6/						
Net foreign assets	2.0	5.1	3.4	9.5	5.3	...
Net domestic assets	7.4	3.9	5.7	3.9	4.8	...
Of which: credit to the private sector	1.4	3.6	5.1	2.7	5.5	...
Of which: net claims on the government 2/	5.1	-3.3	-2.1	-0.2	-1.8	...
Broad money	9.4	9.0	9.1	13.4	10.2	...
Six-month treasury bill rate (in percent, p.a.)	8.6	10.4	...	...	...	...
	(In percent of GDP)					
External sector						
Merchandise trade balance	-2.3	-2.1	-1.4	-1.4	-1.5	-1.4
Merchandise exports	13.3	15.0	14.9	14.8	15.2	15.4
Merchandise imports	15.6	17.1	16.4	16.2	16.7	16.8
Current account excluding official transfers	-3.4	-3.0	-2.3	-1.3	-2.3	-2.3
Current account including official transfers	-1.9	-1.6	0.2	1.0	-0.8	-1.8

Table 1. Pakistan: Selected Economic and Financial Indicators, 1999/2000–2003/04 (Concluded)

	1999/2000	2000/01	Prog. 2001/02	Rev. Proj. 2001/02	Proj. 2002/03	Proj. 2003/04
	(In percent of exports of goods and services)					
External public- and publicly-guaranteed debt	310.7	318.4	316.9	292.4	280.9	263.8
Debt service 7/	47.7	24.9	36.5	37.5	36.9	31.4
Implicit interest rate (in percent) 8/	4.9	4.4	4.3	4.4	4.8	4.8
Gross reserves (in millions of U.S. dollars) 9/	908	1,679	2,647	3,549	4,182	4,960
In weeks of next years' imports of goods and services	3.8	7.2	11.0	14.1	15.5	17.3
In percent of short-term external debt 10/	10.9	25.0	63.4	58.3	87.0	120.9
Memorandum items:						
ICOR, three-year moving average	4.7	4.8	4.5	4.6	3.7	3.3
Real effective exchange rate (percentage change)	-0.6	-2.6	...	...	...	...
Terms of trade (percentage change)	-9.2	-1.6	0.3	0.2	1.6	2.1
Real per-capita GDP (percentage change)	2.2	1.2	1.1	1.0	2.7	2.9
GDP at market prices (in billions of Pakistani rupees)	3,183	3,472	3,695	3,686	4,023	4,406

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

1/ Includes public sector enterprises.

2/ Excluding KESC recapitalization and CBR bonds.

3/ Defined as the sum of net domestic government debt and external public- and publicly-guaranteed debt.

4/ Gross domestic government debt, including U.S. dollar bonds (except for the column "Prog. 2001/02"), net of government deposits with the banking system.

5/ 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.

6/ Revised program data for 2001/02 and projections for 2002/03 are evaluated at program exchange rates.

7/ Including interests on short-term debt.

8/ 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.

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

10/ Short-term debt is defined on the basis of remaining maturity.

Table 2. Pakistan: Balance of Payments, 2000/01–2003/04

(In millions of U.S. dollars)

	2000/01	Q1–Q3 Prel. 2001/02	Q4 Rev Proj. 2001/02	Prog. 2001/02	Rev. Proj. 2001/02	Proj. 2002/03	Proj. 2003/04
Current account (excluding official transfers)	-1,807	3	-814	-1,364	-811	-1,434	-1,550
Current account balance (including official transfers)	-968	1,189	-590	127	599	-497	-1,191
Trade balance	-1,268	-276	-590	-866	-866	-931	-976
Exports f.o.b.	8,934	6,628	2,275	8,914	8,903	9,633	10,403
Imports f.o.b.	-10,202	-6,904	-2,865	-9,780	-9,769	-10,564	-11,379
Services (net)	-2,999	-1,796	-883	-2,957	-2,679	-3,063	-3,119
Of which: interest payments	-1,478	-1,074	-537	-1,543	-1,611	-1,622	-1,609
Private transfers (net)	2,460	2,075	660	2,459	2,735	2,560	2,545
Official transfers (net) 1/	839	1,185	224	1,491	1,410	937	359
Of which: Saudi Oil Facility	683	417	160	609	577	642	107
Of which: additional grant pledges	. . .	673	18	767	690	160	111
Capital account	-767	-1,526	-453	-2,526	-1,979	-1,619	-1,162
Public medium- and long-term capital	-686	-1,006	-442	-962	-1,448	-1,510	-1,139
Project and nonproject loans	-332	-645	-150	-781	-794	-718	-799
Disbursements	1,463	501	219	738	721	660	697
Amortization	-1,795	-1,146	-369	-1,519	-1,515	-1,378	-1,496
Commercial banks and IDB (net)	-76	-157	-67	-224	-224	-158	-33
Other	-278	-205	-225	44	-430	-634	-307
Public sector short-term (net)	-59	-815	-174	-725	-990	-51	-369
Private medium- and long-term	765	-97	-36	-182	-133	78	471
Of which: FDI	322	290	75	355	365	360	450
Private short-term (including errors & omissions) 2/	-788	393	199	-658	592	-136	-125
Overall balance (before debt relief)	-1,735	-337	-1,042	-2,400	-1,380	-2,117	-2,353
Financing	1,735	337	1,042	2,400	1,380	2,117	2,353
Reserve assets (increase -)	-1,088	-2,028	-327	-1,284	-2,355	-898	-998
State Bank of Pakistan (including FE-25s)	-729	-1,855	-98	-1,048	-1,953	-699	-833
Deposit money banks	-359	-173	-229	-236	-402	-199	-165
Fund repurchases	-194	-124	-77	-195	-201	-324	-389
Net exceptional financing	3,017	2,489	1,446	3,878	3,935	3,338	3,739
Arrears (increase +)	-525	0	0	0	0	0	0
Rescheduling 3/	1,587	769	520	1,251	1,289	1,033	1,145
Of which: Private Sector Involvement	0	0	0	0	0	100	200
Rollover of foreign deposits with banking system 4/	1,676	1,097	217	1,189	1,314	500	800
Program financing from IFIs	279	623	710	1,438	1,333	1,605	1,544
World Bank	0	95	600	581	695	705	650
AsDB	0	150	0	370	150	460	453
IMF	279	378	110	488	488	440	442
Privatization receipts	0	0	0	0	0	200	250
Financing gap	0	0	0	0	0	0	0
			(In percent of GDP)				
Memorandum items:							
Current account (excluding official transfers)	-3.0	0.0	-1.4	-2.3	-1.3	-2.3	-2.3
Current account balance (including official transfers)	-1.6	2.0	-1.0	0.2	1.0	-0.8	-1.8
Exports f.o.b. (12-month growth rate, percent)	9.1	0.7	-3.2	-0.2	-0.3	8.2	8.0
Imports f.o.b. (12-month growth rate, percent)	6.2	-11.0	17.3	-4.1	-4.2	8.1	7.7
End-period gross official reserves 5/	1,679	3,486	3,549	2,647	3,549	4,182	4,960
(In weeks of next year imports of goods and nonfactor services)	7.2	13.9	14.1	11.0	14.1	15.5	17.3

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 on through 2001/02.
2/ Includes repayment of foreign currency deposits held in NBFIs and banks (reschedulings shown as exceptional financing).
3/ Includes rescheduling of bilateral debt in 1999 and 2001, and rescheduling of commercial bank credit and Eurobonds in 1999.
4/ Includes rollover of FE-45 deposits with the banking system, of Kuwait's and U.A.E.'s deposits with the SBP, and Bank of China's deposits with the NBP.
5/ Excluding gold, foreign currency deposits held with the SBP, and net of outstanding short-term foreign currency swap and forward contracts.

Table 3. Pakistan: Consolidated Government Budget, 2000/01–2003/04 (Continued)

	Rev. Act. 2000/01	Prog. 2001/02	Rev. Proj. 2001/02	Q1–Q3 Prog. 2001/02	Q1–Q3 Prov. 2001/02	Proj. 2002/03	Proj. 2003/04
	(In billions of Pakistani rupees)						
Revenue and grants	591.1	714.4	698.2	500.6	495.1	750.0	797.1
Revenue	546.4	625.4	612.0	427.2	424.9	693.6	765.2
Tax revenue	444.8	486.0	467.4	328.8	320.1	546.2	611.7
Federal	425.4	464.6	446.9	313.7	305.9	522.8	585.1
CBR revenue	393.9	414.3	400.4	277.4	269.8	460.6	516.7
Direct tax	127.4	146.5	141.2	101.7	96.2	148.4	155.6
Federal excise duty	49.2	47.1	47.1	31.5	31.2	50.0	55.8
Sales tax	152.8	170.1	167.9	114.1	113.4	205.6	243.6
Customs duties	64.5	50.5	44.2	30.2	29.0	56.5	61.9
Petroleum surcharge	17.9	34.0	30.0	24.5	24.5	45.5	50.8
Gas surcharge	12.6	15.0	14.9	10.9	10.8	15.0	15.8
Other	1.0	1.3	1.5	0.9	0.7	1.7	1.9
Provincial	19.4	21.4	20.5	15.1	14.2	23.4	26.6
Nontax revenue	101.6	139.4	144.6	98.4	104.8	147.5	153.4
Federal	81.9	117.3	124.2	85.4	93.4	125.2	130.3
Provincial	19.7	22.1	20.4	13.1	11.4	22.3	23.2
Grants	44.7	89.0	86.2	73.3	70.2	56.3	31.9
Expenditure	726.9	837.6	873.8	587.6	540.6	872.0	917.8
Current expenditure	650.7	705.5	690.7	492.1	444.0	735.0	752.6
Federal	500.8	535.4	523.7	376.0	352.3	547.4	543.1
Interest payments	234.7	257.0	250.2	184.8	172.8	264.0	263.3
Domestic	183.5	195.4	192.1	146.1	137.1	192.4	194.1
Foreign	51.2	61.6	58.1	38.7	35.7	71.6	69.1
Defense 1/	131.2	149.6	149.6	102.2	94.5	146.0	145.6
Running of the civil government 1/	45.9	52.0	52.0	35.7	35.3	56.0	58.2
Pensions	30.9	33.6	33.6	21.3	19.4	35.0	40.5
Subsidies	14.7	15.7	15.1	10.0	10.9	24.0	14.4
Grants	24.0	19.6	19.6	14.4	15.0	18.7	19.7
Other	-0.4	7.9	3.7	5.8	0.5	3.8	1.3
Of which : bank restructuring	0.0	6.5	3.2	3.2	0.0	3.3	0.0
Unidentified	19.9	0.0	0.0	1.7	4.0	0.0	0.0
Provincial	149.9	170.1	167.0	116.1	91.8	187.6	209.5
Development expenditure and net lending	76.2	132.1	183.1	95.6	96.5	137.0	165.2
Public Sector Development Program 2/	92.5	127.0	124.7	88.6	91.5	144.0	166.7
Federal 2/	69.6	97.0	95.5	67.8	70.5	96.0	110.1
Provincial	22.9	30.0	29.2	20.8	21.0	48.0	56.6
KESC recapitalization and CBR bonds	0.0	0.0	52.0	0.0	0.0	...	0.0
Net lending	-16.3	5.1	6.4	7.0	5.0	-7.0	-1.5
Augmented budget balance (excluding grants) 3/	-180.5	-212.3	-261.8	-160.5	-115.7	...	-152.6
Budget balance (excluding grants) 4/	-180.5	-212.3	-209.8	-160.5	-115.7	-178.4	-152.6
Budget balance (including grants)	-135.8	-123.2	-175.7	-87.2	-45.5	-122.1	-120.7
Financing	135.8	123.2	175.7	87.2	45.5	122.1	120.7
External	74.2	59.0	43.0	10.6	-2.8	95.1	69.1
Domestic	61.6	57.7	131.5	73.4	48.2	14.9	25.5
Bank	-32.3	-6.9	49.8	-4.0	-0.9	-29.2	-14.0
Of which: KESC and CBR bonds	0.0	0.0	52.0	0.0	0.0	...	0.0
Nonbank	93.9	64.6	81.7	77.4	49.1	44.1	25.5
Privatization proceeds	0.0	6.5	1.2	3.2	0.0	12.0	26.0
Financing gap	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:							
Primary balance	54.2	44.7	40.4	24.3	57.1	85.6	110.7
Social and poverty-related expenditure 5/	119.3	136.4	136.4	96.6	80.0	161.0	185.1

Table 3. Pakistan: Consolidated Government Budget, 2000/01–2003/04 (Concluded)

	Rev. Act. 2000/01	Prog. 2001/02	Rev. Proj. 2001/02	Q1–Q3 Prog. 2001/02	Q1–Q3 Prov. 2001/02	Proj. 2002/03	Proj. 2003/04
	(In percent of GDP, unless stated otherwise)						
Revenue and grants	17.0	19.3	18.9	13.5	13.4	18.6	18.1
Revenue	15.7	16.9	16.6	11.6	11.5	17.2	17.4
Tax revenue	12.8	13.2	12.7	8.9	8.7	13.6	13.9
Federal	12.3	12.6	12.1	8.5	8.3	13.0	13.3
CBR revenue	11.3	11.2	10.9	7.5	7.3	11.4	11.7
Direct tax	3.7	4.0	3.8	2.8	2.6	3.7	3.5
Federal excise duty	1.4	1.3	1.3	0.9	0.8	1.2	1.3
Sales tax	4.4	4.6	4.6	3.1	3.1	5.1	5.5
Customs duties	1.9	1.4	1.2	0.8	0.8	1.4	1.4
Petroleum surcharge	0.5	0.9	0.8	0.7	0.7	1.1	1.2
Gas surcharge	0.4	0.4	0.4	0.3	0.3	0.4	0.4
Other	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Provincial	0.6	0.6	0.6	0.4	0.4	0.6	0.6
Nontax revenue	2.9	3.8	3.9	2.7	2.8	3.7	3.5
Grants	1.3	2.4	2.3	2.0	1.9	1.4	0.7
Expenditure	20.9	22.7	23.7	15.9	14.6	21.7	20.8
Current expenditure	18.7	19.1	18.7	13.3	12.0	18.3	17.1
Federal	14.4	14.5	14.2	10.2	9.5	13.6	12.3
Interest payments	6.8	7.0	6.8	5.0	4.7	6.6	6.0
Domestic	5.3	5.3	5.2	4.0	3.7	4.8	4.4
Foreign	1.5	1.7	1.6	1.0	1.0	1.8	1.6
Defense 1/	3.8	4.0	4.1	2.8	2.6	3.6	3.3
Running of the civil government 1/	1.3	1.4	1.4	1.0	1.0	1.4	1.3
Pensions	0.9	0.9	0.9	0.6	0.5	0.9	0.9
Subsidies	0.4	0.4	0.4	0.3	0.3	0.6	0.3
Grants	0.7	0.5	0.5	0.4	0.4	0.5	0.4
Other	0.0	0.2	0.1	0.2	0.0	0.1	0.0
Unidentified	0.6	0.0	0.0	0.0	0.1	0.0	0.0
Provincial	4.3	4.6	4.5	3.1	2.5	4.7	4.8
Development expenditure and net lending	2.2	3.6	5.0	2.6	2.6	3.4	3.7
Public Sector Development Program 2/	2.7	3.4	3.4	2.4	2.5	3.6	3.8
KESC recapitalization and CBR bonds	0.0	0.0	1.4	0.0	0.0	...	0.0
Net lending	-0.5	0.1	0.2	0.2	0.1	-0.2	0.0
Augmented budget balance (excluding grants) 3/	-5.2	-5.7	-7.1	-4.3	-3.1	...	-3.5
Budget balance (excluding grants) 4/	-5.2	-5.7	-5.7	-4.3	-3.1	-4.4	-3.5
Budget balance (including grants)	-3.9	-3.3	-4.8	-2.4	-1.2	-3.0	-2.7
Financing	3.9	3.3	4.8	2.4	1.2	3.0	2.7
External	2.1	1.6	1.2	0.3	-0.1	2.4	1.6
Domestic	1.8	1.6	3.6	2.0	1.3	0.4	0.6
Bank	-0.9	-0.2	1.3	-0.1	0.0	-0.7	-0.3
Of which: KESC and CBR bonds	0.0	0.0	1.4	0.0	0.0	...	0.0
Nonbank	2.7	1.7	2.2	2.1	1.3	1.1	0.6
Privatization proceeds	0.0	0.2	0.0	0.1	0.0	0.3	0.6
Financing gap	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:							
Primary balance	1.6	1.2	1.1	0.7	1.5	2.1	2.5
Social and poverty-related expenditure 5/	3.4	3.7	3.7	2.6	2.2	4.0	4.2
GDP (in billions of Pakistani rupees)	3,472	3,695	3,686	3,695	3,695	4,023	4,406

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

1/ Excluding pensions.
2/ In 2001/02, includes PRs 10 billion and PRs 3 billion of spending related to drought and fiscal devolution, respectively.
3/ Including government bond issues for KESC recapitalization and clearance of bank claims on CBR.
4/ Used for PRGF program purposes.
5/ As defined in the I-PRSP.

Table 4. Pakistan: Monetary Survey, 1999/2000–2002/03

	Act.		Monetary Program 2001/02						Monetary Program 2002/03 5/		
			Dec. 1/		Mar. 1/		Jun. 1/		Sep.	Dec.	Jun.
	1999/2000	2000/01 1/	Prog. 2/ 2001	Act. 2001	Prog. 2/ 2002	Act. 2002	Prog. 3/ 2002	Proj. 4/ 2002	Prog. 2002	Prog. 2002	Proj. 2003
	(End-of-period stocks; in billions of Pakistani rupees)										
Net foreign assets	-45	26	68	107	53	147	80	171	184	204	252
Net domestic assets	1,446	1,500	1,542	1,553	1,547	1,532	1,586	1,560	1,571	1,607	1,644
Net claims on government	617	570	549	556	542	546	550	619	613	596	587
Of which:											
Net bank borrowing	533	500	503	493	509	499	507	549	545	534	520
Commodity operations	107	95	71	90	59	72	70	93	92	87	90
Net claims on nongovernment	843	905	989	957	1,000	944	1,013	923	939	992	1,038
Private sector	753	804	873	853	875	840	880	845	854	902	939
Public sector	90	101	116	105	125	105	133	78	85	90	98
Privatization account	-3	-3	-3	-3	-3	-3	-3	-3	-3	-3	-3
Other items, net	-11	29	8	42	8	45	26	21	22	22	22
Total liquidity (broad money)	1,401	1,527	1,610	1,660	1,600	1,679	1,666	1,731	1,755	1,811	1,896
Of which:											
Pakistani rupee liquidity	1,288	1,373	1,456	1,507	1,445	1,518	1,515	1,571	1,605	1,662	1,748
	(Changes in percent of stock of broad money at the beginning of the fiscal year)										
Net foreign assets	2.0	5.1	2.6	5.3	1.6	7.9	3.4	9.5	1.3	2.5	5.3
Net domestic assets	7.4	3.9	2.9	3.4	3.2	2.1	5.7	3.9	0.6	2.7	4.8
Of which:											
Net bank borrowing by government	2.1	-2.4	-2.2	-0.9	-2.7	-1.6	-2.1	3.2	-0.3	-1.3	-1.8
Net claims on private sector	1.4	3.6	4.7	3.2	4.9	2.3	5.1	2.7	0.5	3.3	5.5
	(Changes over 12 months; in percent)										
Broad money	9.4	9.0	9.0	11.8	9.1	13.8	9.1	13.4	15.5	9.7	10.2
Net claims on private sector	2.5	6.8	4.4	2.0	4.7	0.4	9.8	5.1	9.2	5.8	11.2
Memorandum item:											
Indicative program exchange rate	...	...	63.98	63.98	63.98	63.98	63.98	63.98	60.07	60.07	60.07

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

1/ At indicative program exchange rate.
2/ Stocks as reported in EBS/01/197.
3/ Stocks as reported in EBS/02/43.
4/ The projections for June 2002 are based on revised balance of payments projections and include the issuance of PRs 52 billion in government paper for pending tax refunds to banks and to repay KESC's debt.
5/ The program exchange rate for the 2002/03 monetary program is PRs 60.07 per US$, the end-March 2002 actual exchange rate. September 2002 and December 2002 columns represent program targets, while June 2003 are program projections. The projected monetary stocks are based on June 2002 projections and monetary program flows evaluated at the 2002/03 program exchange rate.

Table 5. Pakistan: Accounts of the State Bank of Pakistan, 1999/2000–2002/03

	Act.		Monetary Program 2001/02						Monetary Program 2002/03 5/		
			Dec. 1/		Mar. 1/		Jun. 1/		Sep.	Dec.	Jun.
			Prog. 2/	Act.	Prog. 2/	Act.	Prog. 3/	Proj. 4/	Prog.	Prog.	Proj.
	1999/2000	2000/01	2001	2001	2002	2002	2002	2002	2002	2002	2003
	(End-of-period stocks; in billions of Pakistani rupees)										
Net foreign assets	-55.6	-16.2	5.1	57.3	-18.5	92.2	30.2	100.7	113.8	124.4	153.6
Net domestic assets	553.4	549.4	568.6	532.7	586.2	476.3	556.2	478.3	482.4	491.4	492.4
Net claims on government	369.0	335.0	365.5	332.4	381.6	264.3	352.3	260.4	257.7	264.2	260.2
Of which:											
Budgetary support	392.7	360.3	391.0	357.9	407.1	289.0	378.3	284.8	282.1	289.4	283.6
Claims on nongovernment	51.2	40.1	40.1	27.8	40.1	24.2	27.8	25.7	25.7	25.7	25.7
Claims on scheduled banks	193.4	198.0	201.0	184.8	202.5	195.6	204.0	200.0	202.5	205.0	210.0
Other items, net	-57.3	-20.8	-35.0	-9.4	-35.0	-4.9	-24.9	-4.9	-0.5	-0.5	-0.5
Reserve money 6/	497.8	533.2	573.7	589.9	567.7	568.5	586.5	579.0	596.2	615.8	646.0
Of which:											
Banks' reserves	114.7	127.3	130.5	127.0	131.0	101.7	139.9	105.3	113.0	116.0	120.8
Currency	375.1	394.6	432.0	451.8	425.4	455.6	435.4	462.4	471.9	488.5	513.9
	(Changes in percent of stock of reserve money at the beginning of the fiscal year)										
Net foreign assets	-3.3	7.3	4.0	13.8	-0.4	20.3	8.7	12.0	3.3	5.2	10.2
Net domestic assets	28.4	-0.2	3.6	-3.1	6.9	-13.7	1.3	-13.3	0.0	1.5	1.7
Of which:											
Budgetary support	28.4	-6.5	1.5	-0.5	4.5	-13.3	-0.9	-15.7	-16.1	-15.0	-15.7
	(Changes over 12 months; in percent)										
Reserve money 7/	25.1	3.3	...	14.3	...	5.8	10.0	8.6	12.1	4.4	11.9
Currency	22.4	5.2	0.3	4.9	5.1	12.5	10.3	6.2	18.2	8.1	11.1
Memorandum item:											
Indicative program exchange rate	...	63.98	63.98	63.98	63.98	63.98	63.98	63.98	60.07	60.07	60.07

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

1/ At indicative program exchange rates.

2/ Stocks as reported in EBS/01/197.

3/ Stocks as reported in EBS/02/43.

4/ The projections for June 2002 are based on revised balance of payments projections and include the issuance of PRs 52 billion in government paper for pending tax refunds to banks and to repay KESC's debt.

5/ The program exchange rate for the 2002/03 monetary program is PRs 60.07 per US$, the end-March 2002 actual exchange rate. September 2002 and December 2002 columns represent program targets, while June 2003 are program projections. The projected monetary stocks are based on June 2002 projections and monetary program flows evaluated at the 2002/03 program exchange rate.

6/ Starting in April 2000/01, reserve money includes special reserves on foreign currency deposits.

7/ For the purpose of calculating the 12-month growth rate, reserve money is considered net of the special reserves and corrected for the transformation of the special deposits accounts into treasury bills in December 2000 and March 2001.

Table 6. Pakistan: Gross Financing Requirements, 2001/02–2003/04

(In millions of U.S. dollars)

	2001/02	2002/03	2003/04
Gross financing requirements	-8,185	-5,726	-6,206
External current account deficit	599	-497	-1,191
Debt amortization	-6,228	-4,007	-3,629
Medium- and long-term debt	-2,852	-2,717	-2,215
Public sector	-2,445	-2,296	-1,838
Multilateral (excluding IMF)	-604	-612	-673
Bilateral	-817	-658	-581
Bonds (net)	-38	-192	-183
Other (including SBP liabilities)	-987	-834	-401
Private sector	-407	-421	-377
Short-term debt	-3,376	-1,289	-1,414
Public sector	-2,197	-951	-1,269
Private sector	-1,179	-338	-145
Repayment of arrears	0	0	0
Gross reserves accumulation	-2,355	-898	-998
Of which: official reserves	-1,953	-699	-833
IMF repurchases and repayments	-201	-324	-389
Available financing	8,185	5,726	6,206
FDI and portfolio investment (net, excluding public securities) 1/	394	650	900
Debt financing from private creditors	2,954	1,265	1,470
Medium- and long-term financing	409	175	200
To private sector	107	175	200
To public sector	302	0	0
Short-term financing	2,545	1,090	1,270
To public sector	1,461	900	1,200
To private sector	1,084	190	70
Official creditors	2,854	2,758	2,744
Project lending	721	660	697
Balance of payments support	2,134	2,098	2,047
AsDB and World Bank	845	1,165	1,103
Debt relief from bilateral creditors 2/	1,289	933	945
Private sector involvement	0	100	200
IMF	488	440	442
Other net capital flows 3/	1,495	512	450
Financing gap	0	0	0

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

1/ Includes privatization receipts.
2/ Debt relief agreed in January 2001 and in December 2001.
3/ Includes SBP purchases in the interbank market.

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

	1998/99	1999/2000	2000/01	2001/02 Proj.	2002/03 Proj.	2003/04 Proj.
	(In millions of U.S. dollars)					
Total public- and publicly-guaranteed external debt	29,318	29,757	32,743	31,597	31,382	31,452
Medium- and long-term debt	25,445	26,009	28,165	27,954	28,051	28,138
Project & nonproject aid	24,105	24,792	26,647	26,698	27,144	27,448
Commercial banks and IDB	730	560	634	410	252	219
Other (including securities and frozen foreign currency accounts)	610	657	885	847	655	472
Short-term debt (by initial maturity)	2,049	2,253	3,075	1,853	1,426	1,355
Commercial banks and IDB	583	671	834	276	393	393
FEBCs and DBCs	196	147	72	49	31	12
SBP liabilities (including swaps)	1,270	1,435	2,169	1,528	1,002	950
Fund credit and loans	1,825	1,496	1,503	1,790	1,906	1,959
Service of medium- and long-term public- and publicly-guaranteed debt	3,499	4,250	2,273	3,844	3,986	3,582
Amortization	2,484	3,113	1,185	2,646	2,620	2,227
Interest	1,015	1,137	1,088	1,198	1,366	1,356
Interest on public- and publicly-guaranteed short-term debt	265	319	284	212	139	160
	(In percent of GDP)					
Total public- and publicly-guaranteed external debt	50.0	48.3	54.9	52.5	49.5	46.5
Long-term	43.4	42.2	47.3	46.5	44.3	41.6
Of which: project and nonproject aid	41.1	40.2	44.7	44.4	42.8	40.5
Short-term	3.5	3.7	5.2	3.1	2.3	2.0
Fund credit and loans	3.1	2.4	2.5	3.0	3.0	2.9
Service of medium- and long-term public- and publicly-guaranteed debt	6.0	6.9	3.8	6.4	6.3	5.3
Amortization	4.2	5.1	2.0	4.4	4.1	3.3
Interest	1.7	1.8	1.8	2.0	2.2	2.0
Interest on public- and publicly-guaranteed short-term debt	0.5	0.5	0.5	0.4	0.2	0.2
	(In percent of exports of goods and nonfactor services)					
Total public- and publicly-guaranteed external debt	331.6	310.7	318.4	292.4	280.9	263.8
Service of medium- and long-term public- and publicly-guaranteed debt	39.6	44.4	22.1	35.6	35.7	30.0
Amortization	28.1	32.5	11.5	24.5	23.5	18.7
Interest	11.5	11.9	10.6	11.1	12.2	11.4
Memorandum items:						
Implicit interest on public- and publicly-guaranteed external debt	4.4	4.9	4.4	4.4	4.8	4.8
Total external debt	35,309	34,338	37,955	36,159	35,425	35,368
(In percent of GDP)	60.2	55.7	63.7	60.1	55.9	52.2

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

Table 8. Pakistan: Indicators of External Vulnerability, 1989/99–2001/02

	1998/99	1999/2000	2000/01	Latest available observation		Rev. Proj. 2001/02
Financial indicators						
Net public debt (in percent of GDP)	93.6	91.6	100.9	...		95.5
Broad money (12-month percentage change)	6.2	9.4	9.0	13.8	2/	13.4
Private sector credit (12-month percentage change)	8.5	2.5	6.4	0.1	2/	5.1
180-day treasury bill yield (in percent)	13.1	8.6	10.4	6.4	3/	...
180-day treasury bill yield, real (in percent)	7.4	5.1	6.0	3.1	3/	...
Karachi Stock Exchange index						
End-of-period	1,055	1,521	1,366	1,673	4/	...
Period average	985	1,514	1,436	...		...
External Indicators						
Exports (12-month percentage changes, in U.S. dollars)	-10.7	8.8	9.1	-6.6	5/	-0.3
Imports (12-month percentage changes, in U.S. dollars)	-6.7	-0.1	6.2	-14.3	5/	-4.2
Terms of trade (12-month percentage changes)	4.1	-9.2	-1.6	...		0.2
Current account balance (excluding official transfers in percent of GDP	-4.6	-3.4	-3.0	...		-1.3
Gross Official Reserves (in millions of U.S. dollars)	1,672	908	1,679	3,658	4/	3,549
In weeks of imports of goods and nonfactor services	7.4	3.8	7.2	...		14.1
In percent of broad money	6.5	3.3	7.0	...		13.2
In percent of total short-term debt at remaining maturity	22.0	10.9	25.0	...		58.3
Total external debt (in millions of U.S. dollars)	35,309	34,338	37,955	...		36,159
In percent of exports of goods and nonfactor services	399.4	358.6	369.1	...		334.6
Actual debt service (in percent of exports of goods and services) 1/	81.3	84.4	61.4	...		52.6
Exchange rate (Pakistani rupees per U.S. dollar, period average)	50.1	51.6	58.3	60.1	4/	...
Real exchange rate (12-month percentage changes)	-9.1	-0.6	-2.6	5.6	2/	...

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

1/ Scheduled debt service on total debt minus rescheduled debt service plus debt service on previously rescheduled debt.
2/ March 2002.
3/ May 2002.
4/ May 28, 2002.
5/ First quarter of calendar year 2002.

Table 9. Pakistan: Indicators of Fund Credit, 2000/01–2007/08 1/

		Proj.						
	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08
Outstanding Fund credit								
In millions of SDRs	1,207	1407	1490	1527	1391	1207	1091	971
In millions of U.S. dollars	1,503	1,790	1,906	1,959	1,785	1,548	1,400	1,246
In percent of:								
Quota	116.7	136.1	144.2	147.7	134.6	116.7	105.5	93.9
GDP	2.5	3.0	3.0	2.9	2.5	2.1	1.8	1.6
Exports of goods and nonfactor services	14.6	16.6	17.1	16.4	13.9	11.3	9.5	8.0
Public- and publicly-guaranteed debt	4.6	5.7	6.1	6.2	5.8	5.1	4.7	4.2
Debt service to the Fund								
In millions of SDRs	228	203	290	351	331	222	126	129
In millions of U.S. dollars	294	258	371	451	425	285	162	166
In percent of:								
Exports of goods and nonfactor services	2.9	2.4	3.3	3.8	3.3	2.1	1.1	1.1
Gross official reserves	17.5	7.3	8.9	9.1	8.0	5.3	2.9	2.6

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

1/ Assuming PRGF disbursements as scheduled.

Table 10. Pakistan: Social Indicators, 1970–2004

	Latest single year				I-PRSP Target	South Asia	Lower-income (world-wide)
						Latest single year (1990–2000)	
	1970–75	1980–85	1993–99	2000	2003/04		
Population							
Total population, mid-year (in millions)	71.0	94.8	134.8	138.1	…	1,355.0	2,459.0
Growth rate (percent annual average)	3.2	2.7	2.4	2.4	1.8	1.9	1.9
Urban population (percent of population)	26.4	29.8	36.5	37.0	…	28.0	32.0
Total fertility rate (births per woman)	7.0	6.5	4.8	4.7	4.1	3.4	3.7
Unemployment (as percentage of total labor force)	…	3.7	n.a.	…	…	…	…
Income							
GNP per capita (1995 U.S. dollars)	275.7	366.5	511.3	…	569.5	445.9	449.1
Consumer price index (percentage change)	20.9	5.6	4.1	4.3	5.0	4.1	4.1
Food price index (percentage change)	…	4.4	3.9	1.9	5.0	…	…
Social indicators							
Public expenditure							
Health (percent of GDP)	…	…	0.5	…	0.5	0.9	1.2
Education (percent of GNI)	2.2	2.9	1.6	…	1.8	3.1	3.3
Education 1/							
Gross primary school enrollment rate (in percent of age group)							
Total	39.5	43.7	73.5	…	100.0	100.3	96.0
Male	52.7	55.7	100.6	…	119.0	109.6	102.5
Female	25.5	30.4	45.4	…	76.0	90.2	85.5
Gross secondary school enrollment rate (in percent of age group)	14.7	17.2	25.6	…	68.0	48.6	45.7
Illiteracy rate (as percentage of population aged 15 and above)	75.8	68.2	55.0	54.0	41.0	45.0	38.0
Access to safe water (in percent of population)							
Total	…	38.0	63.0	…	68.0	87.0	76.0
Urban	75.0	84.0	83.0	…	87.0	92.0	88.0
Rural	5.0	28.0	53.0	…	57.0	85.0	70.0
Immunization rate (percent under 12 months)							
Measles	…	23.0	81.0	…	…	62.7	64.0
DPT	…	30.0	80.0	…	…	75.2	70.4
Life Expectancy at birth (years)							
Total	52.3	57.4	62.5	63.0	64.4	62.6	59.1
Male	52.1	56.9	61.5	…	…	61.8	58.1
Female	52.5	58.0	63.6	…	…	63.4	60.2
Mortality							
Children under 5 years (per thousand live births)	183.0	161.0	126.0	110.3	65.0	98.6	116.3
Adult (15–59 years)							
Male (per 1,000 population)	339.5	282.5	186.0	…	…	223.2	288.3
Female (per 1,000 population)	381.1	290.9	153.0	…	…	212.2	257.7

Source: World Bank: World Development Indicators; and Government of Pakistan.

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

Pakistan: Fund Relations
As of April 30, 2002

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	1,969.51	190.5
Reserve position in Fund	0.12	0.0

III. SDR Department:	SDR Million	%Allocation
Net cumulative allocation	169.99	100.0
Holdings	3.63	2.1

IV. Outstanding Purchases and Loans:	SDR Million	%Quota
Stand-by arrangements	465.00	45.0
Extended arrangements	162.31	15.7
Contingency and Compensatory	308.61	29.9
ESAF/PRGF arrangements	513.66	49.7

V. Latest Financial Arrangements:

Type	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
PRGF	12/06/2001	12/05/2004	1,033.70	172.30
Stand-By	11/29/2000	09/30/2001	465.00	465.00
EFF	10/20/1997	10/19/2000	454.92	113.74

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

	Overdue		Forthcoming			
	04/30/02	2002	2003	2004	2005	2006
Principal	0.0	127.5	292.8	330.5	291.4	124.5
Charges/Interest	0.0	25.7	28.7	21.4	13.7	7.5
Total	0.0	153.2	321.5	351.9	305.1	132.0

Repurchase Obligations: Repurchases in the credit tranches including the Compensatory Financing Facility, are to be completed in 3¼–5 years. Repurchases under the Extended Fund Facility are due in 4½–10 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 May 31, 2002, the FIBR was PRs 60.12 per US$1.

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) on November 29, 2000.

IX. **Safeguards Assessments**

A Stage One safeguards assessment of the State Bank of Pakistan (SBP) was completed on October 26, 2000. The assessment concluded that high risks may exist in the area of external audit mechanism, financial reporting and internal control, and recommended a Stage Two (on-site) assessment. The Stage Two (on-site) assessment was completed on February 13, 2001 and staff's findings and recommendations were reported to Fund management (EBS/01/39, Appendix IV) and to the authorities. A monitoring exercise related to safeguards developments at the SBP has been undertaken. All the recommended remedial actions arising from the initial safeguards assessment have been implemented and no new critical vulnerabilities have been identified. The Stage Two recommendations included in the Stand-By Arrangement conditionality remain applicable to Pakistan's PRGF arrangement, which was approved on December 6, 2001 and is scheduled to expire on December 5, 2004.

X. **ROSCs**

Fiscal Transparency Module	11/28/2000	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 (ROSC). In August 2000, a joint FAD-STA mission reviewed progress in the strengthening of the fiscal reporting and accounting systems and assisted authorities in the preparation of revised fiscal data for 1993/94–1998/99. In September 2000, a mission provided technical assistance 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. In January 2002, another mission advised the authorities on fiscal data management, quality, and transparency.

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. In February 2002, a mission reviewed external sector statistics and provided advice on steps to be undertaken to subscribe to the SDDS.

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

XII. Resident Representative

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

Pakistan: Relations with the World Bank Group

Background

1. IBRD and IDA have approved 96 loans and 145 credits to Pakistan since 1952, totaling US$6,975.3 million and US$6,372.7 million, respectively (net of cancellations). Of these amounts, US$3,337.3 million has been repaid and US$776.9 million remain undisbursed. Current total obligations to the World Bank stand at US$7,032.8 million, of which US$4,288.5 million are IDA and US$2,744.2 million are IBRD, as of April 30, 2002. IDA credits constitute 59 percent and IBRD loans 41 percent of the World Bank portfolio.

2. The **volume** of World Bank lending to Pakistan has varied considerably over the last 2 decades. IBRD and IDA assistance to Pakistan steadily increased during the 1980s, with average annual commitments growing from about US$255 million in the early 1980s to US$730 million during FY 1988–91, owing in large part to substantial adjustment lending—supporting the government's reform program. New commitments fluctuated throughout the remainder of the 1990s, from a low of US$85 million in FY 1997 to a high of US$808 million in FY 1998—the latter reflecting support for reform programs in banking, irrigation and drainage, and the second phase of the Social Action Program. After July 1999, when the Government's reform program went off track, and since the new government took over in October 1999, the World Bank focused its assistance on policy advice and nonlending services, while the Government formulated its overall reform program. New lending resumed in June 2001 with an IDA-funded US$350 million Structural Adjustment Credit. Since then an additional US$454 million in IDA credits has been approved including US$300 million for banking sector restructuring and US$130 million for emergency drought recovery assistance.

3. **The composition** of IBRD/IDA lending has also shifted significantly in recent years, reflecting an increasing emphasis on human development. In FY 1980–90, 28 percent of total commitments went to agriculture, (including irrigation), 28 percent to electric, power/energy/oil and gas, and 18 percent to industry/telecommunications and transport, while the social sectors accounted for 7 percent (education, health, nutrition and population). Since 1990, commitments to the social sectors have averaged 19 percent, while commitments to agriculture declined to 10 percent, with electricity, energy, and oil and gas at 22 percent, and industry/telecommunications and transport falling to 3 percent.

4. IFC and MIGA also have substantial portfolios with Pakistan. IFC's disbursed own account portfolio is US$442 million in 49 companies, of which US$76 million is in equity and the balance of US$368 million in loans. Among IFC's 49 portfolio companies, eight are in arrears, with principal of US$43.6 million overdue as of end-April 2002. The B Loan portfolio is currently US$229 million in 11 companies, with a strong concentration in the power sector. As of April 30, 2002, MIGA's gross exposure in Pakistan is US$92.6 million. The portfolio is approximately evenly divided between the financial sector and infrastructure

sector. Within the infrastructure sector, most the guarantees support the power and telecom sectors.

5. Since 1998, IFC has approved one new investment of US$50 million in a US$100 million Trade Enhancement Facility. It has restructured its existing portfolio, canceling a third of its approved investments in 23 companies. More than a third (36 percent) of its disbursed portfolio is in 5 IPP companies. The other main areas of investment have been financial institutions (26 percent), cement (20 percent), and textiles (8 percent). In FY 2002 MIGA has underwritten a software manufacturing project and is currently working on supporting a mobile telecom project.

Program Focus

6. The overriding objective of the World Bank Group's assistance strategy is to help Pakistan reduce poverty through support of the government's implementation of its Interim Poverty Reduction Strategy (I-PRSP). The I-PRSP focuses on (a) strengthening governance and the integrity of the civil service; (b) creating opportunities through accelerating growth of agriculture, small and medium scale industries, information technology, and oil and gas sectors; and (c) reducing poverty through revival of growth and re-orienting public expenditure towards human development and poverty reduction. A Joint Staff Assessment (JSA) on the I-PRSP was discussed by the Boards of the World Bank and the IMF on December 4 and 6, 2001, respectively. The full PRSP is expected to be completed after October 2002 when a newly elected government takes office.

7. The main goal of the World Bank Group's Assistance Strategy is to support Pakistan's fundamental reforms for a transition to a modern Islamic state through a program of analytical services, institutional capacity building, and demand-pull lending. The World Bank Group's program priorities are focused on the reforms to (a) strengthen macroeconomic stability and government effectiveness; (b) improve the business environment for growth; and (c) improve equity through support for pro-poor and pro-gender equity policies. The 2002 CAS, which will be presented to the World Bank's Board of Executive Directors on June 11, 2002, sets out a strategy in support of these objectives for the period FY 2003–05.

8. The World Bank works closely with the IMF and the government on structural reforms underpinning macroeconomic stability, particularly in areas with an impact on the balance of payments and public finances. In this context, an IDA-financed US$500 million Structural Adjustment Credit is expected to be approved on June 11, 2002 in support of the government's actions in the areas of improving public expenditure management and supporting reforms of tax administration, safe and sound banking, efficient public utilities, and structural fiscal and governance reforms. The World Bank is also supporting government actions to strengthen financial management and public procurement through the **Project to Improve Financial Reporting and Accounting**, and the preparation of a **Country Procurement Assessment Report**. The government's public investment program is reviewed annually by the World Bank and advice provided on fiscal reform and public expenditure restructuring. The World Bank is now engaged with several provinces on

provincial reform strategies in the context of improved resource management and the pending devolution of many public services to local governments and communities.

9. The World Bank Group's support to strengthening the investment climate includes a combination of analytical work and financial assistance targeted to reforms in key sectors. The World Bank Group continues to encourage the federal and provincial governments to pursue the trade liberalization and modernization of industrial, business and labor regulations that are already under way. To build the knowledge base to underpin the policy dialogue on private sector development, the World Bank Group plans to carry out a significant program of analytical work. In addition to a Development Policy Review (completed in FY 2002) which provides the World Bank's assessment of the adequacy of the current development policy agenda, including for rural development, to achieve rapid growth and poverty reduction; the World Bank will complete in FY 2003 an Investment Climate and Economic Performance Study. An analysis of the trade regime will also be undertaken in FY 2003. In addition to the governance reforms which have a direct bearing on the investment climate, the World Bank Group continues to support financially the reforms of the governance and regulatory environment for power, gas, oil, financial sector, pricing and tariffs reforms, and privatization, as well as support to provincial and district governments reforms to improve the quality of basic infrastructure and social services.

10. The World Bank continues to assist Pakistan with achieving governance improvements in the banking sector. The World Bank has maintained close dialogue with the government on banking sector reform following the Banking Sector Adjustment Loan in December 1997, through technical assistance to the Central Bank and preparation of a financial sector update in 2000. As a result of this dialogue, a major **Banking Sector Restructuring and Privatization Project** was approved by the Board on October 23, 2001. The World Bank Group will continue its support to financial sector development by focusing on deepening banking sector governance reforms, support to bank privatization and to strengthening the regulatory and supervisory capacity of the State Bank of Pakistan. This last outcome is supported through a **Banking Sector Technical Assistance** project which is expected to be approved early in FY 2003.

11. IFC will support the development of new products to better meet the needs of the private sector (e.g., long-term finance for infrastructure), and expand access to financial services to new clients (e.g., the bankable poor through micro-finance or leasing institutions), and to the under-served small and medium enterprises sector.

12. In the social sectors, the World Bank Group's assistance is geared toward support to the implementation of the Education Sector Reform (ESR) Strategy and the government's priority of strengthening public health programs and maternal and child health and family planning. Accordingly the World Bank is focusing on: (a) sector adjustment lending to support the National Education Sector Reform Strategy; (b) support to the National Education Assessment System; (c) a program of analytical work to underpin the policy dialogue during the implementation of the ESR; and (d) province-based support to implementing the ESR within the fiscal and economic reforms of Sindh and NWFP to start

with. In FY 2003 World Bank Group assistance to health sector reforms will include the **HIV/AIDS Prevention Project**, as well as analytical work, technical assistance, and policy dialogue, as appropriate.

13. Supporting the rural sector through community-based infrastructure projects (particularly for water supply and sanitation services) and the spread of micro-credit have been part of the World Bank Group's strategy to reduce and mitigate risks for Pakistan's poor. The World Bank will continue, under this CAS, to pilot new approaches, and also help scale up those which have proven effective such as the Community Infrastructure and Services Project (CIP) and the Pakistan Poverty Alleviation Fund (PPAF). Building on the experience of the Community Infrastructure Project in NWFP, the World Bank has prepared the **Azad Jammu Kashmir CIP** project for Board approval in early FY 2003.

14. To undertake this program effectively, the World Bank Group is working to more fully involve communities, the private sector, Pakistani NGOs and donors. Successful implementation of the program also calls for continued close coordination among IBRD/IDA, IFC and MIGA. Extensive consultations were held with government and members of civil society concerning the World Bank Group's strategy for Pakistan. The results of these consultations are reflected in the soon-to-be-completed CAS. The World Bank has also supported the government's efforts to better communicate its reform program to the international community, including through the Pakistan Development Forum, most recently held in Paris in April 2002, and to strengthen aid coordination. The World Bank will continue to facilitate the annual donors meetings as well as provincial and special topic forums on Pakistan's development.

New Commitments by the World Bank Group

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

15. Total annual new IBRD and IDA commitments in coming fiscal years could average between US$400 million and US$800 million, depending on the pace and depth of structural reforms and so long as Pakistan remains creditworthy for IBRD lending. The World Bank does not propose any IBRD lending in FY 2003.

16. In FY 2002, IFC has committed a US$30 million A loan in support of the Bhit Gas Development project, and will invest in two microfinance institutions. IFC sees good prospects for further investments in gas and mining, where clients value IFC's political risk mitigation. IFC is also pursuing opportunities to invest in financial services, manufacturing (especially garments and textiles), telecoms, health and education, IT and SMEs through partial guarantees. New investment is expected to be in the range of US$150–250 million over the next three years which will keep IFC's exposure near existing levels.

Technical assistance by the World Bank

17. Many World Bank-financed projects have technical assistance elements built into project design, including the Banking Sector Technical Assistance project with a net commitment value of US$26.5 million, the Sindh Structural Adjustment Credit with a net commitment of US$90 million, and the Trade and Transport Facilitation Project with a net commitment amount of US$3 million. Several Institutional Development Fund (IDF) grants have also been approved to assist the government develop and implement policy reforms in key areas, including support to the National Reconstruction Bureau, and support for reform in the regulatory and legal policy environment. Small amounts of technical support are also provided in the areas of financial sector monitoring and tax administration.

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

As of April 30, 2002

(In millions of U.S. dollars)

	IBRD	IDA	TOTAL
1. Original Principal	6,975.25	6,372.69	13,347.94
2. Cancellations	1,004.97	866.65	1,871.62
3. Disbursements to date	5,747.74	5,054.88	10,802.62
4. Repayments	2,736.25	601.09	3,337.34
5. Undisbursed	217.71	559.15	776.86
6. Exchange Adjustment:	(233.81)	-	(233.81)
7. Borrower's Obligation:	2,744.23	4,288.53	7,032.76

June 18, 2002

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

Dear Mr. Köhler:

The Pakistani authorities held discussions with Fund staff in May 2002 for the second review under the PRGF Arrangement. Based on these discussions, the attached Memorandum of Economic and Financial Policies (MEFP) reviews economic developments and policy implementation through March 2002 under the arrangement, updates the macroeconomic framework, and discusses the financial policies and structural reform program for the remainder of the fiscal year 2001/02 and fiscal year 2002/03. It supplements the MEFP dated November 22, 2001 and the supplementary MEFP dated March 12, 2002.

All performance criteria for end-March 2002 were met, except for the performance criterion on the Central Board of Revenue (CBR) revenue. As detailed in the MEFP, the CBR revenue shortfall reflects mostly continued lower-than-expected imports in the aftermath of the September 2001 events, and as described below a range of tax policy and tax administration reform has been implemented since March to strengthen tax collection. There has been the beginning of a turnaround in revenue performance during March–May 2002, along with a recovery of exports and imports. We expect this recovery to continue, although we recognize that it will be difficult to achieve the June target for CBR revenue, especially in light of the current level of regional tensions. We expect all other performance criteria for June 2002 to be met, on the external side with large margins. On this basis, we request a waiver for the nonobservance of the performance criterion on revenue of the CBR at end-March 2002.

On the basis of the performance up to end-March 2002 and the policies set out in the attached memorandum, the government requests the completion of the second review. We expect the third and fourth reviews under the arrangement to be completed as scheduled by end-September and end-December 2002, respectively.

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, we stand ready to take any additional measures appropriate for this purpose, and will consult with the Fund in accordance with the policies of the Fund on such consultations.

Sincerely yours,

____________s____________
Shaukat Aziz
Minister of Finance and Economic Affairs

____________s____________
Ishrat Husain
Governor
State Bank of Pakistan

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

PAKISTAN

Memorandum of Economic and Financial Policies for the remainder of FY 2001/02 and for FY 2002/03

I. Developments during January–May 2002

1. **The referendum held on April 30 confirmed strong support for a continuation of the reform program and extension of President Musharraf's tenure for the next five years.** This outcome should provide medium-term institutional and political stability, and strengthen the government's capacity to proceed forcefully with the implementation of its economic reform agenda. The parliamentary elections in October 2002 will provide the opportunity to strengthen involvement of the political forces of the country in the formulation and implementation of the reform program, and to deepen public ownership. On the other hand, the hoped-for reduction of military tensions on the eastern border is not yet in sight and this, along with isolated terrorist acts, impedes a faster recovery of private investment and growth. On a brighter side, the continuation of private foreign exchange inflows and steady financial support by the international community have allowed the State Bank of Pakistan (SBP) to build an unprecedented level of foreign exchange reserves, thus reducing the economy's external vulnerability. All quantitative performance criteria for end-March 2002 have been met, except (as discussed below) for the Central Board of Revenue (CBR) revenue (Table 1(a)).

2. **Macroeconomic developments have been broadly in line with the program.** While there has been some pick up of inflation in recent months, the average consumer price index (CPI) over July 2001–April 2002 increased by only 2.6 percent compared to the same period last fiscal year, consistent with the target of about 3 percent for the current fiscal year. In the agricultural sector, latest available data on the cotton crop indicate that the impact of various pests was less damaging than anticipated and production better than originally forecast. Rice and sugarcane production appear broadly in line with program expectations, while the wheat crop may fall short of projections, reflecting the continued shortfall in water availability from "normal" levels. Overall, agricultural value added in FY 2001/02 is projected to grow by 2 percent, in line with program projections. Growth in manufacturing is also close to projection, with a strong performance of sugar refining and more moderate growth in other manufacturing. Looking ahead, if tentative signs of a pick up in manufacturing, particularly textile, cement, and automobile firm up with the expected deepening of the incipient recovery in external demand, real GDP growth should reach the targeted 3.3 percent for this fiscal year.

3. **The balance of payments position has continued to improve.** Available trade data (on a custom basis) through April 2002 confirm a strong pick up in trade since March. Exports during March–April (in U.S. dollar terms) were 2.9 percent higher year-on-year (against a decline of 2.9 percent over the period July–February); and imports rose by 6.5 percent (against a decline of 10.1 percent over the period July–February). The improved

export performance reflects mainly a recovery in textile orders from abroad, while higher imports reflect both the surge in oil prices and strong volume growth in most categories of goods. Remittances and private capital inflows were strong, in line with greater efforts of banks to capture transfers from migrants, and growing confidence of the business community, particularly of the expatriate community, in Pakistan's economic outlook. Official transfers are accruing broadly as projected. Official reserves reached US$3.7 billion at end-May 2002. Since early 2002, the rupee has been virtually stable, and the spread between the kerb and interbank markets has remained at around 0.2 percent. We expect these trends to continue in the coming months, and the current account balance (including official transfers) to end up at a surplus of about 1.0 percent of GDP. With a lower-than-anticipated capital account deficit, gross official reserves should reach the unprecedented level of US$3.5 billion, equivalent to 3.4 months of next year imports, by end of June.

4. **Following a period of accommodative monetary policy between September 2001 and early February 2002 in response to the weakening economy, we have tightened our monetary stance to ensure continued low inflation**. The end-March ceiling for net domestic assets (NDA) of the central bank and the flow on the net foreign assets (NFA) were respected with wide margins. In line with the more comfortable reserve position, the SBP stopped offering forward cover on banks' incremental foreign exchange deposits (FE-31) from April 1, 2002, leaving this task to the market. The 12-month increase in reserve money, adjusted for the effects of the various exceptional operations in 2001 on the base, slowed to 5.8 percent in March 2002 (down from the December 2001 spike of 14.3 percent). However, broad money growth accelerated to 13.8 percent in the year through March (from 11.8 percent through December 2001), driven by large foreign exchange inflows. We decided not to fully sterilize these inflows as we believe that this monetary expansion may reflect a shift to higher money demand, in particular for rupee liquidity, reflecting increased confidence in the domestic currency, as for example indicated by the decline in foreign currency deposits and the stability of the exchange rate. Factors related to the use of the rupee in Afghanistan may also play a role. In light of some firmer signs of an economic upturn and a slight pick up of inflation, we have since March 2002 tightened the monetary stance through more active open market operations and increases in refinancing rates; as a result, the weighted average yield on the six-month treasury bill in March/April hovered at 6.5 percent in recent auctions, compared to 5.6 percent at the mid-February auction. We expect these trends to continue and are confident that the monetary targets for end-June will be achieved.

5. **The end-March performance criteria on net bank borrowing by the government and on bank credit to public enterprises were also met**. Following what appeared to be excessively high bank borrowing by smaller public enterprises in the months to December, we undertook a major exercise to update the list of public enterprises and reconcile relevant data between the Ministry of Finance, the SBP, and commercial banks. The exercise confirmed that commercial banks had reported public enterprise credit on the basis of outdated lists of public enterprises, including firms that had been privatized in recent years, as well as a few cases of liquidated or recapitalized enterprises whose liabilities had been assumed by the government. The revised set of enterprises on which the relevant credit

aggregate is to be monitored is now consistent across banks and agreed between the Ministry of Finance and the SBP. On this basis, we have revised downward the data on outstanding public enterprise credit, and revised upward private sector credit as well as government credit back to June 2001. The revised data indicate that the end-December 2001 performance criterion was actually observed, while the end-March 2002 target has been met. The revisions do not alter earlier judgments regarding compliance with program limits on bank credit to the government, including under the recent stand-by arrangement.

6. **By improving further the management of federal current expenditure, we met the end-March fiscal deficit performance criterion comfortably, despite shortfalls in CBR revenue.** CBR revenue for July 2001–March 2002 fell about PRs 8 billion short of the modified program target. In part, this reflects lower-than-expected imports through February and the appreciation of the rupee, which led to continued shortfalls in customs duties and sales tax receipts (about 40 percent of which derive from imports) but also in income tax, as much of the latter is collected through withholding on imports and other transactions. Another factor was lower withholding on interest income from securities, due to declining interest rates. These exogenous factors were compounded by continued shortcomings in tax administration, including difficulties to prevent abuse of existing loopholes in the refund system. Nonetheless, in March and April 2002, CBR revenue exceeded revenue collected in the same months of 2001 by 6 percent and 16 percent, respectively, indicating that some turnaround in tax collection is finally occurring. Furthermore, the backlog of refunds has been reduced to levels reflecting normal procedural lags, which we view as an important governance reform in itself. Revenue from petroleum and gas surcharges has been on track through March, but will likely come in below target for the year, following a temporary lowering of petroleum taxes during April and May. The latter was motivated by the desire to soften the impact of various other concomitant tax and gas pricing measures on consumers, in the context of surging international oil prices. Petroleum taxation has been fully restored from June 1, 2002 onwards, and we do not intend to take any measures related to petroleum taxation that will adversely affect the budget in the coming fiscal year. Nontax revenue, including compensation for services to the coalition in the fight against terrorism, was well above expectations, despite lower-than-expected interest payments from the Water and Power Development Authority (WAPDA). WAPDA's financial difficulties also reduced its principal repayments to the budget, raising net lending above projections. Defense expenditure picked up about as expected starting in January 2002, while other federal current expenditure was lower than projected during the period January–March 2002. Development expenditure rose in most recent months and local governments have now become operational to a degree which has allowed for an acceleration in the execution of the Interim Poverty Reduction Strategy Paper (I-PRSP) expenditure. These expenditures reached PRs 80 billion by end-March 2002, 17 percent below the programmed outlays, compared to a shortfall by 25 percent during July–December 2001. We expect to meet the fiscal deficit target for end-June, but are aware that this will require three major elements to fall in place: First, that the recovery of imports, some pick up in domestic activity, and the impact of the recent elimination of a few exemptions, coupled with major collection efforts, will allow CBR to further improve revenue collection. Second, that military tensions in the region do not further

intensify. Third, that budgetary support for WAPDA can be limited to deferral of debt service payments to the budget (PRs 23 billion).

7. **Structural reforms are on track, as detailed in the attached Table 2, with important steps in the tax administration reform implemented in February and March 2002.** In addition, we have stepped up the privatization program. In early March 2002, a 90 percent stake in Pak-Saudi Fertilizer for about PRs 8 billion was sold to domestic investors; in April/May, minority public interests in seven oil and gas fields were sold, mainly to foreign investors, for US$188 million. The sale of United Bank Limited (UBL) will take place in early June; in this context we have also replaced commercial banks' claims on the government due to taxes paid through 2000 on interest accrued but not collected by government paper for PRs 22 billion. In line with our commitment to bring the Karachi Electric Supply Company (KESC) to the point of sale by July 31, 2002 (see below), the privatization commission recently invited expression of interest by potential investors, so far two major international companies expressed interest. In March, we dismantled the gas price agreement with Petroleum Pakistan Limited (PPL) and as the first step in bringing the PPL wellhead price gradually closer to the market price, increased it by more than 50 percent. Concurrently, we increased consumer gas prices by an average of 8.5 percent, in line with our commitment to bring gas prices to reflect costs and gradually eliminate cross-subsidization among different categories of consumers.

8. **The financial restructuring of KESC is on track and the reorganization of WAPDA has recently made progress.** In April, the government repaid the bulk of KESC's debt to banks for PRs 22 billion and debt to suppliers for PRs 8 billion, increasing its equity correspondingly. While the operation had been programmed to take place through the exchange of bonds, because of favorable treasury bill rates we preferred a cash operation, financed by a special issue of treasury bills. The cabinet approved continued army support for collection enforcement to any new owner of KESC. The National Electric Power Regulatory Authority (NEPRA) is expected to formulate a set of multi-year tariff rules to provide regulatory certainty. The cabinet also approved in April 2002 the transfer of WAPDA's assets and liabilities to the new distribution (DISCOs), generation (GENCOs), and the transmission company, and by end-April all the DISCOs licenses had been issued. In mid-May, the government agreed with the World Bank on a Financial Improvement Plan (FIP) for WAPDA and its successor companies in agreement with WAPDA and NEPRA, as explained below. A first tariff increase by an average of 4 percent took place in mid-May combining the implementation of the increase under the fuel adjustment clause, that had been delayed in April due to the difficult socio-political context referred to above, with a partial implementation of the structural increase needed to absorb fuel cost increases up to the year 2000. We are confident that implementation of the agreed package will bring WAPDA to financial viability and higher efficiency, thus reducing its drain on the budget.

II. Economic and Financial Policies for FY 2002/03

A. Macroeconomic Objectives and Policies

9. **Developments so far and the strengthening of the international recovery bode well for a significant pick up in domestic economic activity, and the ambitious macroeconomic objectives under the program for FY 2002/03 appear achievable.** Assuming water availability at the level of recent years and a recovery of export orders as security concerns subside and international demand accelerates, real GDP growth (at factor cost) is projected to reach 4.5 percent in FY 2002/03. Building on recent price developments, assuming continued broad stability of the exchange rate, and barring persistent increases in international oil prices, we have lowered the inflation target from 5 percent to 4 percent. Higher imports related to the pick up of domestic activity as well as a return of remittances closer to historical levels are expected to cause the current account deficit—excluding official transfers—to slightly widen to 2.3 percent of GDP (from 1.3 percent of GDP projected for FY 2001/02), despite a strong recovery of exports. The latter is expected to be driven by an improvement in unit prices, a shift to higher value-added products in the textile sector, and the recent increase in market access to major trading partner markets. Including official transfers, which are expected to decrease from exceptionally high levels in FY 2001/02, the current account is projected to move from a 1.0 percent of GDP surplus to a 0.8 percent of GDP deficit in FY 2002/03. This deterioration will be offset by a lower capital account deficit, largely on account of lower public sector net short-term outflows (including lower repayment of trade credits and of foreign currency deposits). Private net inflows are expected to fall off from the exceptionally high levels of FY 2001/02 that reflected a portfolio shift of Pakistani balances abroad toward the domestic financial system. We expect that net exceptional financing, notably in the form of rescheduled debt payments and program financing from the International Financial Institutions (IFIs), will be somewhat lower than in FY 2001/02, at about US$2.6 billion. Gross official reserves would reach US$4.2 billion in June 2003, equivalent to four months of imports of goods and nonfactor services.

10. **In line with our strategy of fiscal consolidation to extricate Pakistan from unsustainable debt levels, we formulated the FY 2002/03 budget with the aim to reduce the consolidated government budget deficit (excluding grants) to 4.4 percent of GDP, while substantially raising social expenditure**. We expect this reduction to result from an increased tax effort and reduced low-priority expenditure, so as to ensure the implementation of the planned shift in public expenditure toward human development. This shift will also be reflected in considerable additional transfers to the provinces, in part related to World Bank loans to support provincial programs centered on improvements in governance and the provision of social services. In addition, should external budgetary cash grants plus capital grants reflecting debt cancellation exceed the programmed levels, such excess may be used for additional expenditure on I-PRSP categories for up to 0.5 percent of GDP, as specified in the Technical Memorandum of Understanding (TMU). As in the past, should unforeseen developments threaten the fiscal deficit target, we would reduce nonpriority expenditure and enact contingent tax measures as specified below.

11. **Achieving our fiscal deficit target while protecting human development expenditure will require a significant improvement in tax revenue performance.** The target for FY 2002/03 on total tax revenue of 13.6 percent of GDP implies an increase of around 0.9 percentage points of GDP over the expected outcome for FY 2001/02. Part of this increase reflects a base effect due to the one-off impact of the regional conflict (on imports and exports) and change in sales and customs refund procedures, cautiously estimated at 0.5 percent of GDP. Therefore our target implies a structural increase in tax revenue of about 0.4 percent of GDP. While the impact of improvements in tax administration have been disappointing so far, we believe that an increasing impact of the reform of CBR together with a few important tax policy measures will make this objective achievable. The full-year impact of the recent elimination of GST exemptions on nonlife-saving pharmaceuticals and fertilizers and of the January increase in diesel taxation should yield 0.15 percent of GDP, while the elimination of the exemption on domestic edible oil/vegetable ghee would add 0.1 percent of GDP on an annual basis. In order to limit the negative impact on the poor of the elimination of GST exemption on edible oil/vegetable ghee and on medicines, we have strengthened the budgetary allocation to food and food-for-work programs targeted toward the most vulnerable. We also envisage establishing a few special programs in the poorest areas of the country, such as distribution of food at schools to girls regularly attending classes. In order to protect low-income earners, we increased the personal income tax threshold from PRs 60,000 to PRs 80,000. To further remove distortions in income taxation that impede the efficient allocation of resources and provide privileged treatment to certain kind of incomes or specific entities or sectors, the budget for FY 2002/03 includes an income tax reform package that should be broadly revenue-neutral in the short term. It includes the elimination of two minor withholding taxes, the elimination of 55 income tax rebates, concessions, and nonstandard exemptions from the CRITO-list, the lowering of the interest income withholding threshold on National Saving Schemes (NSS), and a further step in unifying corporate income taxes. In the context of the planned World Bank-support operation to Sindh and North West Frontier Province (NWFP) and in view of the poor collection from the agricultural income tax, we will work with provincial governments to strengthen their tax policy and administration and implement base-broadening and revenue-enhancing measures, including stronger enforcement efforts on the agricultural income tax. We have also further streamlined the system of excises with the 2002/03 budget, and eliminated six minor excise taxes, while adjusting the rates of others to maintain revenue neutrality. Finally, we will pursue our strategy to harmonize petroleum taxation among the different products. Should revenue fall short of the target by end-2002, we will implement appropriate revenue measures.

12. **Unfortunately, the continued tension on the eastern border constrains our ability to create space for the much needed increase in human development expenditure.** Nonetheless, we intend to reduce the share of defense expenditure in GDP to about 3.6 percent, thus reverting to our trend aimed at maintaining defense expenditure constant in real terms over the medium term. To ensure that human development expenditures are as effective as possible we have been holding discussions with the World Bank staff to assess the quality of the proposed Public Sector Development Program (PSDP) and the I-PRSP

programs. With the FY 2002/03 budget, the elected district governments will be responsible for preparing their investment budgets in line with the needs and priorities of the community they administer. We expect that the devolution of investment expenditure to elected local administrations will increase the effectiveness of such expenditure (see below). We also expect that various reforms in government procurement policies, the restructuring of WAPDA and KESC, and better monitoring and greater accountability of public enterprises (as detailed below) will achieve the programmed reduction of quasi-fiscal activities and of explicit and hidden subsidies to public enterprises.

13. **We remain committed to a policy mix combining a flexible exchange rate and prudent monetary policies, geared toward achieving the inflation and reserves targets.** The targets for broad money and reserve money growth are broadly in line with the projected nominal GDP growth. We will ensure that our interest rate policy as well as the pace of SBP purchases of foreign exchange is consistent with the inflation objective and the monetary/reserves targets, within the framework of a fully flexible exchange rate. In light of the continued volatility in money demand, and notably the uncertainty as to whether the recent decline in velocity is a structural shift or only a temporary phenomenon, we will continue to closely monitor inflation developments and prospects as well as monetary aggregates, and stand ready to respond to any reemergence of inflationary pressures with a more aggressive absorption of liquidity. Given the limited stability of monetary aggregates, we are accelerating preparatory work toward moving to an inflation targeting framework; an important step will be legal reforms, to become effective before end-2002, enshrining greater independence of the SBP in the law (see below).

B. Structural Policies

Tax policy and tax administration

14. As described above, an important income tax reform package will become effective with the FY2002/03 budget, and income earned from July 1, 2002 will be covered by the new income tax law promulgated in September 2001, notably including nonmonetary benefits in taxable income. On the sales tax side, beyond the elimination of the GST exemption for nonlife-saving pharmaceuticals last April, we will eliminate the exemption for edible oil/ghee with the FY 2002/03 budget. We will also maintain, for FY 2002/03, the special GST rate of 20 percent on certain inputs as it helps to put pressures on traders to register under the GST to be able to get credit for sales tax payments. We estimate the measure is yielding PRs 2 billion per annum. Reform of the CBR will be pursued forcefully. We are on track to make a large taxpayer unit (LTU) in Karachi operational by July 1, 2002, as a pilot to provide valuable lessons for the planned functional integration of the administration of all taxes on a national basis. Ahead of schedule, we will establish a model income tax office for small and medium taxpayers in Lahore. Business procedures within CBR are being reformed, with the help of World Bank-financed consultants. Human resources management will be revamped over the next 12–15 months, including by late 2002, recruitment procedures that will emphasize CBR relevant special skills, a move to more merit-based promotion and remuneration rules, and

developing a system of performance-related bonuses. Modern information technology will be introduced at all levels, with focus in the short term on providing the LTU with a database integrated across taxes, and PC-based information systems.

I-PRSP implementation, public expenditure management, and fiscal transparency

15. I-PRSP implementation and reforms on improving fiscal transparency and data quality are proceeding as envisaged under the program. Implementation of the anti-poverty measures under the I-PRSP continue. Specific actions in recent months include electricity subsidies for use of tubewells by farmers in drought-stricken areas, and the launching of a program to reschedule debt of small farmers in such areas. The recently established I-PRSP secretariat has intensified the monitoring of pro-poor expenditures, which are now regularly reported to the public on a quarterly basis, and with the Department for International Development (DFID) and World Bank support we are in the process of identifying suitable intermediate poverty indicators that could be monitored by early 2003. We will improve our I-PRSP quarterly monitoring as specified in Table 2. Three such indicators have been incorporated into the regular reporting under the program (see TMU), while recognizing that the outcome data reported by the existing systems suffer from various shortcomings that will be addressed over the coming months and year. On fiscal transparency and data quality, we will continue to implement measures in line with the Accountable Fiscal Management Framework (AFMF), and as agreed with the World Bank in the context of the Pakistan Improvement of Financial Reporting and Accounting (PIFRA) project. We will issue the FY 2003/04 budget call on the basis of the New Accounting Model (NAM), in parallel with the old one, for the federal government and NWFP, to push ahead with the eventual implementation of this model at all levels of government. At the provincial level, fiscal transparency and data work is being supported through the IFIs-financed provincial structural adjustment loans. As part of these reforms, Sindh Province will begin to publish quarterly fiscal data on its website, starting with the first quarter of FY 2002/03.

Other governance reforms

16. Ongoing reforms in the areas of devolution, civil service, tax policy and administration, and public financial management, as well as our ambitious privatization program all derive from the core of our reform program, that is to improve governance. Specific additional steps involve the reform of police and the judiciary under an Asian Development Bank (AsDB)-supported program, and public procurement reforms under the SAC II including the passage of a law establishing the Public Procurement Regulatory Authority. We recently invited Transparency International (TI) to assess the status of our anti-corruption activities and to make suggestions how to make them more effective. TI has clearly recognized our efforts and confirmed its view that corruption at the top levels of government has very significantly decreased. TI also made recommendations aimed at further reducing corruption, in particular through a proactive information and transparency policy, continued civil service reform, and reform of the procurement system, which we will carefully review and as appropriate incorporate in our reform agenda. A first step will be to

increase accountability of public enterprise managers by publishing quarterly performance reports for key public enterprises, as detailed below.

Public enterprises

17. The privatization program suffered a serious setback due to the events of September 11, but is now broadly on track, except that the privatization of Pakistan Telecommunications Company Limited (PTCL) has been delayed by a few months due to limited investor interest in the context of the weak financial position of the international telecommunication sector. We are also in the process to work out quarterly performance targets for Pakistan International Airlines (PIA), Pakistan Railways, Pakistan Steel Mills, and WAPDA/successor companies, to be ready in August 2002, with quarterly public reporting on such targets to start in November and covering the first quarter of FY 2002/03. In particular for designing a monitoring and reporting framework for WAPDA, which is complicated by the ongoing unbundling of WAPDA into various corporate entities, in line with the strategy supported by the World Bank, we have requested urgent assistance from the World Bank. The quarterly performance targets for WAPDA/successor entities will be derived from the financial improvement plan (FIP) recently agreed with the World Bank, covering the period through June 2004. The key elements of the FIP include a request to NEPRA for a structural average tariff increase of 16 percent in July 2002; enhanced efforts on billing including prompt disconnection of consumers whose current bills are not paid in a timely manner; limits on the growth in administrative expenses; strict application of the automatic fuel adjustment clause; and realistic targets for reduction of technical and distribution losses. On this basis, WAPDA should not require any further budgetary support (deferral of debt service or cash support) from FY 2003 onwards.

Agriculture and marketing reforms

18. Our strategy in agriculture centers on better water management, providing better extension service to improve yields and reduce vulnerability to drought and pests, and to gradually reduce government involvement in the marketing of agricultural commodities, as specified in a reform program supported by an AsDB loan. A policy statement setting out the government's policies in this regard will be issued shortly. However, during FY 2001/02 the private sector has been quite slow in assuming a greater role, especially in investing into wheat storage facilities. In part this reflects uncertainty as to whether the recent wheat surpluses will be sustained (and with it the possibility to export freely), or whether a return to deficits would imply a return to the rationing and control mechanisms of the past. In part, it also reflects a continued policy of supporting the wheat price through public procurement at a fixed price. However, private traders and mills seem now ready to embark on a significant storage building program, owing to an incentive package including (a) interest rate subsidies to allow private traders to borrow at the same rate as public procurement agencies for procurement and storage building; (b) guarantee of occupancy of new storage facilities by the Pakistan Agricultural Storage and Services Corporation (PASSCO, the public procurement agency managing the national security stock) for the first five years; (c) support for private

exporters toward the cost of upgrading domestically procured wheat to export quality; (d) setting up of export silo facilities at Port Qasim; (e) the ongoing rapid development of laboratories certifying for international, and perhaps soon to be developed national, standards; and (f) a policy of gradually rising issue prices starting in September 2002, to reflect the physical and financial cost of storage. The incentive package will be reviewed at the latest by June 2004.

Financial sector and exchange system reforms

19. **Banking sector reform** is proceeding as planned, centered on the privatization of the nationalized banks (UBL in June, Habib in the fall of 2002, and further floating of the National Bank of Pakistan (NBP) shares in 2002/03) following extensive restructuring of the branch networks, staffing, and balance sheets in the context of a World Bank project. We are also modernizing the prudential framework, particularly for SME and consumer financing. We plan to pursue an evolutionary approach to Islamic finance, encouraging the development of Islamic banking alongside traditional financial institutions, while adapting regulations for the supervision of chartered Islamic banks. We look forward to discussing our strategy in detail with the planned IMF/World Bank Financial Sector Assessment Program (FSAP) mission, and finalize specific actions in particular (a) to protect the financial system against illicit use, by bringing anti-money laundering rules up to best practices; (b) further modernize the prudential framework; and (c) phasing out the remnants of administered credit allocation (such as prescribed lending to agriculture). In the context of a **capital market reform** program supported by an AsDB loan, we will aim to further strengthen stock market supervision, develop secondary markets for government paper, and streamline the instruments of the national saving scheme. With the FY 2002/03 budget, we will take further steps toward harmonizing withholding rates across all financial instruments (including NSS) and rationalizing interest rates for NSS instruments. A new central bank law will be adopted by end-October 2002, strengthening SBP independence in particular in the area of reserve management, in line with Fund safeguard assessment recommendations. To further deepen the foreign exchange market, and strengthen monitoring of inward transfers, we will enact a legal and regulatory framework for the transformation of moneychangers into foreign exchange companies (which will be allowed inward transfers) by August 2002, and subsequently allow banks to purchase foreign exchange from moneychangers at freely negotiated rates, thus moving further toward unification of the interbank and the kerb market.

C. Financing Issues

20. **We are confident that the program is fully financed for FY 2002/03**. We are working to conclude the bilateral agreements implementing the recent Paris Club Agreed Minute as scheduled on favorable terms, and have initiated discussions with all creditors. In line with the Paris Club Agreement, we will seek to ensure treatment of our debt due to all bilateral creditors on terms comparable to those agreed with the Paris Club creditors. During meetings with our official development partners, notably during the recent Pakistan Development Forum in Paris, partner countries and multilateral institutions indicated strong

support for our reform strategy, as laid out in the I-PRSP, and we expect to obtain financial support at least at the levels assumed in the program, including possibly sizable debt swaps (for social expenditure) in the context of the aforementioned bilateral debt restructuring agreements, as well as in some cases outright debt cancellation. We are also firmly determined to meet the conditionality attached to program loan disbursements with the AsDB and World Bank to ensure the projected disbursements on time.

III. Data Issues

21. In the context of the project to revise and change the base year of national accounts, five additional studies, including on agriculture, construction, and large scale manufacturing, have been completed and will be sent to IMF staff for comments shortly. Three other studies, including on saving and investment, that had to be outsourced should be ready by June 2002. Our plan to publish producer price indices has been somewhat delayed, and is now scheduled for late 2002. Due to administrative capacity constraints, the planned steps toward improvement in statistical data dissemination outlined in the March 2002 MEFP could not be taken. These steps will however be implemented by June 30, 2002. Work on institutional reform plans for the statistical system has been carried on. With the help of a foreign technical advisor, we expect to finalize a restructuring plan by mid-2002.

IV. Program Monitoring

22. The proposed quantitative performance criteria and indicative targets for end-September and end-December 2002 are set out in Table 1. Table 2 reports on the status of the structural performance criteria and benchmarks; it also includes the new measures we intend to take in FY 2002/03 and the actions we intend to take prior to the Board discussion of the second review. To clarify the definition of program targets and to extend the reporting requirements under the program to additional variables considered essential for appropriate monitoring, the existing TMU has been amended. Starting July 1, 2002, the attached TMU will replace the existing one for the definition of performance criteria and for program monitoring purposes; it now specifically includes a few monitorable social sector targets. We expect the third review to take place as scheduled by end-September 2002. The review will focus on public enterprise finances and the monitoring of I-PRSP expenditures and intermediate outcome indicators.

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

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

	Outstanding Stock End-Jun. 2001 2/	Prog. End-Dec. 2001	Adj. Prog. End-Dec. 2001	Act. End-Dec. 2001 2/	Prog. End-Mar. 2002	Adj. Prog. End-Mar. 2002	Act. End-Mar. 2002	Prog. End-Jun. 2002
Net foreign assets of the SBP (floor in millions of U.S. dollars)*	-253.5	461.5	220.5	1,148.5	93.5	-285.0	1,694.5	725.8
				(In billions of Pakistani rupees)				
Net domestic assets of the SBP*	549.4	11.0	26.4	-16.7	28.5	52.7	-73.1	6.8
Overall budget balance (floor)*		-107.8	-107.8	-99.0	-160.5	-160.5	-115.7	-212.3
Net government bank borrowing*	499.7	-9.6	6.4	-6.7	-4.0	12.0	-0.9	-6.9
CBR revenue (floor)*		183.3	...	174.5	277.4	...	269.8	414.3
Net credit to public sector enterprises*	100.7	5.5	...	3.9	14.0	...	3.8	22.5
Accumulation of budgetary arrears to WAPDA by list of priority connections*		0.00	...	-0.02	0.00	...	0.00	0.00
Social- and poverty-related spending ("I-PRSP budgetary expenditure")	...	62.0	...	45.9	96.6	...	80.0	136.4
				(In millions of U.S. dollars)				
Contracting or guaranteeing of short-term external debt by the government and the SBP*		500.0	...	120.0	700.0	...	305.0	800.0
Contracting or guaranteeing of noncessional medium-term and long-term debt by the government* 3/		600.0	...	223.0	600.0	...	223.0	750.0
Of which: external debt with an initial maturity of over one year and up to five years*		300.0	...	0.0	300.0	...	0.0	300.0
Accumulation of external payments arrears (continuous performance criterion during the program period)*		0.0	...	0.0	0.0	...	0.0	0.0
SBP's forex reserves held with foreign branches of domestic banks (outstanding stock)	320.0	250.0	...	238.9	175.0	...	78.4	100.0
Of which: other than current account*	200.0	150.0	...	140.4	75.0	...	34.2	0.0
Contracting of foreign currency swap and forward sales*		0.0	...	0.0	0.0	...	0.0	0.0
Memorandum items:								
Net external program financing		109.7	...	-180.0	-63.5	...	-480.5	225.2
External cash budget grants		616.5	...	625.5	801.4	...	672.9	766.5
Poverty alleviation and other programs eligible for additional grant-financed expenditure (in billions of Pakistani rupees) 4/		41.3	...	n.a.	63.4	...	n.a.	90.1
Foreign currency deposits with the SBP (including reserve requirements)	399.0	4.0	...	34.0	20.0	...	52.0	71.9
Daily cash reserve requirements ratio (in percentage points)	4.0	4.0	...	4.0	4.0	...	4.0	4.0
Issuance of government bonds to banks in the context of the recapitalization of KESC and clearance of banks' claims on CBR (in billions of Pakistani rupees)		0.0	...	0.0	0.0	...	0.0	56.0

Source: Pakistani authorities.

1/ The relevant variables are defined in the Technical Memorandum of Understanding (TMU) dated November 2001 and the TMU dated March 12, 2002, and are subject to adjustors specified in the TMUs. For variables marked "*" the end-December 2001, end-March 2002, and end-June 2002 program flows represent ceilings (or floor, if indicated) that constitute performance criteria. All other targets are indicative.

2/ The June 2001 stock data and the December 2001 actual flow data for overall budget balance, net government bank borrowing, and net credit to public enterprises have been corrected for various data revisions. The revisions relates to (a) the inclusion of the BSAL account and the Privatization Fund in SBP net claims on the government; (b) the reclassification of some bonds issued by public corporations, but serviced by the government, from net credit to public enterprises to net government bank borrowing; and (c) the reclassification of credit to privatized public enterprises from net credit to public enterprise to credit to the private sector.

3/ Excluding PRGF loans.

4/ See definition in the TMU dated March 12, 2002, Table 2.

Table 1(b). Pakistan: Quantitative Targets, September 2002–June 2003 1/

(Cumulative flows from July 1, 2002 unless otherwise specified)

	Proj. Stock End-Jun. 2002	Prog. End-Sep. 2002	Prog. End-Dec. 2002	Proj. End-Mar. 2003	Proj. End-Jun. 2003
Net foreign assets of the SBP (floor in millions of U.S. dollars)*	1,574.0	320.0	497.0	845.0	983.0
		(In billions of Pakistani rupees)			
Net domestic assets of the SBP*	482.6	-0.2	8.8	-6.6	9.8
Overall budget balance (floor)*	...	-56.4	-98.7	-136.2	-178.4
Net government bank borrowing*	549.5	-4.4	-15.9	-38.6	-29.2
CBR revenue (floor)*	...	90.0	200.5	310.2	460.6
Net banking sector claims on public sector enterprises*	...	7.0	11.7	16.3	20.0
		(In millions of U.S. dollars)			
Outstanding stock of short-term external debt owed or guaranteed by the government and the SBP*	325.0	500.0	500.0	500.0	500.0
Contracting or guaranteeing of noncessional medium-term and long-term debt by the government* 2/	...	600.0	600.0	600.0	750.0
Accumulation of external payments arrears (continuous performance criterion during the program period)*	...	0.0	0.0	0.0	0.0
SBP's forex reserves held with foreign branches of domestic banks (outstanding stock)	100.0	100.0	100.0	100.0	100.0
Of which: other than current account*	0.0	0.0	0.0	0.0	0.0
Stock of outstanding foreign currency swap and forward sales between SBP and residents*	...	400.0	400.0	400.0	400.0
Memorandum items:					
Net external program financing	...	447.5	597.4	980.5	971.2
Of which: privatization proceeds	...	50.0	100.0	150.0	200.0
External cash budget grants	...	36.4	106.6	156.0	160.4
I-PRSP outlays eligible for additional grant-financed expenditure (in billions of Pakistani rupees) 3/	...	35.4	70.8	114.3	161.0
Foreign currency deposits with the SBP (including reserve requirements)	459.0	-22.0	4.0	20.0	71.9
Daily cash reserve requirements ratio (in percentage points)	4.0	4.0	4.0	4.0	4.0

Source: Pakistani authorities.

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

2/ Excluding PRGF loans.

3/ See definition in the TMU, Table 2.

Table 2. Pakistan: Structural Performance Criteria and Benchmarks for the First Two Years Under the PRGF Arrangement (Continued)

Measures	Timing	Status as of June 17, 2002
I. Structural Performance Criteria 1/		
No new exemptions or special privileges regarding income tax, custom duties, or GST to be granted, no new regulatory import duties to be imposed (except for anti-dumping measures), and all time bound exemptions and regulatory import duties to lapse without extension, except for existing contracts and exemptions based on international commitments, and except for custom duty and income tax exemptions for the shipping industry (as described in the MEFP dated March 12, 2002, para. 20).	Continuous	Met so far.
Implement new organizational set-up for CBR headquarters per approved CBR reform plan (as described in MEFP dated November 22, 2001, para. 21).	February 28, 2002	Done.
Apply standard GST penalty regime to retailers and eliminate GST exemptions for all fertilizer wholesale and retail trade.	March 31, 2002	Done.
Implementation of universal self-assessment effective for all income earned from July 1, 2002.	July 1, 2002	
Start operations of a Large Taxpayer Unit, integrating all domestic tax operations.	July 1, 2002	
Implementation of income tax reform package effective for income earned from July 1, 2002 including: elimination of at least two minor withholding taxes; elimination of at least 55 income tax rebates, concessions, and non-standard exemptions from the CRITO-list; and lowering the threshold on NSS schemes subject to withholding tax on interest income from PRs 300,000 to PRs 150,000.	July 1, 2002	
Bring KESC to point of sale, (as detailed in MEFP dated November 22, 2001, para. 23).	July 31, 2002	
Issue circular allowing banks to purchase from August 1, 2002 foreign exchange from money changers at freely negotiated rates.	August 1, 2002	
Issue budget call for 2003/04 budget on the basis of the New Accounting Model (NAM) for federal government and any one province, for parallel run with existing system.	***October 31, 2002***	

Table 2. Pakistan: Structural Performance Criteria and Benchmarks for the First Two Years Under the PRGF Arrangement (Continued)

Measures	Timing	Status as of June 17, 2002
Publish quarterly progress reports on implementation of financial improvement plan of WAPDA/successors.	***November 30, 2002 for the quarter July–September 2002, and February 28, 2003 for the period October–December 2002.***	
	II. Structural Benchmarks 1/	
Prepare list of intermediate indicators (selected from Table 5.3 and Tracking/Monitoring Matrix in Annex I of I-PRSP) with baseline data for 2000/01, and preliminary annual targets for the period FY 2001/02–2003/04.	December 31, 2001	Done as per I-PRSP.
Quarterly published progress reports on implementation of Poverty Reduction Strategy, including "I-PRSP expenditure", ***as well as on progress in (a) establishing institutional framework for I-PRSP monitoring; (b) preparation of full PRSP; and (c) developing baseline data and monitoring framework for intermediate indicators.***	To start end-December 2001 for 2001/02 Q1 data, and continued on the basis of the same quarterly schedule throughout fiscal year 2001/02 and FY 2002/03.	Second report published in late March 2002.
Publish rules and regulations including for record-keeping under the universal self assessment scheme for income tax to become effective July 1, 2002.	March 31, 2002	Draft rules published end-March to obtain public feedback.
Prepare proposals for revised income and sales tax appeals and dispute resolution process with a view to implement them with the FY 2002/03 budget.	March 31, 2002	Done.
Bring United Bank Ltd. and PTCL to the point of sale through transparent and open public offer for sale.	May 31, 2002	Expression of interest invited for both companies in early 2002; PTCL privatization delayed to August due to lack of interest by qualified bidders. Expression of interest for UBL received and due diligence completed; bidding took place in early June.

Table 2. Pakistan: Structural Performance Criteria and Benchmarks for the First Two Years Under the PRGF Arrangement (Continued)

Measures	Timing	Status as of June 17, 2002
Issuance of a streamlined foreign exchange manual to simplify and clarify rules regarding access to foreign exchange and current account transactions.	July 1, 2002	Issued in January 2002.
Establishment of a contributory pension scheme for new recruits in the civil service, and preparation of a third phase public pension reform package, prepared in collaboration with the World Bank and involving actuarially fair reform of early retirement and of commutation tables.	July 1, 2002	Announced in FY 2001/02 budget speech; implementation delayed due to lack of actuarial expertise. Actuarial cell in MoF to be established by end-2002.
Implement structural electricity tariff adjustment consistent with WAPDA financial improvement plan.	***July 15, 2002***	
Preparation of financial plans and quarterly performance targets for FY 2002/03 for PIA, Pakistan Railways, and Pakistan Steel Mills.	***August 31, 2002***	
Eliminate administrative restrictions on the setting of interest rates on foreign currency deposits.	***September 30, 2002***	
Implement revised sales tax and customs refunds rules and procedures to reduce the incidence of incorrect claims and payments.	***September 30, 2002.***	
Prepare customs administration reform plan.	***September 30, 2002***	
Make model income tax office for small and medium taxpayers in Lahore fully operational.	***October 31, 2002***	
Amend SBP Act to strengthen central bank autonomy, in particular in the area of reserve management, per Safeguard Assessment recommendations.	***October 31, 2002***	

Table 2. Pakistan: Structural Performance Criteria and Benchmarks for the First Two Years Under the PRGF Arrangement (Concluded)

Measures	Timing	Status as of June 17, 2002
III. Prior Actions for Completion of Second Review 1/		
Announcement of federal budget consistent with financial program set out in MEFP.		
Adoption by government of quantitative quarterly performance plan and reporting framework for reporting on implementation of WAPDA financial improvement plan for FY 2002/03, and assignment of responsibility for quarterly reporting.		
Full restoration of petroleum levies to February 2002 levels in the context of the fortnightly petroleum price adjustments by June 1, 2002.		***Implemented by June 1, 2002***
Implement interim electricity tariff adjustment by at least PR 0.12 per kwh as called for under the WAPDA financial improvement plan.		***Implemented May 15, 2002.***
Issue rules and regulations pertaining to record keeping under universal self-assessment scheme for income tax to become effective July 1, 2002.		
Issue the revised income and sales tax appeals and dispute resolution rules, to become effective July 1, 2002.		

1/ Measures in bold italics are proposed new conditionality for the second review.

PAKISTAN

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

(June 18, 2002)

1. With effect from July 1, 2002, this memorandum replaces the Technical Memorandum of Understanding (TMU) relating to the monitoring year under the PRGF-supported program, dated March 2002. The main qualitative changes from the March 2002 TMU involve specification of extended reporting requirements on Water and Power Development Authority's (WAPDA) financial performance, while removing the monitoring of arrears on account of priority connections (along with the corresponding performance criterion). Throughout, "government" is meant to comprise the federal and provincial governments, except in relation to the external debt ceiling performance criteria, where it also comprises local governments, as well as public sector enterprises and government-owned banks. The latter refers to enterprises or banks in which the government holds a direct majority ownership interest (i.e. equity participation of above 50 percent).

I. Definitions of Monitoring Variables

Valuation of foreign exchange denominated assets and liabilities

2. For the purposes of monitoring under the program, all assets and liabilities as well as debt contracted, denominated in SDRs or in currencies other than the U.S. dollar, will be converted into U.S. dollars at their rates prevailing as of March 29, 2002, as published in the International Financial Statistics (IFS). The U.S. dollar value of all foreign assets and liabilities, as well as external proper financing and cash grants, will be converted into Pakistan rupees at the end-March 2002 exchange rate of PRs 60.07 per US$1.

3. **Reserve money** (RM) is defined as the sum of: currency outside scheduled banks (deposit money banks); scheduled banks' domestic cash in vaults; scheduled banks' required and excess rupee, as well as foreign exchange deposits with the State Bank of Pakistan (SBP); and deposits of the rest of the economy with the SBP excluding those held by the federal and the provincial governments.

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

money banks, international organizations, and deposits of foreign nonbank financial institutions (NBFI).[1]

5. **Net domestic assets (NDA) of the SBP** are defined as the difference between RM and the NFA of the SBP.

6. **Net borrowing from the banking system by the government** is defined as the difference between the banking system's claims on the central and provincial governments and the deposits of the central and provincial governments with the banking system. For purposes of this memorandum, claims on government exclude credit for commodity operations; government deposits exclude outstanding balances in the Zakat Fund. The stock of bonds which were issued to banks in substitution of outstanding nonperforming loans to certain public entities, and which are being fully serviced by the government, are included in banking system claims on government (e.g. bonds issued in 1995, 1996, and 1998 by GCP, RECP, CEC, TCP to UBL, Habib Bank, and NBP).

7. The definition of the **overall budget deficit (excluding grants)** under the program will be the consolidated budget deficit excluding grants, excluding the operations of local governments financed from local funds. It will be measured by the sum of (a) the total net financing to the federal and provincial governments; and (b) the total external grants to the federal and provincial governments. The former is defined as the sum of net external budget financing (defined below), net borrowing from the banking system (as defined above), and net domestic nonbank financing (defined below). The latter is defined as the sum of project grants, the rupee counterpart of the Saudi Oil Facility, cash external grants for budgetary support, and capital grants reflecting the principal amounts of external debt cancellation or swaps.

8. **Net external budget financing** is defined as net external program financing plus all other external loans for the financing of public projects or other federal or provincial budget expenditures. **Net external program financing** is defined to include external privatization receipts; budget support loans from multilateral (other than the Fund, but including the World Bank's BSAC and any World Bank and Asian Development Bank (AsDB) provincial structural adjustment loans), official bilateral, and private sector sources; rescheduled government debt service and change in stock of external debt service arrears net of government debt amortization due on foreign loans, the latter including any implicit accelerated amortization related to debt swaps or debt cancellation recorded as capital grants. It includes foreign loans onlent to financial institutions and companies (public or private) and emergency relief lending. Program financing excludes all external financing counted as reserve liabilities of the SBP (defined above). Amounts assumed for net external program financing and external grants are provided in Tables 1(a) and 1(b).

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

9. **Net domestic nonbank financing of the budget** is defined as: domestic privatization receipts plus the change, during each fiscal year, in the stock of (a) permanent debt, which consists of nonbank holdings of prize bonds, all federal bonds and securities; plus (b) floating debt held by nonbanks; plus (c) unfunded debt, which consists of National Savings Scheme (NSS) debt, Postal Life Insurance, and the General Provident Fund; plus (d) stock of deposits and reserves received by the government (public accounts deposits); plus (e) suspense account; plus (f) any other government borrowing from domestic nonbank sources net of repayments; minus (g) government deposits with NBFIs. Nonbank holdings of permanent and floating debt is defined as total debt outstanding, as reported by the SBP, minus holdings of banks as per the monetary survey. Total treasury bill and other relevant government debt is valued at discount value.

10. **Net claims of the banking system on public sector enterprises** comprise the banking system's claims on all public sector enterprises, excluding credit for commodity operations. Net claims include both credit and holding of corporate paper, netted against outstanding deposits on the special account with the SBP for payments on public enterprises' rescheduled debt.

External debt

11. The performance criterion on contracting or guaranteeing of medium-term and long-term nonconcessional external debt by the government or the SBP applies not only to debt as defined in point No. 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt (adopted by the IMF Executive Board on August 24, 2000), but also to commitments contracted or guaranteed for which value has not been received.[2] Excluded from this

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[2] The definition of debt set forth in No. 9 of the guidelines reads as follows: "(a) For the purpose of this guideline, the term "debt" will be understood to mean a current, that is, not contingent, liability, created under a contractual arrangement through the provision of value in the form of assets (including currency) or services, and which requires the obligor to make one or more payments in the form of assets (including currency) or services, at some future point(s) in time; these payments will discharge the principal and/or interest liabilities incurred under the contract. Debts can take a number of forms, the primary ones being as follows: (i) loans, that is, advances of money to obligor by the lender made on the basis of an undertaking that the obligor will repay the funds in the future (including deposits, bonds, debentures, commercial loans, and buyers' credits) and temporary exchanges of assets that are equivalent to fully collateralized loans under which the obligor is required to repay the funds, and usually pay interest, by repurchasing the collateral from the buyer in the future (such as repurchase agreements and official swap arrangements); (ii) suppliers' credits, that is, contracts where the supplier permits the obligor to defer payments until some time after the date on which the goods are delivered or services are provided; and (iii) leases, that is, arrangements under which property is provided which the lessee has the right to use for one or more specified period(s) of time that are usually shorter than the total expected service life of the property, while the lessor retains the title to the property. For the purpose of the guideline, the debt is the present value (at the inception of the lease) of all lease payments expected to be made during the period of the agreement excluding those payments that cover the operation, repair or maintenance of the property. (b) Under the definition of debt set out in point 9(a) above, arrears, penalties, and judicially awarded damages arising from the failure to make payment under a contractual obligation that constitutes debt are debt. Failure to make payment on an obligation that is not considered debt under this definition (e.g., payment on delivery) will not give rise to debt."

performance criterion are (a) foreign currency deposit liabilities of the SBP; and (b) the outstanding stock of debt of Foreign Exchange Bearer Certificates (FEBCs), Deposit Bearer Certificates (DBCs), and Foreign Currency Bearer Certificates (FCBCs). The performance criterion setting a limit on the outstanding stock of short-term external debt refers to debt (as defined in footnote 2) with original maturity of up to and including one year. Medium- and long-term external debt comprises debt with initial maturity of over one year. The external debt will be expressed in U.S. dollar terms, with debts in currencies other than the U.S. dollar converted into U.S. dollars at the market rates of the respective currencies prevailing on March 29, 2002 as published in IFS.

12. **Nonconcessional borrowing** is defined as borrowing with a grant element of less than 35 percent, following the methodology set out in the staff report SM/96/86 and approved by the IMF Executive Board on April 5, 1996. The discount rates used to calculate the grant element will be the six-month and ten-year Commercial Interest Reference Rates (CIRRs) averages, as computed by the Policy Development and Review Department of the Fund. Six-month CIRRs are updated mid-February and mid-August (covering the six-month period preceding the date of update) and the ten-year CIRRs averages are updated mid-December (covering a period of 10 years preceding the date of the update). Six-month CIRRs averages are to be used for loans whose maturity is less than 15 years, while ten-year CIRRs averages are to be used for loans whose maturity is equal or more than 15 years.

13. **Poverty-related and social public spending ("I-PRSP expenditure")** consists of central provincial and district government spending under the current budget and the Public Sector Development Program (PSDP), as defined in Table 2. The indicative Interim Poverty Reduction Strategy Paper (I-PRSP) expenditure targets will be adjusted upward by any nondebt creating relief on external interest payment as a result of bilateral debt restructuring and debt swaps.

II. ADJUSTORS

14. The floors on the **NFA of the SBP** and ceilings on the **NDA of the SBP** will be adjusted (a) upward/downward (respectively downward/upward) by the cumulative excess/shortfall in net external program financing (as defined below; Table 1(a)); and (b) upward/downward (respectively downward/upward) by the cumulative excess/shortfall in external cash budget and capital grants resulting from debt cancellation and debt swaps (as defined below; Table 1(b)). Downward adjustments of NFA and upward adjustments of NDA will be capped at US$400 million.

15. The ceiling on **net bank borrowing by the government** will be adjusted downward/upward by the cumulative excess/shortfall in net external program financing plus external cash budget and capital grants resulting from debt cancellation and debt swaps; and upward by any downward adjustment in the budget balance in conjunction with higher I-PRSP expenditure as set out below. Total upward adjustments will be capped at US$400 million. The ceiling will also be adjusted upward by the increase in net claims of the banking system on the government resulting from (a) the takeover of NBFI by a scheduled

bank; and (b) the government's paying-off residual debt of Karachi Electric Supply Corporation (KESC) toward banks or suppliers in the context of privatization, up to PRs 11 billion.

16. The ceilings on the **NDA of the SBP** will also be adjusted downward/upward by the amount of (a) banks' rupee reserves freed/seized by any reduction/increase of the daily CRR of 4 percent; (b) banks' reserves freed/seized by any reduction/increase in the total reserve requirements on foreign currency deposits of 25 percent; and (c) any reduction/increase in the reservable deposit base that is related to definitional changes, as per the following formula: $\Delta NDA = \Delta r B_0 + r_0 \Delta B + \Delta r \Delta B$, where r_0 denotes the reserve requirement ratio prior to any change; B_0 denotes the level of the reservable deposits in the initial definition; Δr is the change in the reserve requirement ratio; and ΔB denotes the change in the reservable deposits as a result of definitional changes.

17. The floor on the **consolidated overall budget balance (excluding grants)** will be adjusted downward for the cumulative excess in external cash budget grants and capital grants resulting from debt cancellation or debt swaps for up to PRs 5 billion at end-September 2002, PRs 10 billion at end-December 2002, PRs 15 billion at end-March 2003, and PRs 20 billion at end-June 2003. Downward adjustments in the floor will have to be matched by identical increases in actual budgetary I-PRSP expenditures above the program levels (Table 2). The floor will also be adjusted downwards by the government's outlays for paying-off residual debt of KESC toward banks or suppliers in the context of privatization, up to PRs 11 billion.

18. The ceiling on **net claims of the banking system on public sector enterprises** will be adjusted downward for the amount of repayment by the government of bank credit to KESC outstanding as of July 1, 2002, in the context of KESC privatization. The ceiling will also be adjusted downward by the amount of net claims reclassified as claims on the private sector as a result of the privatization of any public enterprise.

III. PROGRAM REPORTING REQUIREMENTS

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

- Monthly provisional statements on federal tax and nontax revenue, within one month.

- Deposits into and withdrawals from the privatization fund for each quarter of 2001/02, within one month. Withdrawals will be reported with the following breakdown (a) those which constitute budgetary use of privatization proceeds; (b) those which constitute costs of privatization; and (c) other (with explanation of the purpose of other withdrawals).

- Quarterly statements on budgetary capital receipts and disbursements, including repayments of bonds, recovery of loans from provinces and "others", within two months.

- Monthly (unreconciled) provisional data on federal expenditure and net lending (with separate data on disbursements and repayments), within one month.

- Quarterly statement on consolidated budgetary expenditure, with federal data approved by the Auditor General Pakistan Revenue (AGPR), within two months.

- Quarterly provisional data (from AGPR and AG) on social sector and poverty-related budgetary expenditures, as defined below (Table 2), as well as on the subcategories eligible for additional grant-financed expenditure, as defined in Table 2, within six weeks.

- Quarterly data on the stock of domestic government debt, broken down by instrument, within one month.

- Quarterly data on WAPDA receivables (see Table 3), within one month.

- Monthly provisional data on external budget financing, including proceeds from the Saudi Oil Facility, and cash external grants for budget support (as defined below) as well as capital grants related to debt write-off/swaps, within one month.

- Quarterly data on the revenues and expenditures of the four public enterprises as per Tables 5(b) to 5(e) of the March 2002 TMU (KESC, Pakistan International Airlines, Pakistan Steel Mill Corporation, Pakistan Railways), and for WAPDA and its successor entities in the format of attached Table 4, within one month.

- The following monthly monetary data on a last-Saturday basis, both at current and program exchange rates, within four weeks:

    (i) monetary survey;
    (ii) accounts of the SBP;
    (iii) consolidated accounts of the scheduled banks;
    (iv) banks' lending to the government;
    (v) detailed table on net foreign assets (both for the SBP and scheduled banks);
    (vi) detailed table of scheduled banks' reserves with the SBP.

- The same tables as in the preceding item, but on an end-quarter basis (last business day), both at current and program exchange rates, within four weeks.

- SBP Table on outstanding stock of foreign currency deposits, amended to include the classification of new FCA according to the residency of the holder.

- Daily data on exchange rates (interbank, free market, and Telegraphic Transfers for SBP purchases on the free market), SBP's sales and purchases in the free and interbank foreign exchange markets, swaps and forward outright sales, within two business days.

- Monthly data on the outstanding stock of the SBP's forward foreign currency operations, including swaps and outright forward sales and purchases, within two weeks. The terms of any new transactions (including rollover/renewal of existing ones) will also be provided.

- Monthly data on the SBP's foreign exchange reserves, with details on the currencies, instruments, and institutions in which the reserves are held, within one month.

- Monthly data on net bank claims on public enterprise as per attached list and including details on the six autonomous bodies, within one month. The data will show separately the total amount of direct credit and bank holdings of corporate bonds.

- Monthly data on SBP direct or bridge loans to nationalized banks in the context of the restructuring and privatization operation, within four weeks.

- Monthly data on any other quasi-fiscal operations undertaken by the SBP, on behalf of the government.

- Monthly data on SBP holding of discounted export finance credit under the export finance scheme, within one month.

- Monthly data on outstanding credit to agriculture under the Agriculture Mandatory Credit Targets, within one month.

- Monthly data on scheduled banks' credit for commodity operations, with separate subcategories for Pakistan Agricultural Storage and Services Corporation (PASSCO) and Punjab Provincial Food Department operations, within four weeks.

- The following data on external debt, within six weeks:

  (i) Quarterly stock of public- and publicly-guaranteed external debt (including deferred payments arrangements), by maturity (initial maturities of up to and including one year, and over one year), by creditor and by debtor (central government and publicly guaranteed), and for Paris Club debt, with breakdown in pre- and post-cutoff date stock;

  (ii) Quarterly contracting on guarantees of nonconcessional medium- and long-term government debt; and

  (iii) Monthly statements on rescheduling agreements on public- and publicly-guaranteed debt reached with creditors.

- Quarterly data on external payments arrears on public- and publicly-guaranteed debt with details as in (i) of the preceding item, within six weeks.

- Copies of new or revised ordinances/circulars regarding changes in: tax policy, tax administration, foreign exchange market regulations, and banking regulations no later than three days after official issuance, or notification that ordinances have been posted on the Central Board or Revenue (CBR) and SBP websites.

- Copies of official notification of changes in gas and electricity tariffs (automatic or structural) and in ex-refinery petroleum product prices.

- Monthly data on the import parity prices as well as central depot prices of the six major oil products, within one month.

- Quarterly data on the following indicators, within two months after the end of the quarter:

  (i) Three intermediate poverty indicators identified in the I-PRSP (utilization rate of first level health care facilities for curative care, population covered by Lady Health Workers, and number of functional schools); and

  (ii) Social safety net beneficiaries as identified in the I-PRSP (temporary employment generated by Khushal Program by province, number of beneficiaries of Zakat by province and type of assistance, number of borrowers and size of credit under the PPAF and Khushali Bank programs by province, number of beneficiaries of the Food Support Program by province, acres of land distributed, and beneficiaries by province).

Table 1(a). Pakistan: Net external Program Financing FY 2001/02 and FY 2002/03

(In millions of U.S. dollars)

	(Cumulative from July 1, 2001)						(Cumulative from July 1, 2002)			
	Act.	Act.	Prog.	Act.	Prog.	Rev. Proj.	Proj.			
	Sep. 2001	Dec. 2001	Mar. 2002	Mar. 2002	Jun. 2002	Jun. 2002	Sep. 2002	Dec. 2002	Mar. 2003	Jun. 2003
Program financing (a+b+c+d+e+f-g+h)	**-161.9**	**-180.0**	**-63.5**	**-480.5**	**225.2**	**152.1**	**447.5**	**597.4**	**980.5**	**971.2**
(a) World Bank	0.0	95.0	208.0	95.0	580.9	695.0	185.0	215.0	600.0	615.0
(b) AsDB loans	0.0	150.0	350.0	150.0	370.0	150.0	235.0	385.0	385.0	400.0
(c) Other multilaterals	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
(d) Bilateral loans	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
(e) Commercial bank borrowing	207.0	469.0	718.0	660.2	913.0	905.0	100.0	200.0	300.0	400.0
Of which: IDB	106.0	176.0	320.0	267.2	420.0	412.0	100.0	200.0	300.0	400.0
(f) Privatization receipts	0.0	0.0	0.0	0.0	0.0	0.0	50.0	100.0	150.0	200.0
(g) Amortization due	651.8	1,392.5	2,385.4	2,154.9	2,890.1	2,886.8	393.0	790.9	1,188.4	1,576.9
Multilateral creditors	125.4	262.8	440.6	383.1	526.1	521.7	130.7	270.6	406.1	535.1
Bilateral creditors	192.1	319.9	652.1	477.0	734.0	649.0	184.9	302.0	460.7	559.0
Of which: debt cancellation	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Commercial banks	317.9	772.2	1,238.0	1,236.6	1,590.0	1,633.5	49.5	169.7	242.9	383.4
Other (military) 1/	16.4	37.6	54.7	58.2	40.0	82.6	27.9	48.6	78.7	99.4
(h) Debt service rescheduled/arrears	282.9	498.5	1,045.9	769.2	1,251.4	1,288.9	270.5	488.3	733.9	933.1
Multilateral creditors	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Bilateral creditors	267.7	460.4	1,045.9	716.3	1,213.4	1,207.3	245.9	440.3	662.1	838.5
Commercial banks	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other (military)	15.2	38.1	0.0	52.9	38.0	81.6	24.6	48.0	71.8	94.6

Source: Ministry of Finance.

1/ Includes also any additional external debt amortization mandated under the privatization law, under which 90 percent of any privatization receipts must be used to pay down public debt.

Table1(b). Pakistan: External Grants for FY 2001/02 and FY 2002/03

(In millions of U.S. dollars)

	(Cumulative from July 1, 2001)						(Cumulative from July 1, 2002)			
	Act.	Act.	Prog.	Act.	Prog.	Rev. Proj.	Prog.			
	Sep. 2001	Dec. 2001	Mar. 2002	Mar. 2002	Jun. 2002	Jun. 2002	Sep. 2002	Dec. 2002	Mar. 2003	Jun. 2003
External cash budget grants	**0.0**	**625.5**	**801.4**	**672.9**	**766.5**	**690.4**	**36.4**	**106.6**	**156.0**	**160.4**
United States	0.0	600.0	600.0	600.0	600.0	600.0	0.0	0.0	0.0	0.0
European Union	0.0	0.0	36.6	0.0	25.0	17.5	13.1	21.9	21.9	21.9
Japan	0.0	25.5	150.0	44.5	120.5	44.5	19.0	19.0	64.0	64.0
United Kingdom	0.0	0.0	14.8	28.4	21.0	28.4	0.0	57.0	57.0	57.0
Other	0.0	0.0	0.0	0.0	0.0	0.0	4.3	8.7	13.1	17.5
Saudi Oil Facility	173.0	300.0	544.9	417.0	609.0	577.0	164.3	325.6	484.7	642.4
Project grants	20.5	33.0	32.5	53.4	59.6	64.4	25.2	50.4	75.6	100.8
Capital grants (counterpart to external debt cancellation or debt swaps)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0

Source: Ministry of Finance.

Table 2. Pakistan: I-PRSP Expenditure, 2001/02–2002/03

(In billions of Pakistani rupees)

	Rev. Prog. Year 2001/02	Prov. Q1–Q3 2001/02	Prog. Q1 2002/03	Prog. Q2 2002/03	Prog. Q3 2002/03	Prog. Q4 2002/03	Prog. Year 2002/03
Total	136.4	80.0	35.4	35.4	43.5	46.7	161.0
Education	63.2	43.9					
Current	59.0	41.7					
Development	4.1	2.1					
Health	19.3	10.8					
Current	15.9	9.7					
Development	3.4	1.1					
Population planning	2.1	0.9					
Current	0.0	0.0					
Development	2.1	0.9					
Social security and other welfare	1.7	0.8					
Current	1.6	0.7					
Development	0.1	0.0					
Natural calamities	1.0	0.1					
Rural development 1/	15.2	5.7					
Current	2.8	1.9					
Development	12.5	3.8					
Land reclamation	1.5	1.2					
Food subsidies	8.7	6.0					
Water supply and sanitation	5.5	2.7					
Current	2.0	1.2					
Development	3.5	1.5					
Other	18.2	8.0					
Irrigation	9.4	5.0					
Current	4.8	3.6					
Development	4.6	1.5					
Roads	8.9	3.0					
Current	1.3	1.3					
Development	7.6	1.7					
Memorandum item:							
Khushal program	7.0	...					

Source: Ministry of Finance.

1/ Includes the Khushal program.

Table 3. Pakistan: Position of Billing/Receivables Vis-à-Vis WAPDA for the Quarter of January 1, 2002 to March 31, 2002[1]

(In millions of Pakistani rupees)

SR. NO.	CATEGORY	Memo. item RECEIVABLES AT THE END OF DECEMBER 2001	RECEIVABLES AT THE END OF PREVIOUS QUARTER	AMOUNT WITHDRAWN AGAINST PREVIOUS QUARTER	BILLING DURING QUARTER	TOTAL	PAYMENT DURING QUARTER	RECEIVABLES AT THE END OF THE QUARTER
0	1	2	3	4	5	6=3-4+5	7	8=6-7
A	Federal Government and AJK							
I.	Federal Government agencies	4,915	4,915		2,438	7,353	3,892	3,461
	Of which: Defense	3,162	3,162		881	4,043	2,329	1,714
II.	AJK	2,781	2,781		1,215	3,996	2,981	1,015
	Subtotal	7,696			3,653	11,349	6,873	4,476
B	Provincial Government							
I.	Punjab	0	0		1,372	1,372	259	1,113
II.	NWFP	637	637		512	1,149	695	454
III.	Sindh	0	0		790	790	316	474
IV.	Baluchistan	0	0		144	144	51	93
	Subtotal	637	637		2,818	3,455	1,321	2,134
C	Total Government (A+B)	8,333	8,333		6,471	14,804	8,194	6,610
	Of which:							
	Overdue receivables on priority connections	0.235	0.235					0.232
D	FATA and Agricultural T/wells in Baluchistan							
I.	FATA	7,431	7,431		4,639	12,070	41	12,029
II.	Agricultural. T/wells in Baluchistan	1,896	1,896	784	1,126	2,238	1,021	1,217
	Subtotal	9,327	9,327	784	5,765	14,308	1,062	13,246
E	KESC and other private consumers							
I.	KESC	10,916	10,916		760	11,676	1,186	10,490
II.	Other private consumers	16,440	16,440		30,408	46,846	28,576	18,272
	Subtotal	27,356	27,356		760	11,676	1,186	30,915
	Grand total (C+D+E)	45,015	45,015	784	12,996	40,788	10,442	50,771
	WAPDA debt service liabilities to government *Of which:* paid	12,921	12,921	2,000	6,086	17,007	1,922	15,085

[1] Receivables reflect amounts billed by WAPDA, not necessarily reconciled with the consumers.

Table 4. Pakistan: Financial and Operational Targets for WAPDA and Successor Companies in 2002/03–2003/04

(In millions of Pakistani rupees; unless otherwise indicated)

			Targets					
	2000/01	Prel. Est. 2001/02	Q1 2002/03	Q2 2002/03	Q3 2002/03	Q4 2002/03	Proj. 2002/03	Proj. 2003/04
Main assumptions								
International oil prices (U.S. dollar per barrel) 1/	26.28	22.14	...	...	...	...	...	...
Average exchange rate (Pakistani rupees per U.S. dollar)	58.3	61.0	61.6	62.3	62.9	63.5	62.6	67.3
Average structural tariff increase (in percent)	2.5	2.2	12.8	...	...	...	12.8	...
Units generated (in GWh)	58,416	60,160	17,552	14,126	13,338	16,913	61,929	63,775
Share of thermal units (in percent of units generated)	70.6	70.2	53.1	70.0	80.2	69.2	67.2	61.0
Units purchased (in GWh)	24,446	24,206	4,672	4,989	5,535	6,130	21,326	18,275
Main operational and financial targets								
Technical and nontechnical losses 2/ 3/	25.7	25.0	23.8	18.6	23.3	27.5	23.5	22.0
Debt service coverage ratio 4/ 5/	0.6	0.2	...	...	...	...	1.2	1.8
Total receivables (as a percentage of billing) 2/	26.7	24.4	20.7	19.0	17.3	16.0	16.0	16.0
Public sector receivables (as a percentage of billing) 2/	59.0	53.4	36.4	28.9	22.2	16.0	16.0	16.0
Stock of payables to fuel suppliers and IPPs 2/	3,209	15,284	9,103	8,412	13,786	14,571	14,571	3,656
Administrative expenses increase (in percent) 2/	2.2	15.0	...	...	...	...	10.0	10.0
Summary cash flow statement								
Total cash receipts	183,498	198,776	65,247	61,491	54,705	64,583	246,026	247,357
Total cash receipts (excluding GST, ED & W/Tax)	159,598	176,297	57,529	54,865	48,811	57,505	218,711	218,676
Total cash outflows	152,711	180,872	48,941	51,367	50,976	53,948	205,232	209,740
Purchase of power from IPPs	84,612	109,352	25,462	25,933	27,047	28,012	106,454	100,829
Cost of fuel	29,892	35,113	8,657	9,236	9,757	10,588	38,238	39,173
Debt service to GOP	20,231	164	5,745	5,745	5,745	5,745	22,978	21,035
Debt service other than to GOP	9,096	12,646	2,000	3,376	2,100	3,276	10,753	9,262
Hydel profit payment	6,000	6,000	1,500	1,500	1,500	1,500	6,000	6,000
Operations and Maintenance	15,674	17,782	4,827	4,827	4,827	4,827	19,309	21,026
Other cash outflows	-12,794	-185	750	750	0	0	1,500	12,415
Net cash available before investment program	6,887	-4,575	8,588	3,498	-2,165	3,558	13,479	8,936
Investment program	17,014	20,534	5,406	6,307	7,209	9,759	28,681	17,727
Foreign component	10,127	13,034	3,000	3,500	4,000	5,415	15,915	8,791
Local component	6,887	7,500	2,406	2,807	3,209	4,344	12,766	8,936
Cash surplus (+)/deficit (-)	0	-12,075	6,181	691	-5,374	-785	713	0
Memorandum items								
Average formula-based tariff increase (in percent)								
Number of customers disconnected at least once during period								

Source: Pakistani authorities.

1/ The projections are made on the basis of international oil prices prevalent on December 16, 2001 (for information, the price of the Brent crude was at US$18.8 / barrel).

2/ Ceiling.

3/ Defined as units generated and purchased minus units sold, as a percentage of units generated and purchased.

4/ Floor.

5/ Net revenues divided by debt service requirements, as per definition agreed with the World Bank.

Statement by the IMF Staff Representative
July 3, 2002

1. This statement summarizes the information that has become available since the staff report (EBS/02/107) was circulated to the Executive Board on June 19, 2002. It does not change the thrust of the staff appraisal.

Prior actions

2. The information provided by the authorities indicates that all the prior actions listed in the June 18, 2002 Memorandum of Economic and Financial Policies (MEFP) have been taken.

3. The 2002/03 federal budget is consistent with the program's fiscal objectives, notably a consolidated deficit of 4.4 percent of GDP.[1] The budget speech provides an explicit commitment to the I-PRSP expenditure target for 2002/03 (4 percent of GDP). Staff will undertake a detailed assessment of the expenditure composition and the envisaged pro-poor expenditure restructuring once details of the provincial and district budgets are available.

4. The government has confirmed that the Ministry of Water and Power and the Ministry of Finance will be jointly in charge of quarterly reporting, including to the public, on the implementation of the Water and Power Development Authority's (WAPDA) financial improvement plan as set out in the MEFP.

5. The authorities have issued rules and regulations pertaining to record-keeping under the universal self-assessment scheme for income tax, as well as the revised income and sales tax appeals and dispute resolution rules, both to become effective July 1, 2002.

Progress towards July 1, 2002 structural performance criteria

6. The federal budget for 2002/03 contains all major tax measures planned under the program. These include: implementation of a major income tax reform package effective for income earned from July 1, 2002; further rationalization of the excise tax system; the elimination of the sales tax exemptions for vegetable ghee and cooking oil; and the reduction of the maximum standard tariff rate to 25 percent (from 30 percent) and of the number of tariff slabs from 5 to 4. The very high special duty rates on vehicles were also reduced. The authorities specified a time-bound plan to reach a uniform corporate income tax rate of 35 percent in 5 years. Additional measures include the rationalization of various withholding taxes, elimination of certain subsidies to refineries, and the imposition of a 5–10 percent tariff on petroleum product imports. Increases in depreciation allowances and the amount of

[1] Because of a different presentation of external interest payments (on a cash basis, compared to the program presentation of payments on a due basis), the authorities' budget shows a deficit of 4.0 percent of GDP.

interest payments on housing loans that is tax-deductible are intended to stimulate investment, including in housing.

7. In a landmark reform, with the effectiveness of the income tax ordinance (promulgated in September 2001, for income earned from July 1, 2002) the government has introduced a universal income tax self-assessment system under the income tax on income earned from July 1, 2002 onwards, along with taxation of monetized perquisites and allowances. A brochure explaining the new system will be published in a few weeks. The Large Taxpayer Unit (LTU) in Karachi is on track to start operations on July 1; it will administer all domestic taxes in a functionally integrated manner for approximately 400 taxpayers.

Recent economic developments

8. Despite a significant increase in energy and transportation prices, the consumer price index (CPI) decreased by 0.8 percent in May, due to a drop in food prices. The 12-month increase in May was 2.9 percent, slightly below program projections. Official estimates published with the new budget revised projected real GDP growth for FY 2001/02 slightly upward to 3.6 percent (from 3.3 percent in the program), on account of stronger manufacturing and services. They also estimate real GNP growth at 5.2 percent, due to the very large increase in worker remittances.

9. Recent trade data confirmed a strong pick-up in trade flows. In U.S. dollar terms, exports increased by 6.7 percent in May 2002 year-on-year and imports surged by 18.7 percent. Worker remittances in July 2001–May 2002 more than doubled compared with the same period of FY 2000/01, to US$2.1 billion. Official reserves reached US$4.3 billion on June 28, 2002—much higher than the programmed US$3.5 billion—equivalent to about 4.3 months of imports of goods and nonfactor services. The State Bank of Pakistan (SBP) has continued to actively purchase foreign exchange, mostly on the interbank market. Purchases on the free ("kerb") market fell to 27 percent of total in the quarter to June, compared with 37 percent during July 2001–March 2002, and completely ceased in June 2002.

10. Over the past weeks, the Pakistani rupee remained virtually stable against the U.S. dollar, and thus depreciated against the euro. The spread between the free and interbank markets averaged 0.6 percent in June, and never exceeded 2 percent. The stock market gained about 6 percent in the course of June.

11. Available data on federal revenue and expenditure indicate that the authorities remain on track to meet the end-June fiscal deficit target, while meeting of the Central Board of Revenue (CBR) revenue target seems unlikely. CBR revenue in May was higher than last year by about 9 percent, which confirmed the pickup observed since March. Highly preliminary data for June indicate that revenue in June again grew by about 9 percent year-on-year, indicating that the end-year target of PRs 414 billion would be missed by about PRs 13 billion. In April, performance of other federal revenue and expenditure was in line with projections. Capital spending was on track to surpass the projection for the fourth

quarter, pointing to a further acceleration of I-PRSP spending. Defense outlays as well as domestic interest payments were lower than programmed, while other current expenditure was broadly in line with expectations.

12. With the budget, the authorities published a draft Fiscal Responsibility Law, inviting comments from the general public by July 15, with a view to enact the law by end-August 2002. The draft law would provide a good framework for fiscal transparency and sound fiscal policies. It prescribes the budget statements that the federal government has to provide on a regular basis, and sets a number of rules and targets for fiscal policy. Among these are achieving the "golden rule" no later than by end-June 2007, and reducing public debt to 60 percent of GDP by end-June 2012, while lowering debt by 2.5 percent of GDP each year, under the proviso that pro-poor public expenditures of at least 4 percent of GDP per year should be maintained.

13. On June 24, 2002 (6 days before a binding deadline) the Supreme Court set aside its judgment of December 1999 which upheld the decision of a lower court (the Federal Sharia Court) of 1991 requiring the transformation of the prevailing financial system into an interest-free one. The latest Supreme Court decision instructs the lower court to review its earlier decision through thorough comparative study of financial systems in other contemporary Muslim countries. The Pakistani authorities expect that this latest decision will lift the uncertainty initially caused by the 1991 decision, and that was exacerbated in 1999.

14. The authorities have taken the following two steps toward meeting the Special Data Dissemination Standards: publication of quarterly balance of payment statistics on the SBP's website and issuance of an Advance Release Calendar for selected economic data (various price, foreign trade, and industrial production statistics) on the website of the Federal Bureau of Statistics.

INTERNATIONAL MONETARY FUND

NEWS BRIEF

FOR IMMEDIATE RELEASE

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Washington, D. C. 20431 USA

IMF Completes Second Review of Pakistan's PRGF-Supported Program, Approves US$114 Million Disbursement

The Executive Board of the International Monetary Fund (IMF) completed today the second review of Pakistan's performance under a three-year, SDR 1.03 billion (about US$1.37 billion) Poverty Reduction and Growth Facility (PRGF) arrangement. This decision entitles Pakistan to the release of a further SDR 86.14 million (about US$114 million), which will bring total disbursements under the program (see Press Release No. 01/51) to SDR 258.44 million (about US$343 million).

In approving the disbursement, the Executive Board granted a waiver of Pakistan's non-observance of the quarterly revenue target for the period that ended March 31, 2002. The shortfall in revenue essentially reflected continued lower-than-expected imports in the aftermath of September 2001 events.

The PRGF is the IMF's concessional facility for low-income countries. PRGF-supported programs will in time be based on country-owned poverty reduction strategies adopted in a participatory process involving civil society and development partners, and articulated in a Poverty Reduction Strategy Paper (PRSP). This is intended to ensure that each PRGF-supported program is consistent with a comprehensive framework for macroeconomic, structural, and social policies to foster growth and reduce poverty. PRGF loans carry an annual interest rate of 0.5 percent, and are repayable over 10 years with a 5 ½-year grace period on principal payments.

Following the Executive Board's review of Pakistan, Eduardo Aninat, Deputy Managing Director, and Acting Chairman, made the following statement:

"The Fund commends the authorities for consolidating gains in macroeconomic stability and progressing with structural reforms in a difficult economic and political environment. Inflation remains low and strong private capital inflows and remittances have allowed a build up of official reserves well above program targets. The fiscal deficit for end-March 2002 was lower than programmed. Disappointingly, tax revenue collected by the Central Board of Revenue (CBR) as well as social sector spending were lower than targeted, although recent developments point to improved performance in these areas.

"The authorities' economic program for FY 2002/03 aims at tangible progress toward consolidating macroeconomic stability, reducing poverty, and strengthening governance in a wide range of areas. Barring a further deterioration of the regional security situation or other adverse shocks, real GDP is projected to grow by 4.5 percent, supported by a notable pick up in exports. Cautious monetary and exchange rate policies and continued fiscal consolidation will help keep inflation low and allow for a further accumulation of international reserves.

"Implementation of the budget for FY 2002/03 will help reduce public debt while increasing funding for social services, especially health and education expenditures. This will, however, require strong determination in enforcing tax collection, the continued timely implementation of reforms to enhance tax administration, and improved tracking and effective monitoring of social expenditure and related outcomes. The authorities should also stand ready to undertake appropriate corrective fiscal measures, if needed, to achieve the budgetary targets.

"Forceful implementation of the restructuring strategy for the two power utilities, the Water and Power Development Authority (WAPDA) and Karachi Electric Supply Corporation (KESC), is essential for putting an end to their persistent drain on budgetary resources. Electricity tariff adjustments are needed to correct past increases in input costs, while appropriate safety-net measures should protect the poorest consumers. Moreover, both public utilities need to be held more clearly accountable for their performance in reducing leakage, theft, administrative costs, and enforcing bill collections. The implementation of the financial improvement plan for WAPDA, agreed with the World Bank, will be monitored closely and results reported to the public. Regarding KESC, the challenge will be to complete the required financial restructuring, while establishing sufficient regulatory certainty for potential investors, in order to allow its privatization in a transparent and timely manner. Sustained implementation of the government's wide ranging governance agenda will help support private sector activity and investor confidence," Mr. Aninat said.

Statement by Abbas Mirakhor, Executive Director and Meekal A. Ahmed, Advisor to the Executive Director for Pakistan
July 3, 2002

Key Points

- *Despite an extraordinarily difficult economic and political environment, overall performance under the PRGF was broadly satisfactory;*

- *The recent budget for 2002/03 goes beyond the financial framework under the PRGF and incorporates additional measures. It makes room for social and development spending and provides for effective monitoring;*

- *The authorities will be vigilant in the conduct of monetary policy given the instability in money demand. There is no intention at all to target the exchange rate;*

- *CBR reforms and privatization are high on the authorities' agenda. On the latter, while some concrete successes are expected, security concerns, and the difficulties facing the global telecommunications sector, will make the task more challenging;*

- *Financial improvement and restructuring plans for major public enterprises will be monitored quarterly and the results published to strengthen accountability.*

We thank staff for an excellent paper which portrays well the authorities' accomplishments and the challenges that lie ahead. Despite an extraordinarily difficult economic and political environment, and the lingering effects of the September 11 events, Pakistan has continued making steady progress under the PRGF arrangement, strengthening the foundations for macroeconomic stability, while continuing to implement key structural reforms. Real GDP growth in 2001/02 is expected to be around 3.6 percent (with real GNP growth of 5.2 percent due to the surge in workers' remittances), inflationary pressures have remained quiescent, the exchange rate has been stable, and the balance of payments position has strengthened significantly. In addition, structural reforms were on track with the authorities pushing ahead with the elimination of the GST exemption on fertilizers and an increase in gas prices despite strong domestic opposition. A few privatization operations were concluded, bids for United Bank Limited (UBL) were received, and the process of privatizing Karachi Electric Supply Corporation (KESC) moved a step forward with the recapitalization of the company.

While agreeing that performance, in some instances, was not fully up to expectation, more recent developments are encouraging. To be sure, there was, once again, a shortfall in Central Board of Revenue (CBR) tax receipts. Nevertheless, (i) the fiscal deficit target for end-March was met with a wide margin, thanks to tight expenditure control and overperformance with respect to non-tax revenue; and (ii) there were indications that CBR revenues were starting to pick up suggesting that the effects of the on-going reforms were beginning to be felt.

Similarly, the shortfall in poverty-related expenditures was reduced, with third quarter spending up sharply, as the operational capacity of local governments started to improve. Finally, regarding the delays in price adjustments, the authorities were faced with international oil prices that had spiked to $30/bbl and difficult socio-political circumstances, including simmering public discontent over natural gas price increases and the elimination of the GST exemption on pharmaceuticals. In the circumstances, they judged it prudent to proceed cautiously. However, they were firmly committed to fully implement the measures as soon as possible. This was done shortly after with limited impact on the budget.

As the staff supplement notes, the budget for 2002/03 not only contains all the major tax measures that had been planned under the program, but also incorporates additional measures. Of particular note is the elimination of the GST exemption on vegetable *ghee* and cooking oil, a reduction in the maximum external tariff to 25 percent, as well as a reduction in the number of tariff slabs from 5 to 4, a "landmark reform" of a genuine, universal self-assessment system under the income tax, and a new fiscal responsibility law which is not part of program conditionality. Notwithstanding the tight fiscal framework, the budget entails a major rationalization of expenditure towards higher social and development spending. The World Bank, the U.K. and other donors are assisting the authorities to improve the monitoring of I-PRSP expenditures, and baseline data should be ready by end-2002.

Monetary policy will be geared toward safeguarding Pakistan's impressive progress in bringing inflation down to very modest levels. Given the uncertainties over the recent shift in money demand, the authorities intend to remain vigilant and respond promptly to any development that may threaten the inflation target. On exchange rate policy, they have no intention to target or underwrite "any particular level or range of the exchange rate," given the difficulty in making a judgment as to whether or not the recent appreciation of the Pakistani rupee represents a move to a "sustainable equilibrium." Accordingly, market forces will be allowed full play, and any risk of a "sudden loss of confidence" will be met with a judicious adjustment in the stance of macroeconomic policy.

The authorities recognize that making further progress with their ambitious structural reform agenda will be central to building confidence and raising Pakistan's growth potential. They are cognizant of the importance of a "strong political willingness to enforce tax collection." Reforms of the CBR are, clearly, critical if room is to be created to durably raise pro-poor spending and meet the targets established in the I-PRSP. The staff paper notes that CBR reforms are "gathering momentum" and, with the hoped-for return to a more normal domestic and external environment in 2002/03, CBR revenues should continue to improve and targets be met.

Privatization remains high on the authorities' list of priorities. KESC has been brought a step closer to privatization following financial restructuring, while plans to sell stakes in the fertilizer, oil marketing, oil and gas development, telecommunication, and banking sectors by summer/early fall are on track. Nevertheless, the authorities realize that existing security concerns and the weak financial situation of the international telecom sector could inhibit investor interest in the telecommunication and power sectors. A medium-term financial improvement plan (FIP) for the Water & Power Development Authority (WAPDA), translated into quarterly performance targets with close monitoring, has been developed in consultation with the World Bank. The authorities will also monitor the implementation of restructuring strategies for other major public enterprises to ensure that public entities are held accountable for their performance. They hope that the World Bank will provide any advice and assistance that may be required to ensure that these restructuring strategies are implemented rigorously.

In the financial sector, banking sector reforms are proceeding as planned, prudential regulations are being modernized, particularly for small and medium-sized industry and consumer financing, and a new central bank law will be enacted by end-October aimed at strengthening its independence in line with Fund safeguard assessment recommendations. The authorities hope that an FSAP mission can be sent to Pakistan at an early date to advise them, inter alia, on developing best-practice anti-money laundering and anti-terrorist financing regulations. Finally, the central bank has recently prepared a regulatory framework for the transformation of moneychangers into foreign exchange companies, marking a further step towards unification of the interbank and kerb markets for foreign exchange.

The staff note that in the light of recent tensions in the region, the risks to Pakistan's economic program have "strongly risen." Clearly, an exacerbation of tensions, or their prolongation at a high level, would hinder the authorities' adjustment and reform efforts. However, the authorities are hopeful of a more benign scenario where tensions will gradually abate and the situation returns to normal. They can then turn their fullest attention to the real issues at hand—fostering the nascent recovery of business confidence and pressing ahead with their growth and poverty reduction strategy.