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Pakistan: First Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility (PRGF), and Request for Waiver and Modification of Performance Criteria—Staff Report; Staff Statement; News Brief on the Executive Board Discussion; and Statement by the Executive Director

In the context of the First Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility (PRGF), and Request for Waiver and Modification of Performance Criteria, the following documents have been released and are included in this package:

- the staff report for the First Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility (PRGF), and Request for Waiver and Modification of Performance Criteria, prepared by a staff team of the IMF, following discussions that ended on **February 14, 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 March 12, 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 **March 26, 2002** updating information on recent economic developments.

- a News Brief summarizing the **views of the Executive Board as expressed during its March 26, 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

First Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility (PRGF), and Request for Waiver and Modification of Performance Criteria

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

(In consultation with other departments)

Approved by P. Chabrier and M.T. Hadjimichael

March 12, 2002

- Discussions for the first review under the PRGF arrangement were held in Islamabad and Karachi from January 31–February 14, 2002. The staff team consisted of Mr. Enders (Head), Ms. Fichera, and Mr. Joly (all MED); Mr. Taube (FAD); Mr. Sobolev (PDR); and Ms. Alao (staff assistant, MED). Mr. Chabrier (MED) joined the mission for two days. The mission was assisted by Mr. Ghesquiere (Senior Resident Representative) and overlapped with an FAD technical assistance mission on improving fiscal data quality and fiscal transparency, in addition to an STA SDDS assessment mission. Mr. Panzer (World Bank), participated in some of the discussions.

- Messrs. Chabrier, Enders, and Ghesquiere met with the President of Pakistan, General Pervez Musharraf in Islamabad on February 2. 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. The mission also met with the Governor and the economic and social ministers from Sindh province and several recently elected heads of local governments ("nazims").

- The Managing Director and Mr. Aninat met President Musharraf at Blair house on February 12 and reviewed the economic and political situation in Pakistan and the region.

- At the time of Board approval of the arrangement, Executive Directors noted that Pakistan's economy faced considerable uncertainty arising from the military action in Afghanistan and the slowdown in the world economy. They therefore urged the authorities to consolidate macroeconomic stability and advance with key structural reforms to achieve higher sustainable growth and reduce poverty, as targeted under the Interim Poverty Reduction Strategy Paper (I-PRSP). Directors welcomed the government's commitment to fiscal consolidation and the planned major tax administration reform. They indicated that satisfactory revenue performance was key to the success of the program, and encouraged the authorities to respond promptly with appropriate revenue measures to any shortfall in tax revenue. Directors also underscored the importance of (a) improving the quality and delivery of essential social services; (b) raising transparency and accountability in public finances and avoiding any relaxation of fiscal discipline in the new context of devolution; (c) undertaking further measures to develop and deepen the interbank foreign exchange market; and (d) continuing prudent monetary management to achieve the inflation and reserves objectives.

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

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Appendices

Attachment

List of Acronyms

ADF	Asian Development Fund
AFMF	Accountable Fiscal Management Framework
AGPR	Auditor General Pakistan Revenue
AsDB	Asian Development Bank
CBR	Central Board of Revenue
CGA	Controller General of Accounts
CIRRs	Commercial Interest Reference Rates
DAO	District Accounts Office
FATA	Federally Administered Tribal Areas
FIBR	Floating Interbank Market Exchange Rate
FMC	Fiscal Monitoring Committee
FSAP	Financial Sector Assessment Program
I-PRSP	Interim Poverty Reduction Strategy Paper
IFIs	International Financial Institutions
KESC	Karachi Electricity Supply Corporation
LTU	Large Taxpayer Unit
MEFP	Memorandum of Economic and Financial Policies
MTBF	Medium-Term Budget framework
NAM	New Accounting Model
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 Western 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
PSIA	Poverty and Social Impact Analysis
PTCL	Pakistan Telecommunications Company Limited
ROSC	Report on the Observance of Standards and Codes
SBP	State Bank of Pakistan
TCP	Trading Corporation of Pakistan
TMU	Technical Memorandum of Understanding
UBL	United Bank Limited
WAPDA	Water and Power Development Authority

Executive Summary

Developments in the period October 2001–January 2002 indicate satisfactory progress towards the program's macroeconomic objectives, although growth prospects had to be scaled down and tax revenue was lower than targeted. Inflation was much lower than expected, and strong private capital inflows and low imports resulted in a large accumulation of official reserves and a nominal appreciation of the rupee. Macroeconomic policies have been implemented broadly in line with program expectations.

Progress on the structural front was also in line with the program, in particular in the area of tax administration and fiscal transparency. The privatization process, stalled after September 11, has regained momentum. Restructuring plans for major public enterprises have been recently approved by the President and are internally monitored. However, the financial situation of the two public power utilities has deteriorated and remains a major risk for the budget. Expenditures on social services were disappointingly lower than expected, reflecting start-up problems of the recently established local governments.

All but two quantitative and structural performance criteria for end-December 2001 were met. The breach on net credit to public enterprises reflects weaknesses in monitoring a large number of smaller public corporations. The nonobservance of the performance criterion on Central Board of Revenue (CBR) revenue reflects lower-than-programmed import values and domestic activity, as well as the decision to accelerate payments of outstanding sales tax and customs duty refunds so as to help exporters cope with the negative impact of September 11. This decision may have also increased the potential for abuse. The authorities request waivers for these two breaches and a modification of the CBR revenue performance criterion for end-March 2002.

The authorities are taking corrective measures that should deliver the revised macroeconomic targets for 2001/02 provided regional tensions ease in the near future. Growth and inflation targets were revised downward to reflect recent developments. A package of tax measures, worth about 0.5 percent of GDP on an annual basis and including increased taxation of oil products and the elimination of various sales tax exemptions, should help meet the downward revised target for CBR revenue. On this basis, and also on account of likely higher defense expenditure due to the regional tensions, the projected fiscal deficit was raised from 5.3 to 5.7 percent of GDP. Given the continued instability of money demand, the monetary authorities will need to be vigilant and to stand ready to respond to any reemergence of inflationary or exchange market pressures with a more aggressive absorption of liquidity.

Building on the progress in stabilization, emphasis should shift towards the reforms that will be critical for growth, poverty reduction and improved governance. A sustained shift in public expenditure towards human development should be possible now that local governments are in place; it needs to be complemented by a better monitoring of spending and outcomes. There is also an urgent **need to improve accountability and address the financial imbalances of the public enterprise sector**.

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. The 2002 Article IV consultation with Pakistan was originally envisaged to take place concurrently with the first review of the three-year arrangement under the PRGF. Due to resource constraints stemming from the intensity of work on program-related issues, the consultation is now expected to be combined with the third review. This calendar will allow the staff to discuss during the Article IV consultation the findings of the FSAP missions, which had to be postponed because of the post-September 11 regional turmoil and are now tentatively scheduled for May and June 2002. Accordingly, the staff expects to submit the staff report for the Article IV consultation for Board consideration by August 2002. As of January 31, 2002, total Fund credit and loans outstanding to Pakistan amounted to SDR 1,431 million (138.4 percent of quota).[1]

2. In the attached letter dated March 12, 2002, and the attached Memorandum of Economic and Financial Policies (MEFP) (Attachment I), the government of Pakistan requests completion of the first review under the PRGF arrangement, waivers for the non-observance of two quantitative performance criteria for end-December 2001 and modification of several performance criteria. A second disbursement (SDR 86.1 million) is conditional on the completion of the first review and compliance with end-December performance criteria.

II. Performance under the Program from October 2001–January 2002

3. The PRGF-supported program is aimed at bringing Pakistan's growth closer to its potential, reducing poverty, strengthening macroeconomic stability, and improving governance, as set out in the Interim Poverty Reduction Strategy Paper (I-PRSP).[2] As detailed in the MEFP, developments in the period October 2001–January 2002 indicate satisfactory progress towards the program's macroeconomic objectives, although growth prospects for 2001/02 had to be scaled down and tax revenue was lower than targeted. Macroeconomic policies have been implemented broadly in line with program expectations (Tables 1–6). All quantitative and structural performance criteria for end-December were met, except those on Central Board of Revenue (CBR) revenue and on net credit to public enterprises.

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[1] The relevant Executive Board papers are EBS/01/197 and Supplement 1, and EBD/01/106. Pakistan's relations with the Fund are described in Appendix I.

[2] See EBD/01/107.

4. **Output growth was lower than expected in the first half of FY 2001/02 (July–December 2001).** Large scale manufacturing output grew by only 2.9 percent in July–December 2001 over the same period in 2000, against average growth of about 8 percent in FY 2000/01 (Figure 1). Though part of the slowdown is attributable to a late start of the sugar crushing season, it also reflects the weakening of the economies of Pakistan's main trading partners, as well as the impact of the post-September 11 events, resulting in a sharp fall in export orders in the textile sector. Despite substantial improvements in water management, agricultural output has been affected by the ongoing drought, with an anticipated decline in rice production by about 22 percent. The cotton crop estimate has also been revised downwards due to pest attacks in Punjab.

5. **Recent price developments were better than expected**. Reflecting prudent monetary policy, favorable supply effects from a strong wheat harvest, and the impact of the recent appreciation of the rupee on tradables, the CPI increased by only 2.3 percent in the year to January 2002, and the average for July 2001–January 2002 by 2.5 percent over the same period last fiscal year. Food prices, accounting for about 50 percent of the CPI and critically important for the poor, increased by only 1.3 percent in the year to January 2002, down from an average 3.6 percent in FY 2000/01 (Figure 1).

6. **On the external front, overall developments were better than projected for the quarter to December 2001, resulting in a large accumulation of official reserves, and a nominal appreciation of the rupee**. On a shipment basis, exports held up reasonably well, declining by only 3 percent compared with the same quarter last year, as exporters continued to deliver on contracts placed before September 11.[3] Over the same period, imports declined by 9 percent, due to a lower price and volume of imports of oil and petroleum products. Beyond the slowdown in manufacturing activity, a number of factors explain the volume decline: the depletion of stocks accumulated when the rupee was expected to depreciate; the conversion by many enterprises to domestically produced gas and coal; and the fall in demand for petroleum products for re-export to Afghanistan, following the start of the military campaign. Imports of machinery and capital equipment declined as many investment projects were put on hold after September 11 (Figure 2). As a result, the trade balance improved dramatically and posted a surplus for the quarter. With the decline in imports, freight and insurance costs also fell. Combined with an increase in passenger and cargo load of the national carrier, Pakistan International Airlines (PIA), following the suspension of operations by most foreign airlines, this boosted the services account. Worker remittances strengthened because of growing confidence in the rupee and in the domestic financial system. In addition, the intensified monitoring and international investigation of the hawala system,[4] together with some operational improvements in the domestic banks' collection and

[3] On a payment basis, exports actually increased by 6 percent during the same period, reflecting payment and repatriation lags, due to the fact that exporters are allowed to hold their export revenues in accounts abroad for up to 120 days.

[4] The traditional money transfer system operating in much of the region.

distribution of remittances, motivated many nonresidents to shift to the banking system for transferring income to their families in Pakistan. The authorities perceive the shift from the hawala to the formal financial system as a stable one, and a return to the pre-1998 trend towards increased use of the banking system. The capital account also performed better than anticipated. Direct investments rose, mainly in the oil and power sector. Larger portfolio inflows reflected mostly savings coming from Pakistanis residing abroad, partly channeled through the rising stock market, as well as a return of some institutional investors, who had abandoned Pakistan following the nuclear test in May 1998 (Figure 3). Due to these favorable developments, official reserves have exceeded US$3 billion since December 2001 (about 13 weeks of current imports). Despite the SBP's active purchasing of foreign exchange in the interbank market (US$717 million during October–December 2001) and to a lesser extent in the kerb market (US$236 million), the large foreign exchange inflows during the period October–December triggered an appreciation of the rupee against all major currencies, while the kerb market premium virtually disappeared (Figure 3).

7. **The stronger-than-expected accumulation of net foreign assets (NFA) by the banking system contributed to a 11.7 percent increase in domestic liquidity in the year through December, against a programmed increase of 9 percent.** This probably reflects the higher demand for money, mostly for rupee liquidity, as a result of greater confidence in the domestic currency, triggered by low inflation and the appreciation against other currencies. The growth rate of reserve money (28 percent year-on-year in December) reflects in part artificial base effects (Table 4 and Figure 4).[5] Correcting for the latter, the underlying growth in reserve money was about 14 percent, driven by higher NFA. The monetary authorities were thus rather unexpectedly faced with the classical capital inflow problem. The SBP was reluctant to fully sterilize the surge in NFA, in the context of low inflation, and given the desire to support trade and investment during a difficult period through lower interest rates. Banks used accumulated large excess reserves in January 2002 to buy treasury bills at relatively low interest rates.

8. **The cuts in the SBP discount rate and the decline in treasury bill interest rates by 5 and 7 percentage points, respectively, from June 2001 to early February 2002 did not trigger any significant reduction in commercial banks' lending rates, pointing to insufficient competition in the sector.**[6] In addition to the high lending rates (about 14 percent in nominal terms), the slowdown in manufacturing and export activity and the availability of larger self-financing resulting from higher tax refunds caused private sector credit to stagnate. On the public sector side, bank borrowing by the government declined, but

[5] December 2000 reserve money was reduced through unorthodox operations, as detailed in EBS/01/39. In addition, starting in April 2001, the SBP established a special remunerated reserve requirement on new foreign currency deposits, resulting in a permanent increase in reserve money.

[6] According to the commercial banks, high lending rates reflect a rather inelastic cost structure, on account of a still significant stock of nonperforming assets (including large pending tax refunds).

credit for commodity operations and to public enterprises was much larger than anticipated. The latter reflects unexpectedly large borrowing from minor public corporations, which has yet to be fully understood, and a slower-than-anticipated shift from the public to the private sector in the marketing of wheat and cotton.

9. **CBR tax revenue and nontax revenue fell short of target (by 0.5 percent of annual GDP over the first half of the fiscal year), but the fiscal deficit was met as expenditure was also lower than programmed.** While income tax collection was better than expected during the first half of this fiscal year, reflecting a strengthened tax administration, sales tax and customs revenue were adversely affected by the appreciated exchange rate, lower-than-programmed import volumes and unit values in U.S. dollar terms, and less buoyant domestic activity. In addition, the CBR accelerated payments of outstanding sales tax and customs refunds at a faster rate than programmed, so as to help exporters cope with the negative impact of September 11. This triggered a large increase in refund applications and payments, at odds with underlying developments in trade and prices. In part, this situation may reflect the fact that a wider range of inputs can now be claimed as a result of broadening the sales tax base (for example, energy products, telecommunications, services, retail sector); part of the higher refunds also may represent the counterpart of some buildup in the stock of refunds in the latter part of FY 2000/01. Other factors include a possible increase in illegitimate claims by exporters seeking to exploit the situation, and inflated "invisible pendency".[7] CBR revenue collection again remained below target in January–February 2002. However, the increase in the petroleum development levy on diesel and other oil products in early January 2002 should offset some of the CBR revenue shortfall during the second half of the fiscal year. Nontax revenue shortfalls are mainly explained by lower-than-anticipated interest payments from the Water and Power Development Authority (WAPDA) to the federal budget (see below). On the expenditure side, defense outlays were surprisingly PRs 8 billion lower than programmed, resulting from savings due to the more appreciated exchange rate, and lower fuel prices and imports. Costs related to the conflict in Afghanistan and the recent mobilization of troops at the border with India appear to have been met mostly through use of existing stocks. Savings accrued also on account of the interest bill, due to lower-than-projected exchange and interest rates. Pro-poor outlays (which mostly take place at the provincial and local government level) remained well below last year's level, and fell PRs 16 billion short of expectations as local governments only became operative in late 2001. Overall, the budget deficit (excluding grants) was about PRs 10 billion lower than targeted. Lower-than-anticipated external financing (see below) was compensated by higher domestic nonbank financing.

[7] Unrecorded refunds due to a practice, apparently occurring occasionally in the past, when exporters were asked not to present claims, or saw their applications refused under the pretext of insufficient documentation.

10. **Progress on the structural front was in line with the program** (MEFP, para. 10 and Table 2). The CBR reform project is proceeding as planned and the World Bank has recently approved a project preparation grant to help carry forward the reforms. The Fund has also allocated significant FAD technical assistance in support of this project. Improvements in fiscal transparency are reflected in higher rates of expenditure data reconciliation. The establishment of a comprehensive fiscal accounting and auditing framework is proceeding and the new Controller General of Accounts (CGA), recently separated from the Auditor General Pakistan Revenue (AGPR) office, has been incorporated in the Ministry of Finance and has started operating independently from the AGPR. However, because of unclear institutional responsibility and the attempt at building consensus on the set of indicators chosen, the development of intermediate poverty outcome indicators has been lagging behind. In response, a new unit within the ministry of finance is now being established to oversee the PRSP process. The process of preparing a full PRSP was carried forward with a national conference on Human Development in January, involving government, donors, and civil society. Provinces have started to prepare provincial PRSPs as input into the full national PRSP.

11. **The financial situation of the two public power utilities has deteriorated during the past months; one factor is that the normal commercial practice of cutting off nonpayers proved difficult to implement**. After a plan aimed at recovering arrears incurred by industrial consumers met only limited success, mostly because consumers concerned resorted to the courts to slow proceedings, the Karachi Electricity Supply Corporation (KESC) launched in January 2002 a new recovery drive targeting households' arrears. Meanwhile, its financial situation has deteriorated, with its monthly cash shortfall exceeding PRs 1.2 billion in recent months (Box 1). WAPDA's receivables also increased, although arrears on priority connections decreased, such that the related performance criterion was met. The increase in receivables is partly attributable to KESC, and to a larger extent to the difficulty to collect dues from certain private customers, mostly in the federally administered tribal areas (FATA), due to the security situation, and in Balochistan, due to extreme poverty aggravated by drought, which has weakened agricultural users' capacity to pay.

12. **Other structural reforms include the launching of a project to strengthen "access to justice" through reform of the police and the judiciary, with support from the Asian Development Bank (AsDB), and the liberalization of agricultural commodity markets also supported by the AsDB**. However, the development of private sector storage and marketing capacity especially for wheat appears slow, and the government is still holding large wheat stocks from previous bumper harvests. Collapsing cotton prices have led to continued involvement of the public Trading Corporation of Pakistan (TCP) in the procurement of cotton.

Box 1. The Privatization of Karachi Electric Supply Corporation (KESC)

- KESC is one of Pakistan's two public sector power utilities. It is majority owned by the government, which holds directly or indirectly 93 percent of its equity. The balance is held by the private sector. KESC's shares are listed on the Islamabad, Karachi, and Lahore stock exchanges.

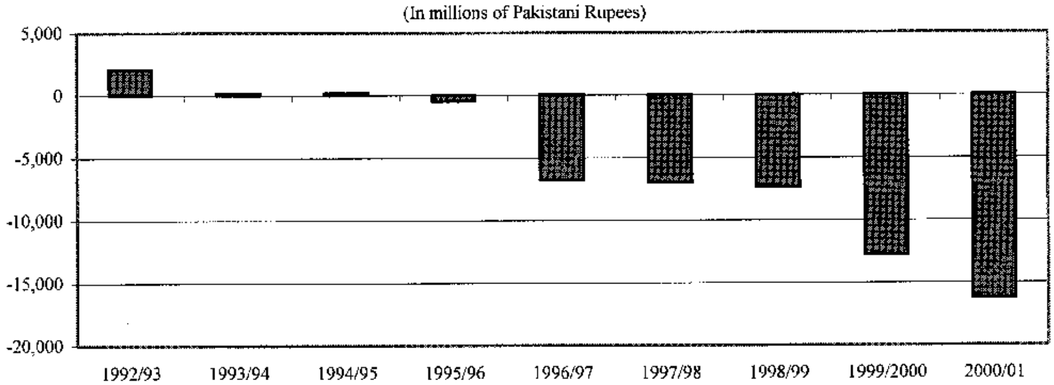
- KESC supplies power to Karachi, the country's largest city and main commercial and financial center. It is a vertically integrated utility. However, its own generation capacity is insufficient to meet power demand, so that it has to buy electricity from WAPDA and independent power producers. KESC's financial situation has deteriorated significantly over the past years. According to the AsDB, which supports Pakistan's energy sector reform program, this poor financial performance is attributable to (a) high levels of transmission and distribution losses, primarily due to theft; (b) inadequate tariff adjustments, which did not reflect the increase in fuel prices in 1999–2000; and (c) weak collection of receivables. The law and security situation in some areas is such that KESC's management and bill collection has become a direct responsibility of the army.

- Due to accumulated losses, KESC's net equity has become negative. The utility is now unable to generate enough cash flow to finance its capital expenditure, meet its debt servicing obligations, and even cover part of its operational expenses, thus becoming a major drain on budgetary resources. At end-2001, KESC's debt amounted to PRs 91 billion (2.5 percent of GDP), including (a) PRs 50 billion due to the government; and (b) PRs 32 billion due to banks (under government guarantee). In addition, KESC has arrears vis-à-vis its major suppliers that amounted to about PRs 17 billion at end-2001 (including about PRs 7 billion vis-à-vis WAPDA). In the first half of FY2001/02, KESC's monthly cash shortfall exceeded PRs 1.2 billion.

- The GOP aims to privatize KESC as rapidly as possible so as to stop the drain on public finances. Privatization will require a major restructuring of KESC's balance sheet, entailing a massive debt for equity swap, with the government assuming KESC's debt (and issuing bonds in favor of creditors) in exchange of an increased share of KESC's equity. KESC's arrears to suppliers would also have to be addressed. Besides financial restructuring, adjustments to the regulatory framework are needed before privatization. In particular, the power sector's regulator (NEPRA) would need to issue generation, transmission, and distribution licenses to KESC and agree on unambiguous tariff rules to entice investors. The respective regulatory responsibilities of NEPRA and the Monopoly Commission may also have to be clarified. While recognizing that the privatization schedule is tight, the government still hopes to bring KESC to the point of sale in July 2002.

KESC's Net Operating Revenue (including interest charges)

(In millions of Pakistani Rupees)



Source: Pakistani authorities

III. Report on the Discussions

13. Discussions with the authorities focused on reviewing the macroeconomic framework and the structural reform program in view of recent domestic and external developments, and formulating macroeconomic policy and program objectives for the remainder of this fiscal year. While much of the uncertainty for Pakistan's economic outlook at the time when the program was designed has dissipated, the recent stand-off with India has created new risks.

A. The Macroeconomic Framework for the Remainder of the Fiscal Year (through June 2002)

14. **Expected real GDP growth (at factor cost) was revised downward by almost half a percentage point to 3.3 percent to reflect continued drought conditions and weak export demand.** Despite a possible surge in sugar refining in the coming months due to a bumper sugarcane crop, production prospects for manufacturing seem weaker now than initially anticipated. In particular, textile producers have accumulated significant inventories over the past few months, and production is likely to slow further before export orders recover. Agricultural output is also expected to underperform vis-à-vis previous estimates, mainly on account of lower rice and cotton crops. The authorities were confident that the projected wheat crop would materialize, despite limited availability of irrigation water and insufficient rains during the sowing season. They felt that farmers learned from last year's drought to better manage scarce water resources.

15. **The inflation target for FY 2001/02 has been substantially reduced.** On the basis of the latest WEO oil price assumptions, domestic energy prices should remain stable. With the expected good wheat crop and bumper sugar production, food prices are likely to increase only moderately. Assuming "core" (nonfood, non-energy) price inflation remaining at its current level (about 3 percent), the average CPI increase for FY 2001/02 is now projected at about 3 percent.

16. **Some of the exceptional factors underpinning the recent strength in the external balance are expected to subside in the coming months.** The impact of the tensions in Afghanistan on exports, through a large decline in textile orders for the spring season,[8] is now expected to hit Pakistan with a longer-than-anticipated lag and be felt mostly in the quarter to March 2002. Transportation and insurance costs, while down from recent peaks, are expected to remain higher than prior to September 11. Nevertheless, the overall sentiment in the business community is that, barring an escalation of tensions with India, the impact of the September 11 events on Pakistan's exports should diminish by the end of the fiscal year. Improved access to the EU market for textiles is expected to have a modest effect in the short run. Pakistan's textile exports to the EU are predominantly low value-added items, whose expected increase in volume will probably translate only to a modest increase in value. In

[8] Reportedly, foreign customers substantially reduced their orders on the ground of security reasons and concerns that Pakistan might not be able to deliver on its contracts.

addition, the recent rupee appreciation has in part offset the impact on export profitability of the agreed-on tariff reduction and relaxation of quotas. At the same time, the positive impact from the expected increase in trade with Afghanistan, following the start of the reconstruction effort, is not expected to materialize before the end of the fiscal year. Total exports in January–June 2002 are thus projected to decline by 5 percent, compared to the same period last year. For the same period, import growth in dollar terms has been scaled down to 2 percent, reflecting low international commodity prices, in particular for oil products and a few staple commodities such as tea. Assuming some pick up in imports of services and the tapering off in the increase in remittances, the external current account deficit (excluding official transfers) for the fiscal year would reach about 2.3 percent of GDP, against an original projection of 3.6 percent of GDP. Reflecting the higher private capital inflows in recent months, the capital account is expected to improve more than originally programmed, and the overall balance of payments to be higher than originally programmed by about US$0.8 billion. However, exceptional financing is expected to be lower by about US$0.6 billion, owing to lower-than-expected IFI disbursements and net debt relief. Expected shortfalls in program financing by the AsDB and the World Bank (about US$250 million) reflect (a) delays in finalizing and announcing the new agricultural policy statement, and in the KESC privatization; and (b) a re-conversion of a small program loan into project loans by the World Bank. However, the size of the SAC II currently under discussion has been conservatively assumed at US$385 million; a higher amount seems possible and would be reflected in higher official reserve accumulation. Finally, the timing of PRGF disbursements has been revised, reflecting the expectation that reviews will be typically concluded at the end of the relevant quarter, and disbursements may therefore slip into the first days of the next quarter. On this basis, and assuming a continued strong pace of foreign exchange purchases by the SBP on the interbank market, the official reserves target for end-June 2002 has been raised to about US$2.6 billion.

B. Fiscal Policy

17. **The fiscal deficit will be larger than originally programmed.** Given the revenue shortfalls to date, and the downward revisions to growth and imports, the original revenue targets have become unachievable and the targeted CBR tax revenue ratio for the fiscal year has been reduced by 0.2 percentage point of GDP, in line with a proposed modification of the end-March target. The mission emphasized that even the revised target implied a sharp improvement during the second half of the fiscal year, and required forceful efforts to ensure tax compliance. Nontax revenue is expected to exceed the original target, in part reflecting compensation for assistance to the coalition against terrorism. Higher defense expenditures will be likely, given continued intense patrolling of the Afghanistan border and the tensions with India. Defense outlays increased significantly starting in January as the army began to replenish stocks. The authorities estimate that during the second half of this fiscal year defense spending will require additional allocations of about PRs 15 billion (0.4 percent of GDP), and more if border tensions do not subside soon. In part, these increases will be offset by savings in other outlays, although lesser than planned debt repayments by WAPDA will raise net lending (see below). On this basis, the fiscal deficit target (excluding grants) was raised by 0.4 percentage point of GDP to 5.7 percent of GDP (and 6.1 percent of GDP if

maximum use is made of grants to increase I-PRSP expenditure). The deficit target is defined excluding the issuance of government bonds in the context of the financial restructuring and privatization of KESC and settlement of banks' claims on CBR due to income tax overpayments (see below and MEFP, para. 27). As detailed in the MEFP, revenue will be underpinned by a package of tax measures worth about 0.5 percent of GDP on an annual basis, including increased taxation of oil products and the elimination of various sales tax exemptions. The authorities have also adopted a timetable providing for effectively charging consumers a 5 percent GST on electricity with the 2003/04 budget, except for a lifeline consumption to protect the poor, with increases in the tax rate by 5 percentage points in each of the subsequent two budgets. Since this timetable for reducing the GST subsidy on electricity[9] is less ambitious than called for under the corresponding performance criterion for end-March 2002, the authorities request a modification of this criterion.

18. **On the tax policy front, the discussions focused on the current refund system, within a framework aimed at improving tax compliance across a broad range of areas.** The current sales tax refund system was introduced in June 2000 and represents a considerable improvement over previous regulations and procedures. It seems basically sound, but the mission raised strong concerns that it does not appear to be enforced effectively. An ongoing study by the CBR on the textile sector (accounting for about 65 percent of total exports) has identified a range of problems and legal loopholes, some of which may have contributed to the recent sharp increase in refund claims and payments.[10] Concerning the refund of custom duties to exporters, improvements in the system are being implemented, including the gradual modification of the structure of duty drawback coefficients to a more realistic level.[11] Accordingly, the existing overly generous refund system will disappear and a large number of exporters will likely switch to an already existing "no duty, no drawback" system, which is easier to administer and less prone to manipulation. Recognizing the efforts already undertaken to improve the functioning of the tax refund system, the mission stressed the need for further corrective action. The CBR should consistently apply existing refund procedures, including by strictly respecting the time limits for consideration of requests and payments of refunds when warranted, and forcefully prosecute frauds. The authorities intend to send to the Fund and the World Bank for

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[9] Currently, GST is paid on all electricity sales by the utilities, but the latter are reimbursed for GST on consumption by households that are thus effectively tax-exempt. The subsidy is explicitly included in the budget (about 0.3 percent of GDP in 2001/02).

[10] These included counterfeit invoices, the possibility to use unlimited stocks of purchased inputs for refund claims, the use of invoices of sales tax nonfilers, and on the side of the administration inappropriate implementation of existing procedures and regulations.

[11] The phasing-in of the new structure was expected to help limit the decline in revenue resulting from the recent reduction in tariffs. While the first two quarterly adjustments in the coefficients were undertaken as planned, the one for January 1, 2002 was not. The authorities now intend to introduce the two remaining adjustments in one step on July 1, 2002. At that point, the input/output coefficients should be fully in line with realistic estimates of production inputs.

comments the ongoing study on GST refunds to textile exporters as soon as completed, and to consult with both institutions before finalizing an action plan aimed at improving the system and its administration in the immediate future.

19. **The authorities requested that the performance criterion that rules out the concession of any new tax exemption be modified** from April 1, 2001 to exempt ships from import duties, and the shipping companies registered in Pakistan from income tax (MEFP, Table 2). In line with the merchant marine policy strategy approved in early 2001, Pakistan would replace the income tax with a US$1 per ton tax on vessels of shipping companies registered in Pakistan. The strategy aims to reverse the trend of Pakistani ships flying flags of convenience to avoid taxation. The proposed exemptions will not have any negative revenue impact per se, given the negligible revenue currently accruing from the sector, although it may increase the scope for transfer pricing to avoid taxes. The mission expressed concern that the measure would weaken the credibility of the government's policy commitment not to grant new tax exemptions, and possibly trigger similar requests by other sectors. The mission was also skeptical that tax exemptions would be a viable approach for rebuilding a domestic shipping sector.

20. **The authorities are confident that I-PRSP expenditure will pick up in the remainder of the fiscal year, as local governments are now in a position to execute local budgets**. The authorities also expect that they will avail of the possibility of spending additional grants to increase the allowed expenditure up to the limits envisaged under the program. The mission stressed the importance of strengthening the fight against poverty. In this context, it felt that risks for continued underspending of I-PRSP expenditure remain significant, given the new local governments' limited experience with expenditure and administrative procedures, particularly in smaller and rural districts. The authorities concurred on the need to bolster efforts in this area, especially to enhance the districts' implementation capacity for executing priority sector projects, and ensure that budgetary allocations at the local levels are fully and properly utilized, while limiting any increase in administrative cost. Training is being provided by both federal and provincial administrations to district administrators to strengthen their skills, reduce the risks of inappropriate use of funds, and support the smooth execution of district budgets. The authorities also recognized the need for improving local revenue mobilization and finalizing the provincial-local government revenue sharing mechanisms. They were aware of the emerging new challenges for preserving recent progress in fiscal transparency and accountability in the context of devolution, and intend to adopt an Accountable Fiscal Management Framework (AFMF) that specifies assurances of accountability and transparency of fiscal management, consistent with the Code of Good Practices on Fiscal Transparency (Box 2).

C. Monetary and Exchange Rate Policy

21. **The authorities remain committed to maintaining a flexible exchange rate and prudent monetary policy aimed at containing inflation, and consistent with the target for reserve accumulation**. The authorities agreed with the mission that monetary developments needed to be kept under close watch, in light of the instability of various

Box 2. Move Towards an Accountable Fiscal Management Framework

- Over the past two years, Pakistan has taken substantive steps to improve fiscal transparency and accountability, including the establishment of Fiscal Monitoring Committees (FMCs) at federal and provincial levels to monitor fiscal reporting and improve the reconciliation of accounts and quality of fiscal data; the separation of audit and accounting, and transfer of the Controller General of Accounts (CGA) office to the executive branch of government; re-establishing Public Accounts Committees (PACs); publication of quarterly fiscal reports on the Ministry of Finance website; and publication of reports on contingent liabilities and tax expenditures for the first time ever in the 2001/02 budget. These measures have resulted in a tangible improvement in the quality and timeliness of fiscal data, and greater public access to these data.

- To consolidate progress made, and meet new challenges, arising particularly at provincial and local government levels through the devolution initiative, the authorities intend to adopt an *accountable fiscal management framework* (AFMF) that specifies assurances of accountability and transparency of fiscal management, consistent with the *Code of Good Practices on Fiscal Transparency.* Several measures have been included in the PRGF policy agenda (MEFP, para. 25):

- **The CGA office** has been set up for the purpose of establishing clear accountability for fiscal reports at all levels of government, including through the implementation of the World Bank sponsored Pakistan Improvement of Financial Reporting and Audit (PIFRA) project. To become fully operational, the CGA office will be provided with more staff and resources, and its relationship with the Auditor General will be more clearly defined to ensure that the separated functions operate effectively to enhance accountability and transparency.

- **The devolution initiative** is giving local communities greater control over public resource management within their areas. Overall fiscal control is assured through a prohibition on local government indebtedness and lack of bank overdrafts. However, spending through local funds is not at present included in general government fiscal reports and certain grants given to local governments (*octroi* and *zila*) are now only recorded as transfers rather than according to final expenditure. As more functions are taken over by the subprovincial levels, unified local government budgets (including all revenues and expenditures), the use of the New Accounting Model (NAM) through PIFRA, and pre-auditing of all transactions through the District Accounts Office (DAO) will be key to maintaining adequate controls and allowing accurate reporting, especially on pro-poor spending. This will require intensive consultation at provincial and local government levels, and close coordination between federal institutions—the National Reconstruction Bureau (NRB), the CGA, and the MoF.

- **A fiscal responsibility law**. The authorities intend to prepare a fiscal responsibility law, which could embody many elements of the AFMF. While drafting of the law is at an early stage, the main elements of such a law (for example, specification of budget documentation and fiscal reporting, coverage of all levels of government, fiscal rules) have been carefully considered and discussed with the staff.

- **Long-term budget reform.** Many of the elements of the AFMF are linked to the immediate need for assurances of reliable accounts and budget data at a relatively basic level. However, as Pakistan develops and seeks broader participation in international capital markets, it will need to establish assurances on a wider range of fiscal risks and full management control over public sector operations. Several elements of the AFMF can only be implemented in the long run, although progress can be made through actions in the short and medium term. These include (a) better disclosure of fiscal risks and off-budget activities (for example, contingent liabilities, tax expenditures) in the annual budget; (b) establishment of a medium-term budget framework (MTBF) as an effective tool for linking asset creation to recurrent spending; and (c) developing a balance sheet approach to government accounts. On the latter, the introduction of the NAM is an important step, though it is recognized that full accrual accounting and budgeting will take many years to implement. However, a plan to do so should be formulated as part of the proposed PIFRA 2 project, and first steps can be taken to consolidate and improve data on government financial assets.

components of money demand witnessed over the last two years, and the uncertainties associated with the recent capitalization. In particular, developments in Afghanistan, where the rupee is widely used, remain a source of potential volatility. They shared the view that a more aggressive absorption of foreign exchange inflows may be warranted to avoid further appreciation of the rupee, with sterilization as needed to keep monetary aggregates on target. The authorities noted that strong capital inflows and recent monetary easing had contributed to a sharp decline in treasury bill rates, but were disappointed that bank lending rates remained high in real terms. In line with balance of payments projections, foreign exchange inflows in the second part of the year are expected to weaken, thus making it easier for the SBP to maintain an appropriately cautious policy mix aimed at keeping domestic liquidity under control and maintaining reserve accumulation at the programmed level. The authorities felt the recent surge in the stock market reflected mostly a return of confidence; the main index remained well below earlier peaks and market capitalization (less than 20 percent of GDP) remained too low to raise much concern about a possible bubble. The authorities plan to link more closely the kerb and interbank foreign exchange market through the reform of the money changers (MEFP, para. 16).

22. **Monetary targets for June were broadly kept as originally set out.** In view of the likelihood of somewhat higher demand for money, reflecting lower inflation and the recent strength of the rupee, the broad money growth target was kept at about 9 percent, despite the downward revision of nominal GDP growth. Meanwhile, the reserve money growth target was raised somewhat to 10 percent (from 9.2 percent originally), given the developments in the multiplier to date. The higher growth reflects entirely higher NFA; the target for net domestic assets (NDA) was tightened. The revised monetary program allows for an annual increase in credit to the private sector of about 10 percent, while the government's repayment of bank borrowing will remain unchanged from the original program target. The revised program, however, allows for a lesser reduction in outstanding credit for commodity operations, in light of the difficulties experienced in selling the large stock of wheat accumulated over the last year. The authorities are aware of the possible risks arising from these commodity operations, but believe that the implementation of the new agricultural strategy supported by the AsDB would rapidly reduce the public sector intervention in this area and minimize the related contingent liabilities. These operations, and public enterprise borrowing more generally, will be brought under closer scrutiny, with regular monthly reporting.

D. Key Structural Issues

23. **The authorities remain strongly committed to implementing their ambitious structural reform agenda, which centers around improved governance in various key areas** (as detailed in the MEFP, paras. 20–31). A main focus of the discussion was the need to (a) strengthen performance, governance, and transparency in the public enterprise sector, and especially address the sizable financial losses of KESC and WAPDA; and (b) further improve fiscal accountability by extending recent progress to provincial and local governments, in conjunction with improving the monitoring of key poverty reducing activities.

24. **The authorities are strengthening governance and accountability in the major public enterprises.** In lieu of the planned formal memoranda of understanding (foreseen in the November 2001 MEFP) with major public enterprises involving performance targets and reporting requirements, restructuring plans for PIA, Pakistan Railways, and Pakistan Steel Mills have been recently approved by the President and are internally monitored. The mission stressed the importance of making implementation of the plans public to enhance accountability; and welcomed that key performance targets and quarterly progress reports will be made available to the public starting later in the year. **The privatization process, stalled after September 11, has regained momentum**. The government sold 10 percent (double the 5 percent as initially envisaged, after the offer was five times over-subscribed) of its interest in National Bank of Pakistan (NBP) through the stock market in late 2001. The cabinet committee on privatization has approved the divestment of government participation in a number of enterprises in the oil and gas sector and in the banking sector. The mission expressed concern about planned commercial external borrowing by PIA for renewal of its fleet with a government guarantee. The authorities emphasized that any borrowing by PIA would be based on a responsible business plan. The commitment to a clearly announced gas pricing framework (MEFP, para. 29) should facilitate privatization of the major public gas producer, Pakistan Petroleum Limited (PPL), over the longer term.

25. **The authorities agreed that the financial situation of the two power utilities, KESC and WAPDA, remains a major risk for the budget**. Continued high losses reflect high rates of theft and power leakage, inadequate tariff adjustments that did not fully reflect increased fuel prices in 1999–2000, contracts with independent power producers including payments for large unused generation capacity, and weak collection of receivables. Despite progress in strengthening accountability and performance, drastic reform is urgently needed. The authorities remain firmly committed to bringing KESC to the point of sale in July 2002. KESC's privatization will initially entail significant costs for public finances, since the government will have to assume a large amount of KESC's debt[12] (Box 1). The restructuring of WAPDA's power arm continues, in close consultation with the World Bank. The unbundling and corporatization of distribution, transmission, and generation activities is expected to be completed by the end of FY 2001/02. The mission stressed the need to improve the collection of receivables, urged the authorities to address the issue of rapidly accumulating payment arrears in FATA, and emphasized that meaningful tariff adjustments are needed to ensure the financial viability of both KESC and WAPDA, along with greater regulatory certainty.

26. **Reforms in the financial sector and foreign exchange market are proceeding as scheduled and in some areas at a faster rate than programmed**. The restructuring of the three nationalized commercial banks in the context of the World Bank-supported Banking Sector Adjustment Loan is proceeding broadly as scheduled (MEFP, para. 27); United Bank

[12] The government plans to issue about PRs 32 billion of government bonds to the concerned creditors; this amount will be excluded from the definition of the budget deficit (see above).

and Habib Bank are planned to be privatized in 2002, the National Bank of Pakistan somewhat later. Most banks have met the new minimum capital requirements of PRs 750 million (for existing banks), effective January 1, 2002. A few minor banks were unable to comply with the new limit and are consulting with the SBP to work out an arrangement to meet the capital requirements, including through mergers with larger banks. The authorities are preparing for the forthcoming FSAP missions and expect them to provide advice on how to enhance the soundness of Pakistan's financial system, including in new areas at the forefront of international debate, such as anti-money laundering. The authorities are proceeding with their strategy to encourage development of an Islamic financial system alongside the existing traditional system. Work on establishing prudential regulations and supervisory practices for Islamic banks is expected to accelerate in order to allow the newly licensed Islamic Bank and any newcomer in the sector to operate in a fully regulated environment and under appropriate supervision. The delegation of certain treasury functions on behalf of the government traditionally provided by the SBP to the newly established SBP services corporation will allow the SBP to focus more effectively on core central banking functions including monetary policy, banking supervision, and foreign exchange and debt management.

IV. Statistical Issues

27. **The authorities remain eager to improve the availability and quality of economic and financial statistics.** Although some studies under the National Accounts project have been delayed, the program to improve the quality of national accounts and to switch to a 1999/2000 base year remains broadly on track. An STA technical assistance mission recently assessed the steps needed to subscribe to the SDDS and reviewed external sector statistics. The authorities indicated that they would take specific measures in the coming months to improve data dissemination, including participation in the GDDS as soon as possible, while implementing the measures required by the SDDS requirements. An STA mission to prepare a Report on the Observance of Standards and Codes (ROSC) on data dissemination is now scheduled for August 2002. Staff welcomed the progress achieved by the authorities towards a fully operational debt management system (DMFAS) and encouraged them to utilize technical assistance from the AsDB and UNCTAD to overcome remaining shortcomings.

V. External Financing of the Program

28. **In line with the revised balance of payment projections, the program for the current fiscal year remains fully financed.** Despite lower-than-projected program financing mainly from the AsDB, external developments so far and projections for the second half of the fiscal year indicate that Pakistan's balance of payments is on track to perform much stronger than originally expected. The authorities reported that negotiations with bilateral creditors in view of implementing the agreed-upon minutes of the Paris Club rescheduling agreement are progressing and that they envisage finalizing bilateral agreements as scheduled (Box 3). The authorities are exploring the means of securing comparable treatment from non-Paris Club creditors.

Box 3. Paris Club Rescheduling Agreement of December 2001

Representatives from Pakistan and eighteen participating creditor countries met in Paris from December 11–13, 2001, to consider Pakistan's request for debt rescheduling.[1/] Agreement was reached on a restructuring of Pakistan's public sector pre-cutoff-date debt in the amount of US$12.5 billion out of a total of US $13.5 billion owed to Paris Club creditors as of November 1, 2001.[2/]

In accordance with the terms of the restructuring, commercial credits are to be repaid over 23 years with five years of grace and progressive payments at the appropriate market rate; Official Development Assistance (ODA) credits (70 percent of the pre-cutoff-date claims) are to be repaid over 38 years with 15 years of grace at interest rates at least as favorable as the concessional rates applying to those loans. In addition, to grant Pakistan cash flow relief during the program period, Paris Club creditors decided to defer for five years, including three years of grace, the repayment of maturities on post-cutoff date debt and the moratorium interest falling due between December 1, 2001 and June 30, 2002. During the subsequent two years, 20 percent of interest accrued, including on the consolidated amounts, will also be deferred on similar terms provided the IMF Executive Board concludes the reviews under the PRGF arrangement.

Assuming comparable treatment of other official bilateral debt, the agreement provides a total cash relief (net of moratorium interest) of about US$2,849 million during the program period—very close to the figure of US$2,852 million assumed under the program (see table below), albeit with a different distribution over the program period. If private sector involvement (namely commercial banks and Eurobonds) were included, total cash flow relief (net of moratorium interest) during the program period would be about US$670 million higher than assumed under the program.

Assuming a relatively low moratorium interest rates under the bilateral agreements to be concluded by September 1, 2002, the ratio of the NPV of debt to exports will decline by about 30 percent to 240 percent. At the end of the PRGF arrangement, the NPV is projected to be at about 210 percent of exports, still well above the 150 percent threshold considered the benchmark for debt sustainability in the case of HIPCs.

Under the agreement with the Paris Club, Pakistan has committed itself to seek comparable treatment from public and private external bilateral creditors not participating in the agreement, and will inform the Chairman of the Paris Club no later than September 1, 2002, on the progress made in negotiations with those creditors. For the purpose of the comparison between the arrangements with the nonparticipating creditors, all relevant elements will be taken into account, including the real exposure of creditors, the level of cash payments received by those creditors as compared to their share of Pakistan's external debt, and the nature and characteristics of the reorganized claims.

Pakistan: Debt Relief under Paris Club Agreement Compared to EBS/01/197

(In millions of U.S. dollars)

	2001/02	2002/03	2003/04	Total
Actual agreement (net of moratorium interest)	974	1,005	870	2,849
Gross relief	1,251	1,223	1,089	3,563
Moratorium interest	278	219	219	715
EBS/01/197 assumptions (net of moratorium interest)	1,004	955	894	2,852
Gross relief	1,027	1,020	997	3,044
Moratorium interest	23	66	103	192
Memorandum items:				
Potential net relief from comparable terms applied to private sector creditors	164	306	209	679

Source: Paris Club; and Fund staff estimates.

[1/] The participating countries were Austria, Belgium, Canada, Denmark, Finland, France, Germany, Italy, Japan, the Netherlands, Norway, Korea, Russia, Spain, Sweden, Switzerland, the U. K., and the U.S.

[2/] The cut-off date for Pakistan is September 30, 1997.

VI. Program Monitoring

29. The staff believes that the pace of reform is broadly satisfactory. To mitigate risks to program implementation and to assert their commitment to the program, the authorities are committed to taking a few actions before the Board consideration of their request for the completion of the first review. These actions are critical to addressing the main risks to the program, through strengthening revenue performance, fiscal transparency, and the financial outlook of the electricity companies. Prior actions and performance criteria, including the modifications, are specified in Tables 1 and 2 in the MEFP (see also Box 4). A revised Technical Memorandum of Understanding (TMU) clarifies various definitions and strengthens reporting requirements.

VII. Staff Appraisal

30. **The authorities have so far been successful in preserving macroeconomic stability in the face of dramatic challenges for economic management, while holding the course on structural reform.** Growth prospects have somewhat weakened due to drought and the fallout from the September 11 attacks, but external balances and inflation improved far more than programmed and the budget deficit target was achieved. Structural reforms continued, and the authorities deserve particular credit for the courageous increase in petroleum taxation at the beginning of 2002. At the same time, some core objectives of the program were not achieved. First, expenditures on social services remained disappointingly low, reflecting start-up problems of the recently established district and municipal governments. Second, tax revenue collection weakened compared to last year. The deliberate decision to support exports through enforcing the timely processing of tax refunds has possibly increased the potential for abuse. Finally, while the SBP has made good use of large official grants and private capital inflows to build reserves, it has not fully avoided an appreciation of the currency that may complicate export recovery, and reserve money growth has accelerated to levels that warrant close watching over the coming weeks and months.

31. **Staff believes that the worst of the post-September 11 effects is over, and that current policies should deliver the revised macroeconomic targets for fiscal 2001/02 provided the stand-off with India eases in the near future.** With capital inflows receding and imports returning to more normal levels, upward pressure on the exchange rate is expected to subside, supporting exports which should start to recover in the coming months. Monetary policy will need to be vigilant given the continued instability of money demand. While it is quite possible that increased confidence and lower inflation have raised money demand, the SBP needs to stand ready to respond to any reemergence of inflationary or exchange market pressures with a more aggressive absorption of liquidity. To ensure the revised budget target is achieved given continued uncertainty especially regarding defense outlays as well as tax revenue prospects, the authorities will have to be ready to curtail lower-priority expenditure, while making every effort to overcome remaining obstacles to local government spending on basic social services. Looking ahead, staff urges the authorities to prepare the 2002/03 budget with a view to ensure an ambitious improvement in the fiscal position, given the setbacks of the current year.

Box 4. Structural Conditionality [1/]

1. Coverage of structural conditionality in the PRGF program

Structural conditionality is detailed in Table 2 of the MEFP, and reflects some streamlining from the recently expired Stand-By Arrangement. The focus is 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. A few measures to deepen the foreign exchange market and streamline foreign exchange regulations are also included and will build on progress made in this area under the Stand-By Arrangement. In addition, the program includes measures concerning public sector enterprise restructuring and privatization, which are not in the core area of Fund responsibility, but are critical to the success of the program. In particular, 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; and decision on such a strategy a prior action. The privatization of UBL, envisaged in the context of a World Bank-supported banking sector restructuring project, is a structural benchmark. Failure to privatize KESC would entail continuous and substantial draining of budgetary resources and undermine medium-term fiscal consolidation. Delays in the privatization of the nationalized banks would be a setback to the efforts to create a sound and efficient financial sector that contributes to growth, and is less vulnerable to government interference.

2. Status of structural conditionality from earlier programs

Virtually all structural measures included in the Stand-By Arrangement, which expired at the end of September 2001, have been implemented. A benchmark on the establishment of best practice anti-money laundering rules has been 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 has only been 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 I-PRSP and the structural reform program in the PRGF 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 2000/01 was delivered under a one-tranche Structural Adjustment Credit. Disbursement was conditional on: (a) reforms in governance, transparency, and efficient use of resources (separation of audit and accounts, establishment of Public Accounts Committees, new public accounting system); (b) civil service reform (strengthening of recruitment, evaluation, and promotion processes); (c) pricing and policy reforms for the deregulation of the power, oil and gas sectors; and (d) policies to improve delivery of social services (enactment and implementation of education sector reforms, measures to reduce teacher and health staff absenteeism, and measures to improve the social sector investment program). Conditionality related to the restructuring of three nationalized banks is part of a banking sector project loan approved at the end of October 2001. A second Structural Adjustment Credit is currently being discussed with conditionality focused on governance, private sector development through enhanced deregulation and privatization, especially in the gas and power sector, and social service delivery.

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.

[1/] Updated from EBS/01/197

32. **Building on the progress in stabilization, emphasis should shift towards the reforms that will be critical for Pakistan's growth and poverty reduction objectives as well as for improved governance.** As clearly acknowledged in Pakistan's I-PRSP, foremost among such reforms will have to be **a sustained shift in public expenditure towards human development**, where Pakistan is dramatically lagging behind its peers. Another set of reforms will **need to address the role of the public enterprise sector**, which suffers from weak governance and transparency. This sector also absorbs large amounts of explicit and hidden subsidies without delivering competitive service; and often requires protection that hurts consumers and imparts a continued anti-export bias to the Pakistani economy at a time when development and diversification of exports is critical.

33. **The need to increase effective spending on human development is overwhelming.** So far, such increases have been held back because of poor governance in the administration of basic social services. With the key building block to ensure better governance now in place—elected local governments are now in charge of setting priorities and monitoring the use of funds—the time has come for a meaningful increase in public spending on human development, while maintaining tight control over administrative expenditures. Staff urges the authorities to ensure that local governments are fully capable to execute their devolved budgets. Well formulated programs on basic social services spending need to be prepared for the next budget, and revenue sharing mechanisms between the federal level, provinces, and districts may have to be redesigned to protect key social spending. To ensure greater efficiency, higher spending needs to be complemented by better monitoring of spending and related outcomes, including at the federal level through the recently established I-PRSP cell.

34. **Given the need for continued fiscal adjustment to extricate Pakistan from its still unsustainable debt, higher social spending will require vigorous pursuit of tax reform, as well as rationalization of expenditures.** On the revenue side, staff urges the authorities to implement fully and on time the planned elimination of the most important remaining sales tax exemptions and of a large number of income tax exemptions in the next budget. These steps are critical towards establishing a broader tax base and reducing the scope for rent seeking. Staff also urges the authorities to pursue vigorously the CBR restructuring process and 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. The revised CBR revenue targets for the current fiscal year leave little room for complacency, and staff urges the authorities to forcefully step up audits and other safeguards against evasion and fraud.

35. **The rationalization of expenditure should include a further reduction in the share of defense expenditure in GDP**, even though ambitious steps with the next budget are unlikely to be feasible because of ongoing regional tensions. The authorities also need to take a hard look at the composition of the public investment budget, in the context of the planned public expenditure review with the World Bank and well ahead of the next budget, so as to **avoid spending on low-priority projects**. Finally, savings should also be achieved by **reducing the many explicit or hidden subsidies** which are insufficiently targeted or which benefit relatively small, but vocal, interest groups. Staff urges the authorities to commit to

and implement clearly announced timetables for the phasing out of such subsidies, notably those associated with its activities in wheat and cotton marketing; the GST subsidy for electricity; the underpricing of gas supplied by the major public gas company; and the various forms of financial support to public enterprises.

36. **Weaknesses in the public enterprise sector represent risks for macroeconomic management and a drag on growth.** Insufficient monitoring of public enterprises by the government has become evident with the recent difficulty to control enterprise credit. Staff welcomes the authorities' commitment to reinforce monitoring of credit to all public enterprises, and that for major enterprises, restructuring strategies have been adopted and are closely monitored. It urges the authorities to publish quarterly key performance targets and outcomes to strengthen public scrutiny and increase pressure for better performance. Staff looks forward to the first round of substantive privatization in April/May this year, and strongly recommends the inclusion of PIA in the longer-term privatization program, and ensure that additional commercial external borrowing to finance expansion of the fleet is based on a sound business plan. To contain the financial losses of WAPDA and KESC, staff urges the authorities to press ahead with the privatization of KESC and the unbundling and corporatization of power distribution, generation, and transmission components of WAPDA. Regulatory reforms to ensure tariffs can be adjusted reasonably quickly to reflect changes in costs, and stronger support by law enforcing agencies for bill collection will also be needed.

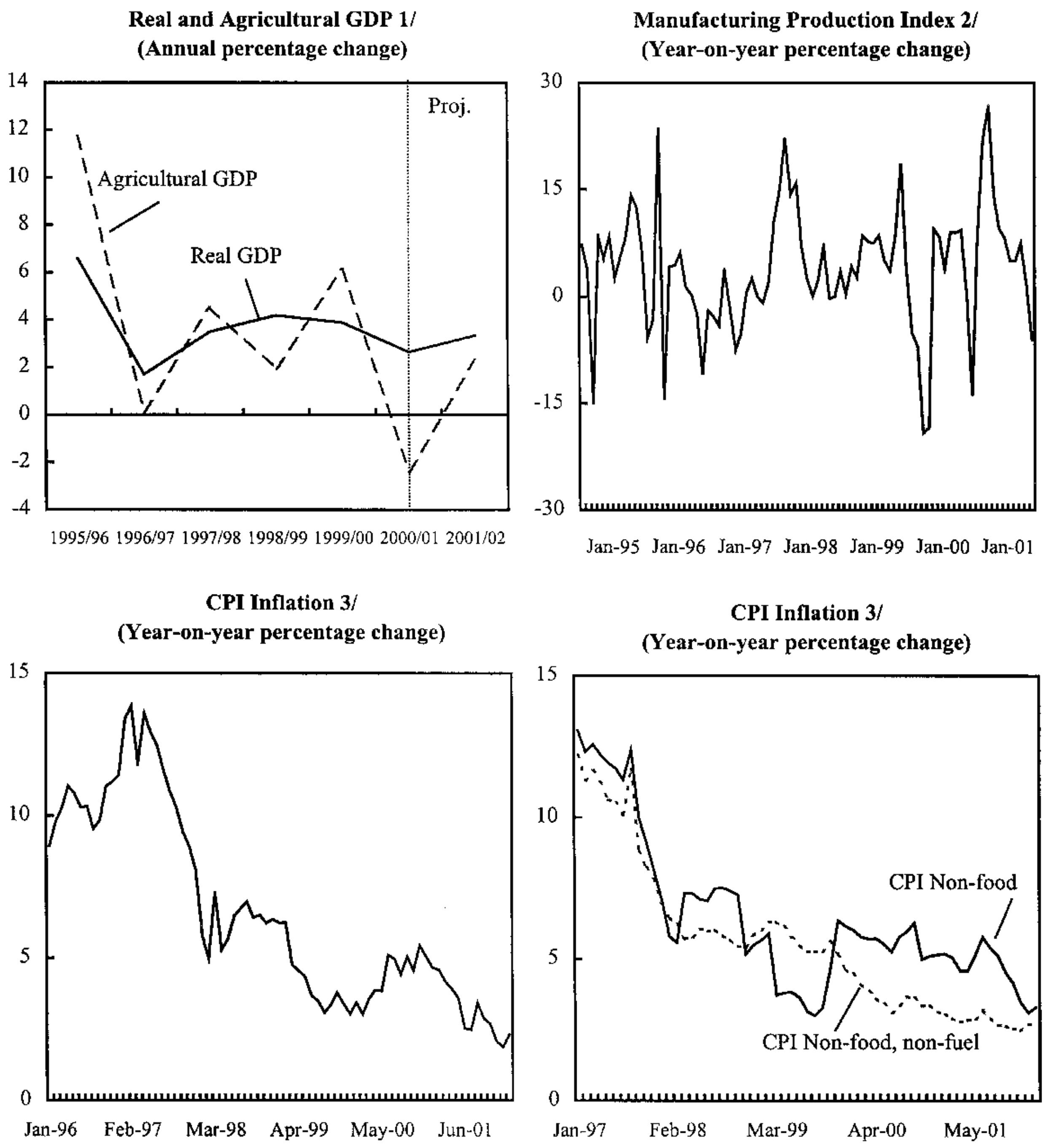
37. **The staff welcomes Pakistan's progress in improving governance, transparency, and data quality in public finances.** However, further improvements in the reconciliation of public expenditure at both the federal and provincial levels are needed, and care should be taken that devolution does not lead to setbacks as accounting functions shift to lower levels of government. The staff encourages the government to implement relevant FAD recommendations, with early steps focusing on strengthening the controller general of accounts and improving local government accounting and reporting. Similarly, staff welcomes the authorities' decision to work towards subscription to the SDDS by 2003, with visible early steps within the next few months. Finally, staff urges the authorities to promulgate as soon as possible amendments to the SBP act to strengthen central bank autonomy, in particular in the area of reserve management, as recommended under the recent safeguards assessment exercise.

38. **Pakistan's economic reform program continues to face risks, but with the exception of the stand-off with India these risks appear now less dramatic than a few months ago and the economy is now much better equipped to deal with adverse shocks.** Staff believes that three main risks remain important. First, a continuation of the stand-off with India would represent obvious risks for expenditure control, but could also threaten the recovery of investor confidence and export demand. Second, the full effect of the drop in export orders in the months following September 11, given lags between orders, shipment, and payment, may yet lie ahead. While such lags have been factored into the projections underlying the program, the risk of a worse outcome than projected cannot be ruled out.

Third, with the political environment changing as Pakistan edges closer to parliamentary elections and the presence of new and untested local governments, some of the more difficult structural reforms as well as the pursuit of fiscal adjustment may face stronger resistance.

39. **In view of Pakistan's track record over the last two years, staff is confident that the government will be able to hold the program broadly on course, even if such risks were to materialize.** The government has a particularly solid record in adhering to the fiscal deficit targets, and strong reserves and a flexible exchange rate regime should help cushion any additional shocks on the external side. The commitment to difficult prior actions and the recent announcement of a new gas pricing framework to reduce subsidies point to a continued strong ability to implement structural reform, even if unpopular. Regarding the proposed modification of two structural performance criteria, the phasing out of the GST subsidy on electricity, slower than originally planned, is motivated by understandable concerns to soften its social impact at a time consumers have to digest sizable gas price and tax increases. The rephasing of this measure should also allow taking into account the findings of the planned World Bank/Fund Poverty and Social Impact Analysis (PSIA) exercise. Staff also supports the proposed modification of the end-March 2002 performance criterion on CBR revenue on the strength of the corrective measures taken or planned. Regarding the proposed tax privileges for the shipping sector, staff does not share the authorities' expectation that such benefits will help reverse the decline of Pakistan's shipping industry. While the direct macroeconomic impact of this modification seems virtually nil, it may affect revenue through greater scope for transfer pricing, and staff sees a risk of other interest groups demanding similar favors. With these reservations, staff recommends the granting of the requested waivers and modifications of performance criteria to allow completion of the first review under the PRGF arrangement.

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

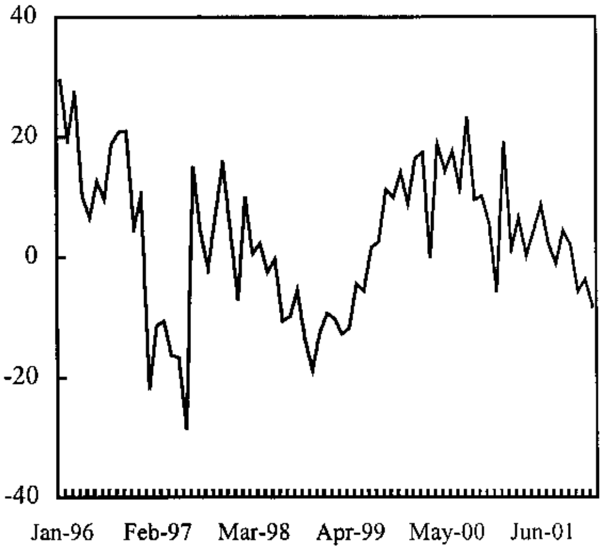


Source: Data provided by the Pakistan authorities.

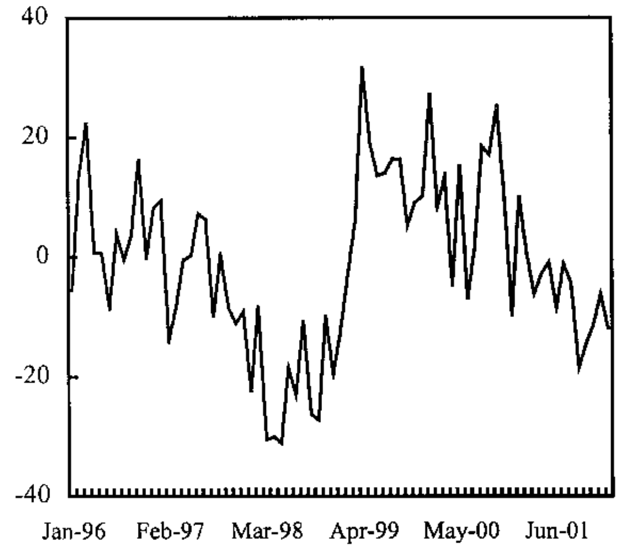
1/ Last observation: projection for 2001/02.
2/ Last observation: November, 2001.
3/ Last observation: January, 2002.

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

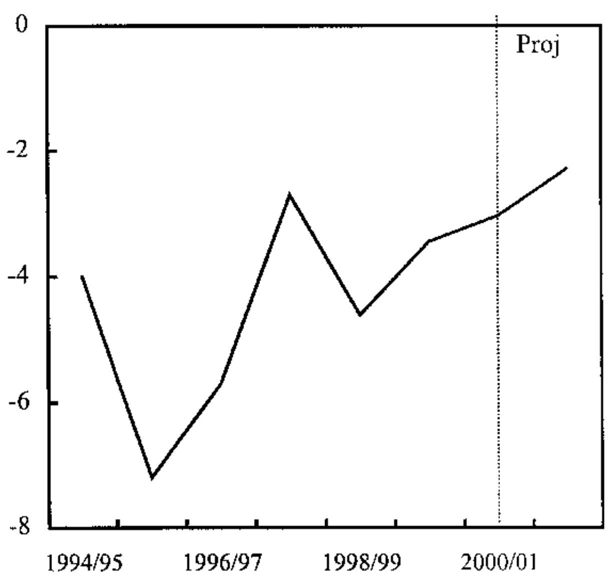
Exports 1/
(Year-on-year percentage change)



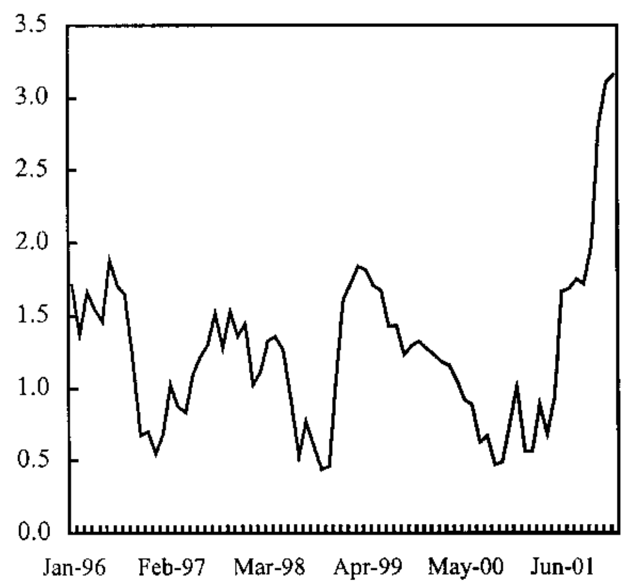
Imports 1/
(Year-on-year percentage change)



Current Account 2/
(In percent of GDP)



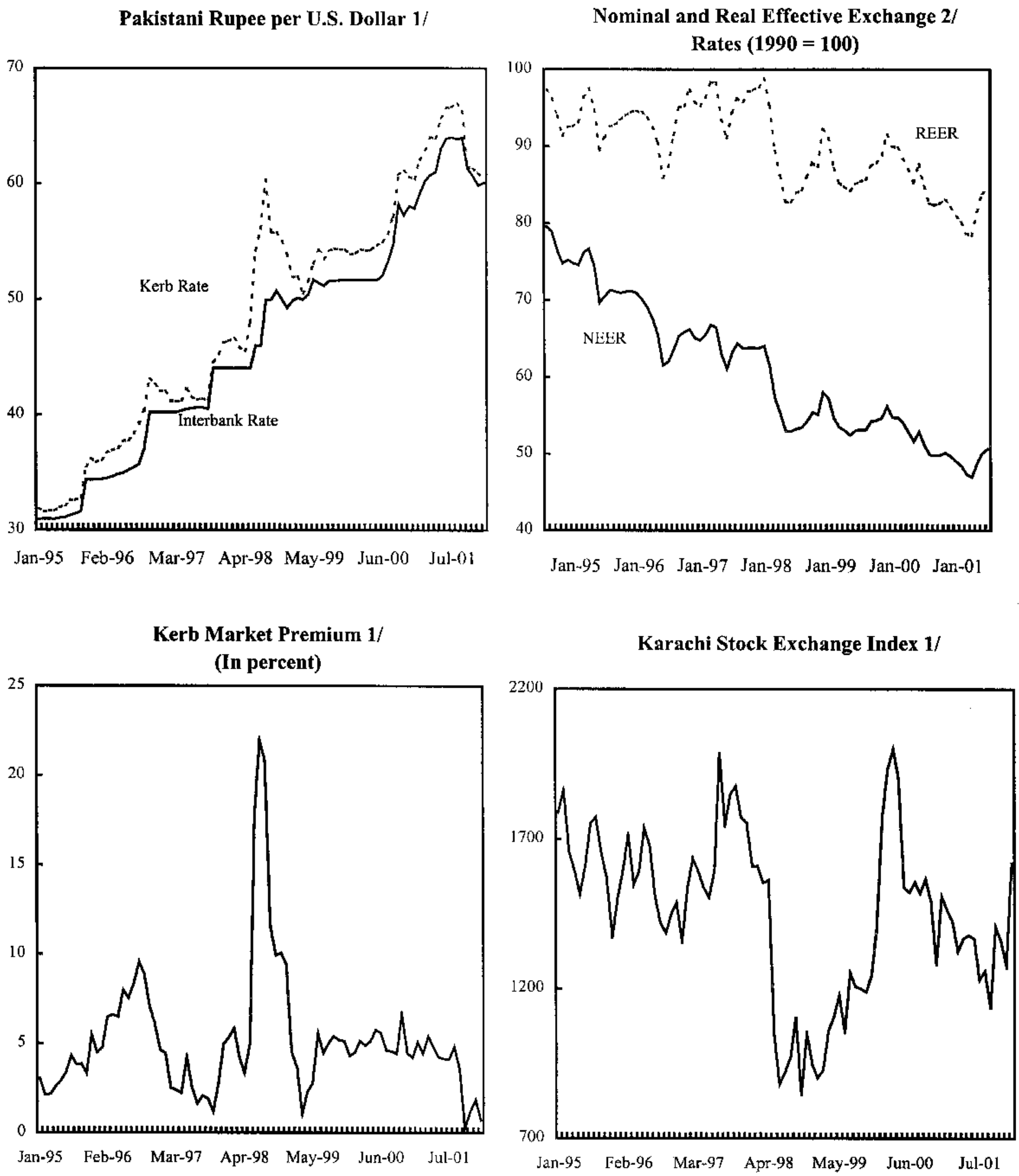
Gross Official Reserves 3/
(In millions of U.S. dollars)



Source: Data provided by the Pakistan authorities.

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

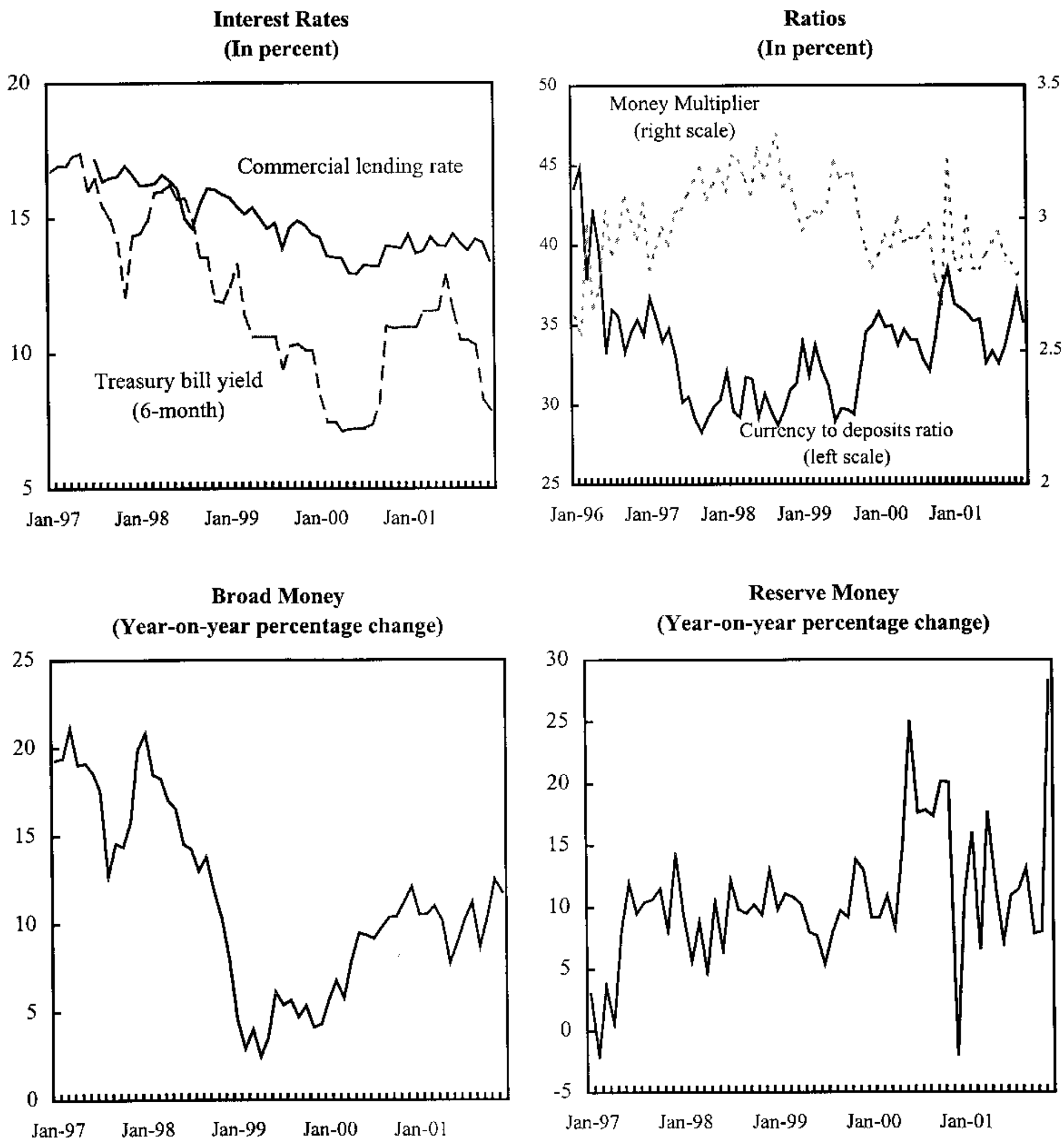
Figure 3. Pakistan: Exchange Rate and Stock Market Developments, 1995–2002



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

1/ Last observation January, 2002.
2/ Last observation December, 2001.

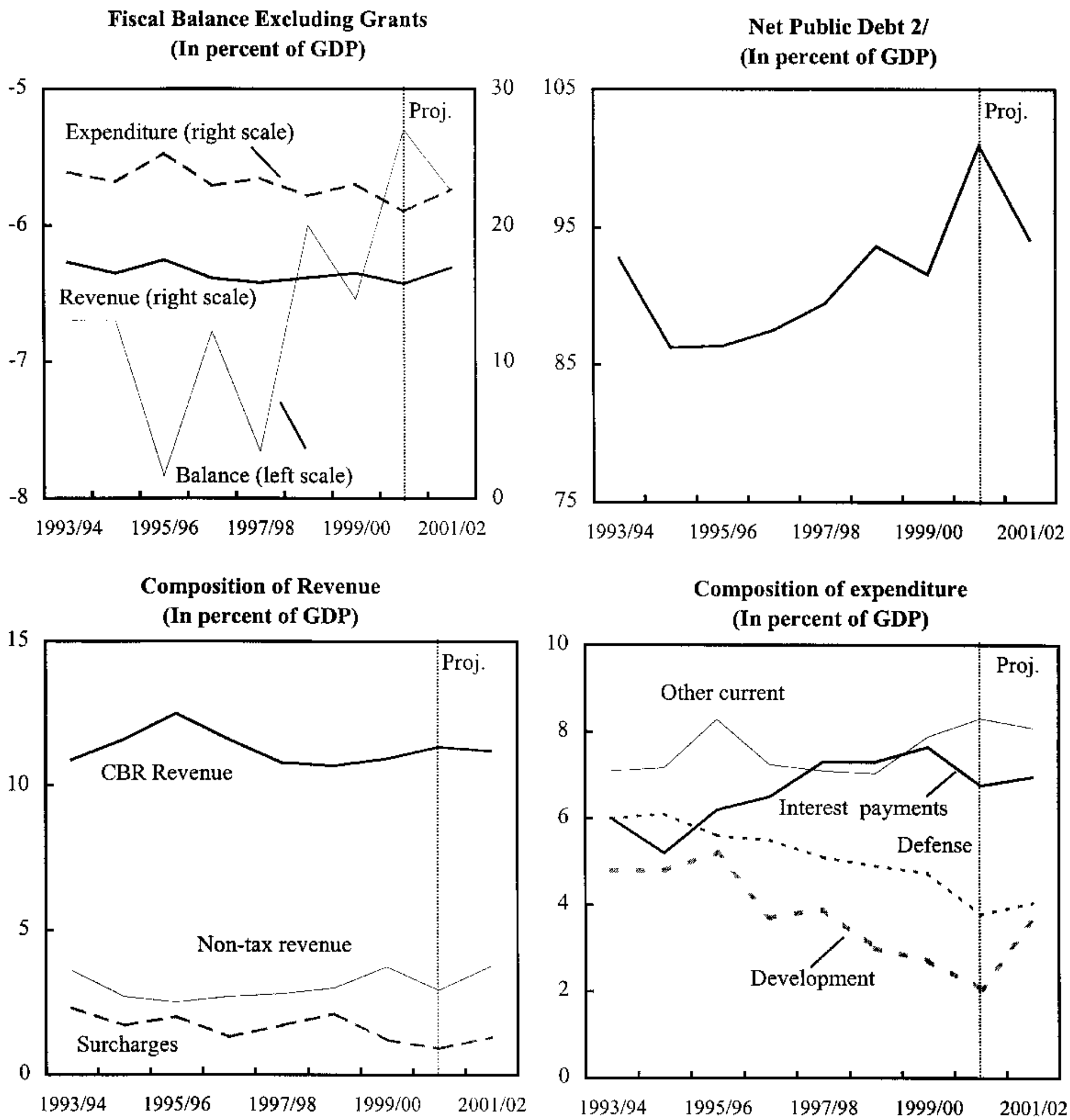
Figure 4. Pakistan: Monetary Developments, 1996–2001 1/



Source: Data provided by the Pakistan authorities.

1/ Last observation December, 2001.

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

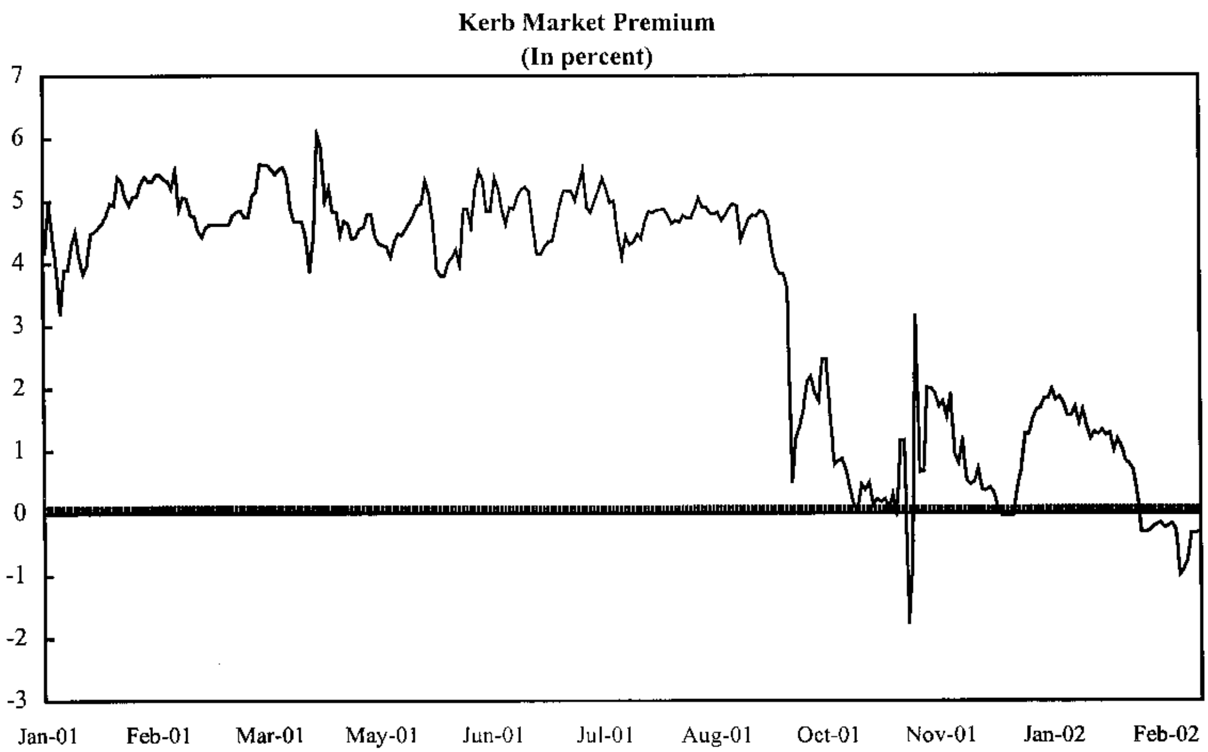


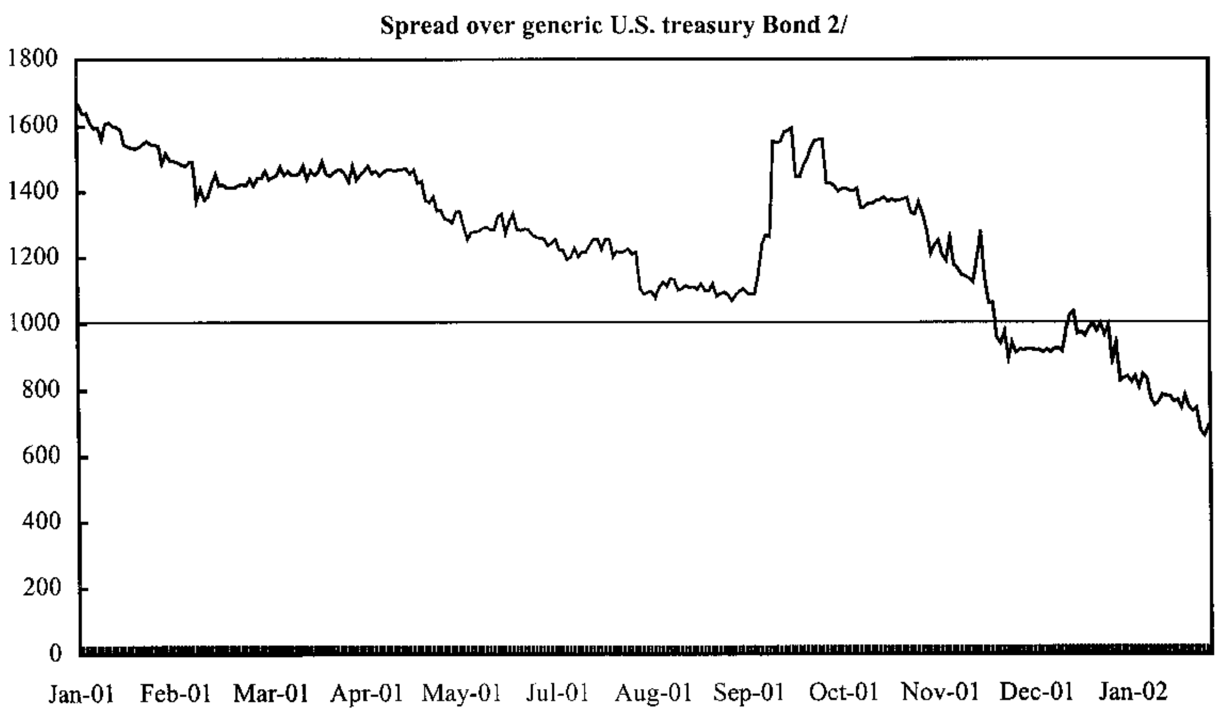
Source: Data provided by the Pakistan authorities.

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: Recent Financial Market Developments 2001–2002 1/





Source: Data provided by Pakistan authorities; and Datastream.

1/ Last observation: February, 2002.

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

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

	1998/99	1999/2000	2000/01	Prog. 2001/02	Rev. Prog. 2001/02	Rev. Proj. 2002/03	Rev. Proj. 2003/04
Output and prices			(Annual changes in percent)				
Real GDP at factor costs	4.2	3.9	2.7	3.7	3.3	4.7	5.2
Real GDP at market prices	3.7	4.4	3.4	3.9	3.4	5.2	5.5
Partner country demand	2.7	4.0	3.2	2.0	1.5	2.5	3.8
Consumer prices (p.a.)	5.7	3.6	4.4	5.0	3.0	3.9	4.0
Consumer prices (end of period)	3.7	5.1	2.5	5.9	3.5	4.0	4.0
Rupees per U.S. dollar (p.a.)	17.0	3.0	12.8	...	...	...	...
Savings and investment			(In percent of GDP)				
Gross national savings	11.9	13.7	13.1	14.6	15.4	15.4	15.8
Government	-3.0	-3.6	-1.8	0.7	0.2	0.8	1.4
Nongovernment 1/	15.0	17.3	14.9	13.8	15.2	14.6	14.4
Gross capital formation	15.6	15.6	14.7	15.2	15.2	16.6	17.5
Government	3.7	3.2	2.7	3.4	3.4	3.6	3.9
Nongovernment 1/	11.9	12.4	12.0	11.8	11.8	13.0	13.6
Public finances			(In percent of GDP)				
Budgetary revenue (excluding grants)	16.2	16.5	15.7	16.5	16.9	17.3	17.3
Budgetary expenditure	22.2	23.0	21.0	21.9	22.7	21.5	20.6
Budgetary balance (excluding grants)	-6.0	-6.5	-5.3	-5.3	-5.7	-4.2	-3.3
Primary balance	1.3	1.1	1.5	1.5	1.2	2.1	2.4
Net public debt 2/	93.6	91.6	100.9	92.4	94.1	90.2	83.1
Net domestic government debt 3/	42.3	42.9	43.1	36.0	41.8	38.2	34.6
Implicit interest rate on public debt (in percent) 4/	8.9	8.8	8.1	7.8	7.3	7.3	6.9
Monetary sector			(Annual changes in percent of initial stock of broad money)				
Net foreign assets	1.6	2.0	5.2	2.6	3.4	...	...
Net domestic assets	4.5	7.4	3.8	6.5	5.7	...	...
Of which: credit to the private sector	8.5	1.4	3.4	7.7	5.1	...	...
Of which: net credit to government	-3.8	6.1	-3.3	-2.8	-2.1	...	...
Broad money	6.2	9.4	9.0	9.1	9.1	...	...
Six-month treasury bill rate (in percent, p.a.)	13.1	8.6	10.4	...	...	...	...
External sector			(In percent of GDP)				
Merchandise trade balance	-3.6	-2.3	-2.1	-2.2	-1.4	-1.5	-1.3
Merchandise exports	12.8	13.3	15.0	15.2	14.9	15.4	15.8
Merchandise imports	16.4	15.6	17.1	17.4	16.4	16.9	17.1
Current account excluding official transfers	-4.6	-3.4	-3.0	-3.6	-2.3	-2.7	-2.1
Current account including official transfers	-3.6	-1.9	-1.6	-0.6	0.2	-1.2	-1.7

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

	1998/99	1999/2000	2000/01	Prog. 2001/02	Rev. Prog. 2001/02	Rev. Proj. 2002/03	Rev. Proj. 2003/04
	(In percent of exports of goods and services)						
External public- and publicly-guaranteed debt	354.2	328.7	318.9	324.0	316.9	298.2	277.0
Debt service 5/	45.0	41.7	33.8	32.0	36.5	32.3	28.7
Implicit interest rate (in percent) 6/	4.0	4.5	4.1	3.8	4.3	4.5	4.3
Gross reserves (millions of U.S. dollars) 7/	1,672	908	1,679	2,385	2,647	3,752	4,555
In weeks of next years' imports of goods and services	7.7	3.9	7.5	9.7	11.0	14.7	17.0
In percent of short-term external debt 8/	30.7	16.1	35.6	...	63.4	85.8	117.9
Memorandum items:							
ICOR, three-year moving average	4.5	4.7	4.8	4.3	4.5	3.6	3.2
Real effective exchange rate (percentage change)	-9.1	-0.6	-2.6	...	...	...	...
Terms of trade (percentage change)	4.1	-9.2	-1.6	-1.0	0.3	3.0	2.6
Real per-capita GDP (percentage change)	1.3	2.1	1.1	1.6	1.1	2.9	3.1
GDP at market prices (in billions of Pakistani rupees)	2,938	3,183	3,472	3,788	3,695	4,042	4,433

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

1/ Includes public sector enterprises.

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

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

4/ 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.

5/ Including interests on short-term debt.

6/ 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.

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

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

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

(In millions of U.S. dollars)

	1999/2000	2000/01	Jul. Dec. Prel. 2001/02	Jan.–Jun. Proj. 2001/02	Prog. 2001/02	Rev. Prog. 2001/02	Proj. 2002/03	Proj. 2003/04
Current account (excluding official transfers)	-2,121	-1,807	-84	-1,280	-2,084	-1,364	-1,658	-1,358
Current account balance (including official transfers)	-1,195	-968	890	-764	-356	127	-733	-1,117
Trade balance	-1,411	-1,268	-85	-781	-1,289	-866	-908	-836
Exports f.o.b.	8,191	8,934	4,527	4,387	8,900	8,914	9,588	10,351
Of which: lifting of textile quotas	...	...	0	100	100	100	200	200
Imports f.o.b.	-9,602	-10,202	-4,612	-5,168	-10,188	-9,780	-10,496	-11,187
Services (net)	-2,708	-2,999	-1,406	-1,551	-3,222	-2,957	-3,095	-2,990
Of which: interest payments	-1,589	-1,478	-682	-861	-1,574	-1,543	-1,580	-1,474
Private transfers (net)	1,997	2,460	1,407	1,052	2,426	2,459	2,345	2,469
Of which: workers' remittances	983	1,086	982	740	1,870	1,722	1,920	1,950
Official transfers (net) 1/	926	839	974	516	1,729	1,491	925	241
Of which: Saudi Oil Facility	791	683	300	309	730	609	584	100
Capital account	-2,697	-767	-749	-1,777	-3,143	-2,526	-1,716	-1,327
Public medium- and long-term capital	-1,488	-686	-539	-423	-1,122	-962	-1,363	-986
Project and nonproject loans	-664	-332	-465	-316	-732	-781	-769	-743
Disbursements	1,304	1,463	294	444	766	738	729	727
Amortization	-1,968	-1,795	-759	-760	-1,498	-1,519	-1,498	-1,470
Commercial banks and IDB (net)	-170	-76	-91	-133	-293	-224	-158	-66
Other	-654	-278	18	26	-97	44	-436	-177
Public sector short-term (net)	-221	-59	-445	-280	-860	-725	94	-369
Private medium- and long-term	273	765	12	-194	-268	-182	113	521
Of which: FDI	471	322	205	150	200	355	400	500
Private short-term (including errors & omissions) 2/	-1,261	-788	222	-880	-893	-658	-559	-493
Overall balance (before debt relief)	-3,892	-1,735	141	-2,541	-3,499	-2,400	-2,449	-2,444
Financing	3,892	1,735	-141	2,541	3,499	2,400	2,449	2,444
Reserve assets (increase -)	208	-1,088	-1,619	335	-779	-1,284	-1,146	-923
Fund repurchases	-287	-194	-87	-108	-185	-195	-324	-389
Net exceptional financing	3,972	3,017	1,565	2,313	3,107	3,878	3,818	3,555
Arrears (increase +)	343	-525	0	0	0	0	0	0
Rescheduling 3/	1,750	1,587	472	779	327	1,251	1,223	1,089
Rollover of foreign deposits with banking system 4/	1,872	1,676	475	714	1,312	1,189	900	800
Program financing from IFIs	7	279	618	820	1,468	1,438	1,395	1,367
World Bank	0	0	95	486	665	581	500	500
AsDB	0	0	145	225	535	370	455	425
IMF	7	279	378	110	268	488	440	442
Privatization receipts	0	0	0	0	0	0	300	300
Financing gap	0	0	0	0	1,356	0	100	200
				(In percent of GDP)				
Memorandum items:								
Current account (excluding official transfers)	-3.4	-3.0	-0.1	-2.1	-3.6	-2.3	-2.7	-2.1
Current account balance (including official transfers)	-1.9	-1.6	1.5	-1.3	-0.6	0.2	-1.2	-1.7
Exports f.o.b. (12-month growth rate, percent)	8.8	9.1	4.7	-4.8	-0.3	-0.2	7.6	8.0
Imports f.o.b. (12-month growth rate, percent)	-0.1	6.2	-9.4	1.1	0.2	-4.1	7.3	6.6
End-period gross official reserves 5/	908	1,679	3,103	2,647	2,385	2,647	3,752	4,555
(In weeks of next year imports of goods and nonfactor service	3.9	7.5	12.9	11.0	9.7	11.0	14.7	17.0

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 UAE's deposits with the SBP, and Bank of China's deposits with the NBP.
5/ Excluding gold, new foreign currency deposits held with the SBP, and net of outstanding short-term foreign currency swap and forward contracts.

Table 3. Pakistan: Monetary Survey, 1998/99–2001/02

	Act.			Sep.	Dec.		Mar.		Jun.	
				Act.	Prog. 2/	Act.	Prog. 2/	Proj.	Prog. 2/	Rev. Prog.
	1998/99	1999/2000	2000/01	2001/02 1/	2001/02 1/	2001/02 1/	2002 1/	2002 1/	2002 1/	2002 1/
	(End-of-period stocks; in billions of Pakistani rupees)									
Net foreign assets	-71	-45	28	14	68	106	53	84	68	80
Net domestic assets	1,351	1,446	1,499	1,505	1,542	1,552	1,547	1,551	1,598	1,586
Net claims on government	551	630	583	598	549	566	542	562	540	550
Of which:										
Net bank borrowing	506	546	514	530	503	503	509	509	506	507
Commodity operations	67	107	95	94	71	90	59	80	59	70
Net claims on nongovernment	817	843	912	882	989	964	1,000	966	1,053	1,013
Private sector	735	753	801	774	873	837	875	843	919	880
Public sector	82	90	111	108	116	127	125	124	133	133
Privatization account	-3	-3	-3	-3	-3	-3	-3	-3	-3	-3
Other items, net	-14	-24	7	28	8	26	8	26	8	26
Total liquidity (broad money)	1,281	1,401	1,527	1,519	1,610	1,658	1,600	1,635	1,665	1,666
Of which:										
Rupee liquidity	1,132	1,288	1,373	1,364	1,456	1,507	1,445	1,484	1,508	1,515
	(Changes in percent of stock of broad money at the beginning of the fiscal year)									
Net foreign assets	1.6	2.0	5.2	4.2	2.6	5.1	1.6	3.7	2.6	3.4
Net domestic assets	4.5	7.4	3.8	4.2	2.9	3.5	3.2	3.4	6.5	5.7
Of which:										
Net bank borrowing by government	-3.9	3.1	-2.3	-1.1	-2.2	-1.1	-2.7	-1.4	-2.8	-2.1
Net claims on private sector	8.5	1.4	3.4	1.5	4.7	2.3	4.9	2.7	7.7	5.1
	(Changes over 12 months; in percent)									
Broad money	6.2	9.4	9.0	8.7	9.0	12.3	9.1	11.5	9.1	9.1
Net claims on private sector	16.2	2.5	6.4	2.7	4.4	0.1	4.7	0.8	14.7	9.8
Memorandum item:										
Indicative program exchange rate	...	...	63.98	63.98	63.98	63.98	63.98	63.98	63.98	63.98

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

1/ At indicative program exchange rate.
2/ As reported in EBS/01/197; June 2002 targets were indicative.

Table 4. Pakistan: Accounts of the State Bank of Pakistan, 1998/99–2001/02

	Act.			Sep. Act.	Dec. Prog. 2/	Dec. Act.	Mar. Prog. 2/	Mar. Proj.	Jun. Prog. 2/	Jun. Rev. Prog.
	1998/99	1999/2000	2000/01	2001/02 1/	2001/02 1/	2001/02 1/	2002 1/	2002 1/	2002 1/	2002 1/
	(End-of-period stocks; in billions of Pakistani rupees)									
Net foreign assets	-42.5	-55.1	-16.2	-26.9	5.1	56.4	-18.5	34.6	-4.5	30.2
Net domestic assets	440.4	552.9	549.4	558.6	568.6	533.8	586.2	545.9	586.9	556.2
Net claims on government	257.8	391.0	357.4	363.9	365.5	349.0	381.6	344.5	380.8	352.3
Of which:										
Budgetary support	279.6	414.6	383.1	389.8	391.0	375.4	407.1	370.2	405.3	378.3
Claims on nongovernment	56.1	51.2	40.1	29.3	40.1	27.8	40.1	26.9	40.1	27.8
Claims on scheduled banks	187.2	193.4	198.0	184.5	201.0	184.8	202.5	202.5	204.0	204.0
Other items, net	-57.7	-79.8	-43.1	-16.2	-35.0	-24.9	-35.0	-24.9	-35.0	-24.9
Reserve money 3/	398.0	497.8	533.2	531.6	573.7	590.2	567.7	580.5	582.4	586.5
Of which:										
Banks' reserves	85.2	114.7	127.3	121.4	130.5	127.2	131.0	129.8	138.1	139.9
Currency	306.6	375.1	394.6	399.3	432.0	451.8	425.4	439.6	433.0	435.4
	(Changes in percent of stock of reserve money at the beginning of the fiscal year)									
Net foreign assets	1.7	-3.3	7.7	-2.0	4.0	13.6	-0.4	9.5	2.2	8.7
Net domestic assets	6.0	28.4	-0.6	1.7	3.6	-2.9	6.9	-0.7	7.0	1.3
Of which:										
Budgetary support	10.1	33.9	-6.3	1.2	1.5	-1.6	4.5	-2.4	4.4	-0.9
	(Changes over 12 months; in percent)									
Reserve money 4/	7.7	25.1	3.3	9.2	...	14.4	...	8.1	...	10.0
Currency	7.7	22.4	5.2	12.3	0.3	4.9	5.1	8.6	9.7	10.3
Memorandum item:										
Indicative program exchange rate	...	...	63.98	63.98	63.98	63.98	63.98	63.98	63.98	63.98

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

1/ At indicative program exchange rates.
2/ As reported in EBS/01/197; June 2002 targets were indicative.
3/ Starting in April 2000/01, reserve money includes special reserves on foreign currency deposits.
4/ For the purpose of calculating the 12-month growth rate, reserve money is considered net of the special reserves and corrected for the transformation of the special deposits accounts into treasury bills in December 2000 and March 2001.

Table 5. Pakistan: Consolidated Government Budget, 2000/01–2003/04 (Continued)

	Prov. 2000/01	Prog. 2001/02	Rev. Prog. 5/ 2001/02	Q1 –Q2 Prog. 2001/02	Q1 –Q2 Prov. 2001/02	Rev. Proj. 6/ 2002/03	Rev. Proj. 6/ 2003/04
	(In billions of Pakistani rupees)						
Revenue and grants	591.1	729.9	714.4	342.7	320.2	752.8	800.6
Revenue	546.4	626.6	625.4	278.7	260.3	697.8	767.5
Tax revenue	444.8	497.1	486.0	215.1	206.2	562.4	626.4
Federal	425.4	475.6	464.6	205.5	197.5	537.6	598.2
CBR revenue	393.9	429.9	414.3	183.3	174.9	485.6	541.4
Direct tax	127.4	142.4	146.5	62.6	63.9	156.4	163.5
Federal excise duty	49.2	49.4	47.1	22.3	20.2	52.8	58.9
Sales tax	152.8	176.8	170.1	75.6	73.5	215.0	258.4
Customs duties	64.5	61.3	50.5	22.9	17.4	61.4	60.6
Petroleum surcharge	17.9	29.0	34.0	14.3	15.2	35.6	39.5
Gas surcharge	12.6	15.0	15.0	7.0	6.8	15.0	15.7
Other	1.0	1.7	1.3	0.9	0.5	1.4	1.6
Provincial	19.4	21.5	21.4	9.6	8.8	24.8	28.2
Nontax revenue	101.6	129.6	139.4	63.6	54.0	135.4	141.1
Grants	44.7	103.2	89.0	64.1	59.9	55.0	33.1
Expenditure	730.3	828.8	837.7	386.2	358.6	868.5	913.5
Current expenditure	654.1	701.5	705.6	332.0	301.2	721.3	737.4
Federal	504.2	525.5	535.5	252.9	240.6	530.2	527.8
Interest payments	234.7	260.1	257.0	128.5	121.4	254.6	251.1
Domestic	183.5	197.9	195.4	98.2	95.7	190.1	181.9
Foreign	51.2	62.2	61.6	30.3	25.7	64.5	69.1
Defense 1/	131.2	134.6	149.6	63.0	54.9	141.5	147.2
Running of the civil government 1/	45.9	52.0	52.0	23.3	19.4	56.1	58.3
Pensions	30.9	33.6	33.6	16.5	12.8	38.4	42.1
Subsidies	14.7	13.7	15.7	6.0	4.3	12.5	10.0
Grants	24.0	22.8	19.6	11.4	9.4	15.8	17.4
Other	-0.4	8.8	7.9	4.2	2.2	11.3	1.7
Unidentified	23.3	0.0	0.0	0.0	16.1	0.0	0.0
Provincial	149.9	176.0	170.1	79.1	60.6	191.1	209.7
Development expenditure and net lending	76.2	127.3	132.1	54.2	57.4	147.1	176.1
Public Sector Development Program 2/	92.5	127.0	127.0	54.0	50.9	144.6	174.8
Net lending	-16.3	0.3	5.1	0.2	6.5	2.5	1.3
Budget balance (excluding grants)	-183.9	-202.2	-212.3	-107.8	-98.3	-170.7	-146.0
Budget balance (excl. grants and one-off expenditure) 3/	-183.9	-182.7	-185.8	-91.5	-95.3	-161.0	-146.0
Budget balance (including grants)	-139.2	-98.9	-123.2	-43.6	-38.4	-115.7	-112.9
Financing	139.2	98.9	123.2	43.6	38.4	115.7	112.9
External	74.2	36.9	59.0	22.9	17.7	86.4	71.8
Domestic	65.0	8.8	57.7	4.3	20.7	3.3	0.6
Bank	-32.3	-7.0	-7.0	-9.6	-10.9	-6.0	-14.0
Nonbank	97.4	15.8	64.7	14.0	31.6	9.3	14.6
Privatization proceeds	0.0	6.5	6.5	0.0	0.0	19.5	27.0
Financing gap	0.0	46.7	0.0	16.3	0.0	6.5	13.5
Memorandum items:							
Primary balance	50.8	58.0	44.7	20.8	23.1	83.9	105.0
Social and poverty-related expenditure 4/	119.3	136.4	136.4	62.0	45.9	158.8	184.4

Table 5. Pakistan: Consolidated Government Budget, 2000/01–2003/04 (Concluded)

	Prov. 2000/01	Prog. 2001/02	Rev. Prog. 5/ 2001/02	Q1 +Q2 Prog. 2001/02	Q1 +Q2 Prov. 2001/02	Rev. Proj. 6/ 2002/03	Rev. Proj. 6/ 2003/04
	(In percent of GDP, unless stated otherwise)						
Revenue and grants	17.0	19.3	19.3	9.3	8.7	18.6	18.1
Revenue	15.7	16.5	16.9	7.5	7.0	17.3	17.3
Tax revenue	12.8	13.1	13.2	5.8	5.6	13.9	14.1
Federal	12.3	12.6	12.6	5.6	5.3	13.3	13.5
CBR revenue	11.3	11.4	11.2	5.0	4.7	12.0	12.2
Direct tax	3.7	3.8	4.0	1.7	1.7	3.9	3.7
Federal excise duty	1.4	1.3	1.3	0.6	0.5	1.3	1.3
Sales tax	4.4	4.7	4.6	2.0	2.0	5.3	5.8
Customs duties	1.9	1.6	1.4	0.6	0.5	1.5	1.4
Petroleum surcharge	0.5	0.8	0.9	0.4	0.4	0.9	0.9
Gas surcharge	0.4	0.4	0.4	0.2	0.2	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	0.3	0.2	0.6	0.6
Nontax revenue	2.9	3.4	3.8	1.7	1.5	3.3	3.2
Grants	1.3	2.7	2.4	1.7	1.6	1.4	0.7
Expenditure	21.0	21.9	22.7	10.5	9.7	21.5	20.6
Current expenditure	18.8	18.5	19.1	9.0	8.2	17.8	16.6
Federal	14.5	13.9	14.5	6.8	6.5	13.1	11.9
Interest payments	6.8	6.9	7.0	3.5	3.3	6.3	5.7
Domestic	5.3	5.2	5.3	2.7	2.6	4.7	4.1
Foreign	1.5	1.6	1.7	0.8	0.7	1.6	1.6
Defense 1/	3.8	3.6	4.0	1.7	1.5	3.5	3.3
Running of the civil government 1/	1.3	1.4	1.4	0.6	0.5	1.4	1.3
Pensions	0.9	0.9	0.9	0.4	0.3	0.9	0.9
Subsidies	0.4	0.4	0.4	0.2	0.1	0.3	0.2
Grants	0.7	0.6	0.5	0.3	0.3	0.4	0.4
Other	0.0	0.2	0.2	0.1	0.1	0.3	0.0
Unidentified	0.7	0.0	0.0	0.0	0.4	0.0	0.0
Provincial	4.3	4.6	4.6	2.1	1.6	4.7	4.7
Development expenditure and net lending	2.2	3.4	3.6	1.5	1.6	3.6	4.0
Public Sector Development Program 2/	2.7	3.4	3.4	1.5	1.4	3.6	3.9
Net lending	-0.5	0.0	0.1	0.0	0.2	0.1	0.0
Budget balance (excluding grants)	-5.3	-5.3	-5.7	-2.9	-2.7	-4.2	-3.3
Budget balance (excl. grants and one-off expenditure) 3/	-5.3	-4.8	-5.0	-2.5	-2.6	-4.0	-3.3
Budget balance (including grants)	-4.0	-2.6	-3.3	-1.2	-1.0	-2.9	-2.5
Financing	4.0	2.6	3.3	1.2	1.0	2.9	2.5
External	2.1	1.0	1.6	0.6	0.5	2.1	1.6
Domestic	1.9	0.2	1.6	0.1	0.6	0.1	0.0
Bank	-0.9	-0.2	-0.2	-0.3	-0.3	-0.1	-0.3
Nonbank	2.8	0.4	1.7	0.4	0.9	0.2	0.3
Privatization proceeds	0.0	0.2	0.2	0.0	0.0	0.5	0.6
Financing gap	0.0	1.2	0.0	0.4	0.0	0.2	0.3
Memorandum items:							
Primary balance	1.5	1.5	1.2	0.6	0.6	2.1	2.4
Social and poverty-related expenditure 4/	3.4	3.6	3.7	1.7	1.2	3.9	4.2
GDP (in billions of Pakistani rupees)	3,472	3,788	3,695	3,695	3,695	4,042	4,433

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/ In 2001/02, projections include one-off expenditure of PRs 10 billion for drought and PRs 6.5 billion for bank restructuring.
4/ As defined in the I-PRSP.
5/ Excluding government bond issues for KESC recapitalization and clearance of bank claims on CBR.
6/ Excluding government bond issues for KESC recapitalization and clearance of bank claims on CBR, but reflecting their interest costs.

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	-7,234	-6,487	-6,414
External current account deficit	127	-733	-1,117
Debt amortization	-5,882	-4,285	-3,986
Medium- and long-term debt	-2,966	-2,639	-2,092
Public sector	-2,080	-2,092	-1,713
Multilateral (excluding IMF)	-605	-613	-643
Bilateral	-900	-706	-682
Bonds (net)	-2	-155	-155
Other (commercial)	-573	-618	-233
Private sector	-886	-547	-379
Short-term debt	-2,916	-1,646	-1,894
Public sector	-1,402	-727	-1,189
Private sector	-1,514	-919	-705
Repayment of arrears	0	0	0
Gross reserves accumulation	-1,284	-1,146	-923
Of which: official reserves	-1,048	-1,116	-833
IMF repurchases and repayments	-195	-324	-389
Available financing	7,234	6,387	6,214
FDI and portfolio investment (net, excluding public securities) 1/	303	785	1,000
Debt financing from private creditors	3,051	2,255	2,032
Medium- and long-term financing	782	175	200
To private sector	401	175	200
To public sector	381	0	0
Short-term financing	2,269	2,080	1,832
To public sector	977	1,220	1,120
To private sector	1,292	860	712
Official creditors	2,940	2,907	2,741
Project lending	738	729	727
Balance of payments support	2,202	2,178	2,014
AsDB and World Bank	951	955	925
Debt relief from bilateral creditors 2/	1,251	1,223	1,089
IMF	488	440	442
Other net capital flows 3/	453	0	0
Financing gap	0	-100	200

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 kerb market.

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

	1998/99	1999/2000	2000/01	Proj. 2001/02	2002/03	2003/04
	(In millions of U.S. dollars)					
Total public- and publicly-guaranteed external debt	29,318	29,757	31,398	31,099	31,400	31,523
Medium- and long-term debt	25,445	26,009	27,826	27,720	27,662	27,801
Project & nonproject aid	23,101	23,834	25,810	26,020	26,296	26,619
Commercial banks and IDB	730	560	698	474	316	250
Other (including securities)	1,614	1,615	1,319	1,227	1,051	932
Short-term debt (by initial maturity)	2,049	2,253	2,069	1,583	1,826	1,758
Commercial banks and IDB	583	671	918	411	676	676
FEBCs and DBCs	196	147	90	67	45	26
Deposits of nonresidents with the SBP	1,270	1,435	1,061	1,105	1,105	1,055
Fund credit and loans	1,825	1,496	1,503	1,796	1,912	1,965
Service of medium- and long-term public- and publicly-guaranteed debt	3,634	3,654	3,242	3,510	3,343	3,209
Amortization	2,569	2,452	2,072	2,238	1,980	1,925
Interest	1,065	1,202	1,170	1,272	1,363	1,284
Interest on public- and publicly-guaranteed short-term debt	92	117	87	70	57	57
	(In percent of GDP)					
Total public- and publicly-guaranteed external debt	50.0	48.3	52.7	52.0	50.4	48.1
Long-term	43.4	42.2	46.7	46.4	44.4	42.4
Of which: project and nonproject aid	39.4	38.7	43.3	43.5	42.2	40.6
Short-term	3.5	3.7	3.5	2.6	2.9	2.7
Fund credit and loans	3.1	2.4	2.5	3.0	3.1	3.0
Service of medium- and long-term public- and publicly-guaranteed debt	6.2	5.9	5.4	5.9	5.4	4.9
Amortization	4.4	4.0	3.5	3.7	3.2	2.9
Interest	1.8	2.0	2.0	2.1	2.2	2.0
Interest on public- and publicly-guaranteed short-term debt	0.2	0.2	0.1	0.1	0.1	0.1
	(In percent of exports of goods and nonfactor services)					
Total public- and publicly-guaranteed external debt	354.2	328.7	318.9	316.9	298.2	277.0
Service of medium- and long-term public- and publicly-guaranteed debt	43.9	40.4	32.9	35.8	31.8	28.2
Amortization	31.0	27.1	21.0	22.8	18.8	16.9
Interest	12.9	13.3	11.9	13.0	12.9	11.3
Memorandum items:						
Implicit interest on public- and publicly-guaranteed external debt	4.0	4.5	4.1	4.3	4.5	4.3
Total external debt	35,309	34,338	37,110	35,743	35,293	35,232
(In percent of GDP)	60.2	55.7	62.3	59.8	56.7	53.7

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	...		94.1
Broad money (12-month percentage change)	6.2	9.4	9.0	12.8	2/	9.1
Private sector credit (12-month percentage change)	8.5	2.5	6.4	0.6	2/	9.8
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	4.1	3/	...
Karachi Stock Exchange index						
End-of-period	1,055	1,521	1,366	1,766	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	6.2	5/	-0.2
Imports (12-month percentage changes, in U.S. dollars)	-6.7	-0.1	6.2	-7.5	5/	-4.1
Terms of trade (12-month percentage changes)	4.1	-9.2	-1.6	...		0.3
Current account balance (excluding official transfers in percent of GDP)	-4.6	-3.4	-3.0	...		-2.3
Gross Official Reserves (in millions of U.S. dollars) 1/	1,672	908	1,679	3,378	4/	2,647
In weeks of imports of goods and nonfactor services	7.7	3.9	7.5	...		11.0
In percent of broad money	6.5	3.3	7.0	...		9.9
In percent of short-term external debt at remaining maturity	30.7	16.1	35.6	...		63.4
Total external debt (in millions of U.S. dollars)	35,309	34,338	37,110	...		35,743
In percent of exports of goods and nonfactor services	426.6	379.3	376.9	...		364.2
Actual debt service (in percent of exports of goods and services) 1/	46.8	54.4	38.2	...		49.2
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	0.0	2/	...

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

1/ Scheduled debt service minus rescheduled debt service plus debt service on previously rescheduled debt.
2/ December 2001.
3/ February 2002.
4/ February 28, 2002.
5/ Fourth quarter of CY 2001.

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

	2000/01	Proj. 2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08
Outstanding Fund credit								
In millions of SDRs	1,207	1412	1495	1531	1413	1207	1091	971
In millions of U.S. dollars	1,503	1,796	1,912	1,965	1,813	1,548	1,400	1,246
In percent of:								
Quota	116.7	136.6	144.6	148.1	136.7	116.7	105.5	93.9
GDP	2.5	3.0	3.1	3.0	2.8	2.3	2.0	1.7
Exports of goods and nonfactor services	12.2	14.6	14.8	14.2	14.1	12.0	10.9	9.7
Public and publicly guaranteed debt	4.8	5.8	6.1	6.2	6.0	5.3	4.9	4.4
Debt service to the Fund								
In millions of SDRs	228	198	290	352	331	222	126	129
In millions of U.S. dollars	294	252	371	451	425	285	162	166
In percent of:								
Exports of goods and nonfactor services	3.0	10.3	14.7	19.0	17.2	2.9	1.5	1.5
Gross official reserves	17.5	9.5	9.9	9.9	10.7	6.8	3.7	3.6

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				PRSP Target	South Asia	Lower-income (world-wide)
						Latest single year (1990–1999)	
	1970–75	1980–85	1993–99	2000	2003/04		
Population							
Total population, mid-year (in millions)	71.0	94.8	134.8	138.1	...	1,329.3	2,417.1
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	31.4
Total fertility rate (births per woman)	7.0	6.5	4.8	...	4.1	3.4	3.7
Unemployment (as percentage of total labour force)	...	3.7	n.a.	...	...	...	...
Income							
GNP per capita (1995 U.S. dollars)	275.7	366.5	511.3	...	652.6	445.9	449.1
Consumer price index (1995 = 100)	16.4	42.4	136.0	141.9	172.5	136.0	138.4
Food price index (1995 = 100)	...	39.3	134.5	137.0	172.6	122.7	140.8
Social indicators							
Public expenditure							
Health (percent of GDP)	...	...	0.5	...	0.5	0.9	1.2
Education (percent of GDP)	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	96.6
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	...	41.0	46.0	38.5
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	...	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 five years (per thousand live births)	183.0	161.0	126.0	...	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 2000; 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 January 31, 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	2,019.92	195.4
Reserve position in Fund	0.11	0.0

III. SDR Department:	SDR Million	%Allocation
Net cumulative allocation	169.99	100.0
Holdings	3.09	1.8

IV. Outstanding Purchases and Loans:	SDR Million	%Quota
Stand-by arrangements	465.00	45.0
Extended arrangements	168.63	16.3
Contingency and Compensatory	352.70	34.1
ESAF/PRGF arrangements	444.74	43.0

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	86.16
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				
	01/31/02	2002	2003	2004	2005	2006
Principal	0.0	195.1	292.8	330.5	291.4	124.5
Charges/Interest	0.0	32.0	26.2	19.5	12.5	6.8
Total	0.0	227.1	319.0	350.0	303.9	131.3

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

A. Nonfinancial Relations

VII. **Exchange System**

Prior to mid-1998, Pakistan implemented a fixed exchange rate system with periodic step devaluation to compensate for the inflation differential with major trading partners. On July 21, 1998, a dual exchange system was introduced consisting of a fixed official exchange rate at PRs 46 per US$1 and a floating interbank market exchange rate (FIBR). Under this system, all authorized transactions were effectively conducted at the so-called "composite rate" which was the weighted average of the FIBR and the official exchange rate. In addition, since May 28, 1998, withdrawals from foreign currency accounts have only been allowed in rupees (at the official exchange rate). An advance import deposit of 30 percent was introduced on July 12, 1998; it was subsequently reduced to 20 percent on January 9, 1999 and to 10 percent on January 24, 1999, and was eliminated on February 24, 1999. On May 19, 1999, the official exchange rate was eliminated and the exchange rate system unified, with all international transactions conducted at the FIBR. As of January 31, 2002, the FIBR was PRs 60.08 per U.S. dollar.

VIII. **Last Article IV Consultation**

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

IX. **Safeguards Assessments**:

A Stage One safeguards assessment of the State Bank of Pakistan 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 State Bank of Pakistan 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.

X. **ROSCs**

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

XI. Recent Technical Assistance

a. **FAD**: In May/June 1997, a mission conducted a review of the public expenditure management system. In May 1997, May 1998, and again in February 1999, missions reviewed the operation of the GST, and recommended measures to improve tax administration and increase tax compliance. In April 1999, a mission reviewed the income tax system and developed a strategy to improve its efficiency, potential for long-term development and ease of administration. A mission in January–February 2000 assisted with the revision of fiscal data and advised on measures to strengthen the fiscal reporting and accounting systems. In May 2000, a mission assisted with the preparation of the fiscal module of the Report on the Observance of Standards and Codes. In August 2000, a joint FAD-STA mission reviewed progress in the strengthening of the fiscal reporting and accounting systems and assisted authorities in the preparation of revised fiscal data for 1993/94–1998/99. 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.

March 12, 2002

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

Dear Mr. Köhler:

The Pakistan authorities held discussions with Fund staff during February 2002 for the first review under the PRGF Arrangement. Based on these discussions, the attached Memorandum on Economic and Financial Policies (MEFP) reviews economic developments and policy implementation in the first three months 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. It supplements the MEFP dated November 22, 2001.

All performance criteria for end-December 2001 were met, except for (a) the performance criterion on Central Board of Revenue (CBR) revenue; and (b) the performance criterion on net credit to public enterprises. As detailed in the MEFP, the CBR revenue shortfall reflects essentially lower-than-expected growth, imports and inflation in the aftermath of the September 2001 events. These factors have also affected CBR revenue collection in the quarter to March 2002, and, on this ground, we request a modification of the related performance criterion for end-March 2002. The breach of the credit ceiling reflects weaknesses in monitoring a large number of smaller public enterprises. We are currently taking corrective actions to improve the monitoring of access to credit by public corporations and believe that we will be able to respect the previously agreed ceiling on net credit to public enterprises for end-March. As detailed in the MEFP, we have taken various difficult tax measures to contain the revenue shortfall. On this basis, we request waivers for non-observance of the quantitative performance criteria on revenue of the CBR and on net credit to public enterprises at end-December 2001.

We also request modifications of two structural performance criteria. The first, regarding the injunction against any new tax exemptions, is requested to be modified to allow certain time-bound tax privileges for shipping, in response to the virtual disappearance of our shipping sector as ship owners have moved to register ships in tax havens around the world. Second, we request modification of the performance criterion regarding the timetable for the phasing out of the GST subsidy on electricity. Such a timetable has been adopted, as set out in the MEFP, but would phase-out the subsidy more gradually than originally envisaged, and would furthermore maintain the subsidy for a small life-line consumption to protect the poor.

On the basis of the performance up to end-2001 and the policies set out in the attached memorandum, the government requests the completion of the first review.

We expect to conclude the second and third reviews under the arrangement by June and September 2002, respectively, as originally scheduled.

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

Sincerely yours,

s	s
Shaukat Aziz Minister of Finance and Economic Affairs	Ishrat Husain Governor State Bank of Pakistan

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

PAKISTAN

Memorandum of Economic and Financial Policies for 2001/02–2003/04

I. Developments During October 2001–January 2002

1. **Over the recent months, the political and economic fallout from developments in Afghanistan has been aggravated by the uncertainties related to the tensions with India.** The establishment at end-2001 of an interim government in Afghanistan slowed the flow of refugees into Pakistan, and the winding down of military operations was followed by the partial reversal in the large increases in freight and insurance premium on merchandise trade, the restoration of international flights by some foreign carriers and the return of the staff of foreign businesses operating in Pakistan. While these developments boded well for the projected economic recovery in the second half of the fiscal year (i.e., January–June 2002), the recent standoff with India, including the build up of large military forces along the border, has created additional and unexpected uncertainties for Pakistan's short-term economic outlook, as well as considerable fiscal cost, although the booming stock market and a stable foreign exchange market indicate growing investor confidence in the economic outlook.

2. **Given the regional security environment, we consider Pakistan's economic performance during the period October 2001–January 2002 quite satisfactory, although growth was lower than projected and tax revenue fell short of the target**. Inflation has been lower than anticipated. Data on international trade suggest that the combined impact of the conflict in Afghanistan and the slowdown in world demand has affected Pakistan's exports broadly as expected so far. Official reserves in the quarter to December 2001 reached US$3.1 billion, and rose further to US$3.4 billion at end-February 2002. All quantitative performance criteria for end-December 2001 have been met, except (as discussed below) for net bank borrowing by public enterprises and for CBR revenue (Table 1).

3. **Output developments over the first half of FY 2001/02 were weaker than projected, reflecting the slowdown in the world economy, the continuation of drought, problems with cotton production, and possibly a stronger-than-anticipated combined impact of the post-September 11 events.** While manufacturing production was already slowing down over the summer of 2001, following the September 11 events this trend accelerated, driven by slowing export growth. For the period July–December 2001 output of large-scale manufacturing rose only by 2.9 percent over the corresponding period in the previous year, compared to growth rates of close to 8 percent in early 2001. Agricultural production is expected to underperform with respect to the program projections because of the effect of widespread cotton pests in Punjab, and worsening water availability that has particularly affected rice production.

4. **Inflation has been lower than expected.** Benefiting from the recent appreciation of the rupee and from a decline in international commodity prices, particularly for oil products, as well as continued large stocks of wheat and sugar and a prudent monetary policy, inflation in the year through January 2002 (as measured by the CPI) declined to 2.3 percent.

5. **A lower-than-programmed external current account deficit and higher capital inflows helped strengthen Pakistan's official reserves and resulted in a nominal appreciation of the rupee against the U.S. dollar of about 6 percent during October 2001–January 2002.** The current account improvement mainly reflects the substantial slowdown in imports, which for the first half of the fiscal year declined in dollar terms by 9.4 percent, compared with the same period of last fiscal year. The sharp decline in import payments is largely explained by lower oil prices, but reflects also a large decline in the volume of hydrocarbon imports. To some extent, this may reflect a one-off adjustment as importers reduced inventories accumulated in the past because of an expected depreciation of the rupee. Exports in U.S. dollar-terms during July–December 2001 rose by only 1.9 percent over last year and growth in January was flat.[1] On a brighter side, official transfers were broadly as programmed. Over the last few months we also witnessed increased capital inflows as nonresident Pakistanis, mainly in the U.S. and U.A.E., repatriated funds to Pakistan. This could be a one-off portfolio shift, motivated on the one hand by fears of tighter scrutiny and controls over bank accounts, in particular those held by residents from the Middle East, and tighter immigration controls, and on the other hand by increased confidence in Pakistan's economic outlook. These inflows helped reduce the spread between the interbank and the kerb market exchange rates to less than 1 percent during most of the period, and at the same time triggered an appreciation of the rupee, despite the SBP's aggressive buying of foreign exchange, virtually all in the interbank market. As a result, and reinforced by an active encouragement of Pakistani banks to compete with moneychangers in the Gulf for providing remittance services, a larger share of remittances from Pakistani workers abroad is now being channeled through the banking system—and this is expected to be a permanent shift.

6. **Data on monetary aggregates through December 2001 point to some continued instability in the composition of money demand over the last quarter, exacerbated by events in Afghanistan where the Pakistani rupee is heavily used.** Broad money expanded by 11.8 percent in 2001, mainly on account of increased rupee deposits. Although the rate of increase in the demand for currency slowed down substantially with respect to the peak reached in December 2000, in recent months the currency to deposit ratio increased again, probably reflecting the increased activity of international aid agencies. On the asset side,

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[1] On a shipment basis, exports declined by 0.5 percent during July–December and by 8 percent in January, compared to last year, a better indication of the impact of September 11 given that exports on a payment basis tend to lag shipments by 1–2 months on average.

NFA of the banking system were well above projections in December 2001, reflecting the stronger-than-expected external balances. Credit to the economy rose less than expected, owing to the weakening real economy, continued high real bank lending rates, and the injection of liquidity via increased tax refunds/rebates. However, the performance criterion on credit to the public enterprise sector was missed because, unexpectedly, credit to the large group of small enterprises which are not closely monitored exceeded the target, even while the major nine public enterprises, which account for more than two-thirds of public enterprise credit and which are closely monitored, were well within their targets. Bank credit to the government declined more than expected during calendar 2001 in part because of a lower overall deficit and higher nonbank domestic financing.

7. **Reflecting unsterilized foreign exchange inflows during December, reserve money grew by 28 percent in the year through December.** The sharp increase is however somewhat misleading as it reflects in part the base effect from the sharp decline in reserve money achieved in December 2000 through the "unorthodox" conversion of some special deposit accounts into treasury bills, as well as the introduction of special reserve requirements on foreign currency accounts in April 2001. Corrected for these operations, reserve money grew by 14 percent. The resulting accumulation of excess reserves held by scheduled banks were mopped up through open market operation in January, reducing reserve money growth year-on-year to 14 percent. NDA of the SBP have declined from the June level, as credit to the budget and to the nongovernment sector fell. Reflecting low inflation, the decline of international interest rates, the slow pace of domestic economic activity, and the lack of pressure on the exchange rate, the yield on six-month treasury bills fell in the mid-February auction to 5.5 percent compared to 12.9 percent at end-June 2001; the SBP's discount rate declined by 5 percentage points over this period. Nevertheless, bank lending rates remain high, at around 14 percent on average.

8. **Revenue performance in the first half of the fiscal year has been worse than anticipated, owing to shortfalls in CBR collection of indirect taxes.** While income taxes performed marginally stronger than programmed, the combination of much lower-than-projected hydrocarbon imports, a sharper slowdown in domestic economic activity, a more appreciated exchange rate, and the decision to reduce more vigorously than programmed the backlog of outstanding customs duty drawbacks and sales tax refunds to exporters resulted in a shortfall on account of these taxes of PRs 8 billion (0.2 percent of program annual GDP) relative to program projections. The acceleration of refunds, which from July to December 2001 amounted to PRs 38 billion (against only PRs 23 billion in the same period of last year, and PRs 32 billion programmed), reflects both governance concerns, that is, to reduce administrative discretion over refunds, as well as the urgent need to encourage export activity at a time when it was hit by the cancellation of orders and freight and insurance difficulties related to the military operations in Afghanistan. To some extent, the increase in refunds may also reflect a higher incidence of tax evasion. With a view to preserving the budget deficit objective for the year, in early January, concurrently with the fortnightly oil price adjustment by the oil marketing companies, the government increased the petroleum development levy by PRs 0.75 per liter on diesel and by PRs 0.25 per liter on other oil products. These

measures, envisaged under the program as a contingency in case of a revenue shortfall, are estimated to produce additional revenue for the second half of the fiscal year of about PRs 5 billion (0.1 percent of GDP).

9. **On the expenditure side, outlays were well below projections on account of a number of factors.** First, much of the provincial expenditures has been devolved to the new local governments, which were established on August 14 but did not become fully operational before end-2001. As a result, such expenditures (including I-PRSP categories) ran lower than last year, essentially limited to salary payments (see below). Second, defense outlays were lower than programmed, reflecting the use of stocks during the mobilization efforts at the borders with Afghanistan and India, and some increase in arrears to utilities. However, defense outlays have increased sharply in January. PSDP spending remained slightly below the program target due to disruptions related to post September 11 events, and the start-up problems of the devolution initiative. Finally, with domestic interest rates somewhat lower than expected and foreign interest payments also lower due to the more appreciated exchange rate, the interest bill was lower than anticipated. As a result, the fiscal deficit for the first half of the year reached only PRs 98 billion, about PRs 10 billion less than expected, and the relevant performance criterion was met. While external grant disbursements materialized broadly as expected, there were shortfalls in World Bank and AsDB loan disbursements which resulted in larger-than-expected nonbank borrowing.

10. **On the structural side, reforms are broadly on track** (for details see Table 2). No new tax exemptions have been granted since the start of the program. A first report on the implementation of the poverty reduction strategy was published in early January in the newspapers and on the website of the Ministry of Finance. All planned measures on fiscal transparency and the reform of tax administration have been implemented.

11. **The CBR reform project is proceeding as scheduled.** The President approved the establishment of a supervisory council, constituted as a Cabinet Committee and chaired by the Finance Minister, to oversee the CBR reforms. At end-February 2002, we completed the organizational restructuring of CBR headquarters by filling the five senior positions in charge of human resource management, IT, taxpayer facilitation, audit, legal affairs, and administration. The preparations for other important milestones, including the establishment of a Large Taxpayer Unit in Karachi by July 1 this year, are underway.

12. **Despite the difficult environment, the privatization process has regained momentum; however, the public utilities (WAPDA and KESC) continue to face severe financial difficulties.** Following the successful divestment of 10 percent of the National Bank of Pakistan (NBP) through the stock market (the issue was heavily over-subscribed), the cabinet committee on privatization recently approved the partial divestment of government shares in a large number of companies (see below). The stock of WAPDA's receivables from the government declined during July–December 2001 by about PRs 3 billion, reflecting in particular the payment of arrears by the Sindh government, and even while defense-sector receivables rose slightly. Arrears on priority connections declined

(Table 1). However, an increase by around PRs 3 billion in receivables from private clients in the federally administered tribal areas (FATA), where WAPDA remains unable to enforce collection or cut off supply, has aggravated the financial difficulties of the already financially distressed company. Both WAPDA and KESC have filed for a structural tariff increase to absorb the run-up in fuel prices during 1999–2000. Multi-year restructuring plans for major public enterprises (except WAPDA) have been approved by the President, setting out performance targets and reporting requirements, with regular monitoring by a committee chaired by the Ministry of Finance.

13. **Reform of the financial sector continued at a rapid pace.** The SBP has increased minimum capital requirements for scheduled banks (PRs 750 million to be reached by end-2001, PRs 1 billion by end-2002). As a result, a few smaller banks are likely to consolidate. The PRs 1 billion requirement already applies to new banks. The noncore functions of the SBP, mainly treasury functions on behalf of the government, have become the responsibility of a separate public corporation, fully owned by the SBP. A first exclusively Islamic Bank (largely foreign-owned) was recently licensed to operate in Pakistan. Meeting a structural benchmark several months ahead of schedule, the SBP issued in January 2002 a new foreign exchange manual that streamlines and clarifies Pakistan's foreign exchange regulations while ensuring full compliance with Article VIII obligations.

II. Economic and Financial Policies for the Remainder of FY 2001/02

A. Macroeconomic Objectives and Policies for 2001/02

14. **The macroeconomic framework for 2001/02 has been revised in light of recent developments, with lower growth and inflation targets.** On the basis of updated estimates of the cotton and rice crops, and recent information on manufacturing activity, we now expect real GDP (at factor cost) to grow by only 3.3 percent for this fiscal year, compared to 3.7 percent originally programmed. Downside risks to this projection continue to arise mainly from uncertainties in the prospects for manufactured exports in light of global economic weakness and regional security risks, and the vulnerability of the wheat and other winter crops due to a 60 percent shortfall in water availability. Given price developments to date, as well as the impact of the recent exchange rate appreciation, and assuming stable international oil prices, we have lowered our inflation target (in terms of the annual average CPI increase) to 3 percent.

15. **On the external side, we now expect better-than-programmed outturns for the current and capital accounts.** We expect a modest recovery in export growth to begin in the months ahead, reflecting both some stabilization of the global economy, the easing of regional tensions, and increased access for our textile exports in the EU, although we remain concerned that export orders have yet to recover. On imports, the decline experienced in the first half of FY 2001/02 is expected to gradually wind up, which would also support the programmed recovery in custom duty and sales tax collection for the remainder of the fiscal year. Regarding the capital account, we continue to view recent inflows of private capital as

mostly reflecting one-off portfolio adjustments, rather than a permanent increase in flows, but we will keep that issue under close scrutiny. Official flows are expected to be as programmed, with shortfalls in AsDB disbursements offset by lower-than-expected amortization payments. All in all, we now target a somewhat larger build-up of official reserves than originally envisaged.

16. **We will continue to keep monetary developments under close review, given the instability in the composition of money demand that was again evident in recent months, and the recent surge in reserve money**. For FY 2001/02, we will maintain projected growth in broad money at 9.1 percent, and reserve money growth at 10 percent, broadly in line with original program targets. On the asset side, we now target a somewhat higher accumulation of net international reserves, and a lower expansion of private credit in light of the injection of liquidity through the increase in tax refunds. We will, through close coordination between the Ministry of Finance and the SBP, strengthen the monitoring of the public enterprises sector beyond the major nine enterprises, to ensure that the credit limit will be strictly enforced. Similarly, in the context of the government's disengagement from agricultural marketing, credit for commodity operations (especially wheat purchases) will be carefully monitored. However, reflecting continued large carry-over of wheat stocks from the last crop, an expected good wheat harvest in the coming months, and the timid pace at which the private sector is getting involved in wheat marketing, such commodity credits will remain higher than originally planned. 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 particular, while we plan to step up our open market operations as needed to bring reserve money growth towards the program path over the coming months, we will keep monetary developments under close review given the uncertainty about money demand, including the possibility of sustained higher money demand reflecting lower inflation and increased confidence. In this context, to further deepen the foreign exchange markets, following the enactment of the legal and regulatory framework for the transformation of moneychangers into foreign exchange companies (planned for August 2002), we will allow banks to purchase foreign exchange from moneychangers at freely negotiated rates, thus moving further towards unification of the interbank and the kerb market.

17. **Fiscal adjustment remains the linchpin of our strategy to extricate Pakistan from the debt trap**. Accordingly, we will make every effort to contain this year's budget deficit (excluding grants) at or below 5.7 percent of GDP (or 6.1 percent on the assumption of maximum use of foreign grants to increase I-PRSP expenditure), despite pressures on both revenues and expenditure from the regional tensions and other exogenous factors. This would imply a deterioration by 0.4 percent of GDP compared to the original program target. The deficit will be defined to exclude any issuance of bonds in the context of the recapitalization of KESC and to banks on account of outstanding claims on CBR (see below).

18. **On the revenue side, we believe that under current circumstances it was imperative to support the export sector by reducing the backlog of (recorded and unrecorded) tax refunds**. This objective was achieved by end-January 2002, and from now on the level of outstanding refunds is expected to remain broadly at current levels. Also, we will carefully monitor and report on fresh applications for refunding custom duties and GST on inputs, as well as the stock of approved refund requests not yet paid. Refund procedures will henceforth be strictly applied while additional safeguards against fraudulent refund requests will be put in place, based on recent consultation with Fund (FAD) and World Bank experts. Deadlines within which applications for refunds must be received and paid (e.g., 72 hours for exports with a good track record in tax compliance—so called gold card holders) will be strictly enforced. Given the larger-than-programmed refunds, sluggish GDP growth, and lower imports, we expect CBR revenue to fall short from the original program target by PRs 16 billion for the year. On this basis, we request to modify the end-March 2002 performance criterion for CBR revenue to PRs 277 billion, and propose to set the end-June performance criterion for CBR revenue accordingly (Table 1). On the other hand, revenue from petroleum taxation will be higher than originally programmed due to the recent increase in tax rates. On this basis we expect overall tax revenue to fall short of the program target by only PRs 11 billion. To underpin the revenue effort, prior to the Board discussion of this review, the government will approve elimination of the GST exemptions on pharmaceuticals, effective from April 1, 2002, which will generate an estimated revenue gain of PRs 6 billion (on an annual basis). Nontax revenue will be boosted by larger-than-budgeted dividends and higher defense services receipts.

19. **On the expenditure side,** we plan to fully spend the budgeted pro-poor and social allocations, despite the low I-PRSP expenditure in the first half of the fiscal year, and, in addition, to increase grant-financed poverty expenditure to the maximum foreseen under the program. At the federal level, such monies have been fully released. However, the unexpected developments on our Eastern border as well as the need to maintain the intense patrolling of the border with Afghanistan makes sizable overruns of security-related expenditure inevitable. Additional outlays of about PRs 15 billion for this year will be required (and more if the situation on the Eastern border is prolonged). Some savings will be possible on other expenditure programs, including on interest due to lower interest rates and the more appreciated exchange rate. Strict control on non I-PRSP expenditure will be continued, and the timeliness and quality of expenditure data for program monitoring purposes improved, taking into account the findings of the recent FAD mission.

B. Structural Policies

Tax policy and tax administration

20. Tax policy (see above) and tax administration reforms are on track. The new organizational set-up for CBR headquarters has been completed in February, the publication of rules and regulations for record keeping under the new income tax law remains scheduled

for March; a proposal for revised income and sales tax appeals and dispute resolution process is under preparation, and the normal penalty regime for GST on retailers will be established by end-March. With Fund and World Bank support, the further work for the CBR reform project will proceed in the months ahead, as outlined in the strategy document prepared in late 2001. We remain committed to granting no new tax exemptions to private operators, except for exempting, for 20 years, the import of ships from import duties and shipping companies registered in Pakistan from income tax. Instead, a tonnage tax (US$1 per ton for ships registered in Pakistan) will be imposed. This approach is consistent with the maritime shipping strategy adopted in mid-2001, designed to reverse the rapid decline of the Pakistani shipping industry over the last decade, as more and more ship owners moved to flying flags of countries with full tax exemption. Since virtually no revenues are currently collected from shipping, the revenue impact of this measure is expected to be positive.

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

21. For the implementation of the I-PRSP, the government has established a federal PRSP cell in the Ministry of Finance and put in place institutional arrangements for executing and monitoring the poverty reduction strategy. The PRSP cell has been mandated with the overall lead in coordinating, monitoring, evaluating, and tracking the implementation of the PRSP strategy; and reporting progress on anti-poverty expenditures, intermediate social indicators, and final outcomes. Furthermore, a high level national PRSP Implementation Committee has also been set up to oversee the work of the cell and ensure the implementation of the PRSP policy reforms, evaluation of their impact, and appropriate adjustment in the policy regime.

22. Regarding I-PRSP expenditure tracking, (unreconciled) expenditure data are being produced on schedule. For the first half of the fiscal year, these data reveal I-PRSP expenditures to be below those in the previous year. The main causes are teething problems associated with the launching of the devolution process; thus spending remained low, largely limited to salaries (which remain under provincial purview) and outlays under the well-established federal/provincial programs. However, with local government accounts now fully operational, we expect I-PRSP spending to pick up rapidly so as to achieve the annual targets.

23. To build consensus on the PRSP intermediate indicators, the government, in collaboration with the DFID and the World Bank, will organize a workshop in March to finalize the selection of intermediate indicators and resolve outstanding issues related to definitions, measurement methodologies, data sets, and sources.

24. Distribution of state land remains a priority commitment of the government. The government of Sindh has distributed recently 25,000 acres of state land to 1,900 landless peasants. In Punjab, 10,000 acres were distributed to 1,300 landless families. The Education Sector Reforms have been accelerated and an additional PRs 2 billion provided for

rehabilitation of the existing primary schools as well as teacher training and management. The additional funds have been provided under agreements entered into with each provincial government to ensure performance-based outcomes and well-tracked expenditures and output indicators. A new initiative, namely, Tawana (Nutrition Support Program) Pakistan has been launched by the Ministry of Women Development and Social Welfare to provide a nutrition package for malnourished girls in primary schools in high poverty districts. This program is expected to have a positive impact on the girls' primary school enrollment rate. Under the National Health Program, which includes the national Program for Family Planning and Primary Health Care, TB Control Program, Malaria Control, National Expanded Program of Immunization (EPI), Special Immunization Activities, and HIV Aids Control, have all been strengthened through additional budgetary allocations and close monitoring of output indicators.

25. We have started providing monthly federal expenditure data (unreconciled) for program monitoring purposes in February 2002. Furthermore, we will adopt shortly an Accountable Fiscal Management Framework (AFMF), seeking to improve fiscal reporting, accounting, medium-term budgeting, and a better legal and institutional framework. In addition to those measures already included in the program, we intend to take the following actions:

(i) Having separated accounting and auditing last year, we are now strengthening the office of the Controller General of Accounts (CGA), including through additional staffing, while continuing the work of the federal Fiscal Monitoring Committee (FMC) and intensifying that of the provincial FMCs (e.g., through more regular meetings and better reporting to the federal FMC), with the objective to further improve and accelerate accounts reconciliation.

(ii) Fiscal reporting will be further improved through a variety of measures, at the federal and provincial levels. As a first step, Sindh province intends to begin shortly publishing quarterly fiscal data on the web, as is by now a well established practice at the federal level.

(iii) In the context of the devolution initiative, we will introduce the New Accounting Model (NAM),[2] with the help of the World Bank supported PIFRA project, at local government levels, and ensure that district budgets are prepared according to the instructions procedures laid down by the provincial AGs, and pre-audited by District Accounts Officers (including all transactions related to federal and provincial transfers and local fund revenue and expenditure). The call for the 2003/04 budget will be issued on the basis of the NAM in October 2002.

[2] It would deliver fiscal data in GFS format, and allow an economic classification of expenditure which under current accounting is difficult.

(iv) As per the commitment in our 2001/02 budget, we will continue the preparation of the fiscal responsibility law to be promulgated during 2002. With the 2002/03 budget, we intend to improve our disclosure of fiscal risks and off-budget fiscal activities (e.g., tax expenditures, contingent liabilities), and intensify work towards establishing a medium-term budget framework to better link asset creation with recurrent expenditures. For the latter, we intend to request further technical assistance.

(v) Civil service reform is proceeding as planned, and the pay and pension reform package was implemented effective December 2001, with virtually all civil servants opting for the higher pay package with streamlined pension benefits. However, the pension system still remains unsustainable over the long term and to prepare the next steps in pension reform, we plan a comprehensive actuarial analysis of the public sector pension liabilities to be ready in early 2003, as an input for a new reform package with the 2003/04 budget.

C. Other Governance Reforms

26. **We have started to implement various other reforms aimed at directly improving governance in key areas.** In the context of the AsDB-supported "Access to Justice" program, we have issued a policy announcement that we will strengthen the judiciary, including through adequate funding with the objective to provide expeditious and inexpensive justice, empowering legally the poor and vulnerable, improving judicial governance and human resources. We will also take measures to separate the investigative branch of the police from the prosecuting branch as part of our police reform. This should help improve police capacity to investigate, prevent crime, maintain public order, and to improve its transparency and accountability.

Public enterprises

27. **Despite the difficult regional environment and an unfavorable climate in world equity markets, our privatization program is on track.** We expect to meet the program objectives of bringing a 51 percent share in United Bank Ltd. (UBL) and a major share (up to 26 percent of B-shares, representing a majority of votes, as well as management control) in the telecom company (PTCL) to the point of sale by May 2002. For UBL, we are working with the group of pre-qualified bidders on due diligence, and on finalizing the cleaning up of its balance sheet. The privatization of UBL will be quickly followed by the sale of 49 percent of Allied Bank, after various court challenges (by employees) have recently been decided in favor of the government. We also plan to sell during 2002 the remaining government share (9 percent) in Muslim Commercial Bank, and are in the process of recruiting financial advisors for the privatization of Habib Bank. In the context of the ongoing privatization of the nationalized banks, we will shortly issue government bonds for about PRs 24 billion to banks to extinguish any outstanding claims on CBR for overpayment of income tax during

1992–2000.[3] For PTCL, the privatization process was well advanced in September last year, but various investor groups that had expressed strong interest at the time put their interest on hold after September 11. We will shortly re-open the invitation for expressions of interest in the hope to attract possibly additional investors, while at the same time attempt to revive the already expressed interests and initiate the pre-qualification process. The bidding for government shares in 11 companies operating at different stages in the oil and gas sector will be launched in March/April 2002. In coordination with the AsDB that is providing technical and financial support for KESC privatization, we have elaborated a strategy for the privatization process which has been approved by the cabinet in late February 2002, with a view towards bringing KESC to the point of sale (of up to 75 percent of shares) by July 2002. To allow initiation of the legal procedures needed to recapitalize KESC and change its capital structure, as required for privatization, we will shortly issue government bonds of about PRs 32 billion to commercial banks to repay KESC's debts outstanding as of March 31, 2002.

28. **The financial performance of several public sector enterprises, especially in the power sector, remains a major source of macro-financial risk and reform efforts in this area will have to be strengthened.** In particular, in the context of the World Bank SAC II currently under negotiation, we will adopt a restructuring strategy aimed at ensuring WAPDA's financial viability. In this context, we will address relevant issues such as the appropriate level of electricity tariffs, which have not yet fully absorbed the structural cost increases during 1999–2000; improving collection of receivables; and clearance of arrears to the federal government, suppliers and banks. In particular, WAPDA is being strongly encouraged to cut off supply to nonpayers of overdue receivables. We will review the legislation governing the independent power sector regulator (NEPRA) to ensure that the fuel adjustment clause is allowed to operate fully automatically. We will also formulate a clear policy regarding the licensing of operators in the power sector, and on this basis move ahead with the corporatization of WAPDA and privatization of some of its generation and distribution units. Monitoring of public enterprises is being strengthened. Beyond closer monitoring of credit (as described above), restructuring plans for PIA, Pakistan Railways, and Pakistan Steel Mills have recently been approved by the President, and are followed by internal monitoring mechanisms (in lieu of the formal memoranda mentioned in our November 2001 MEFP). In addition, we will prepare, by July 2002, a set of key quarterly performance targets for these enterprises and will publish quarterly progress reports, with a two-month lag, on the Ministry of Finance website, starting in November 2002 with data for the quarter July–September.

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[3] Based on a 1997 circular, CBR collected tax on accrued book profits on nonperforming loans until 2000, including backward to 1992. In 2000, the courts ruled against this circular and the practice stopped; banks could claim back those taxes by offsetting them against current tax liabilities. As a result, banks paid little corporate tax in 2000–2001.

29. **Reforms in the gas sector are also gaining momentum.** We are aware that current gas pricing policies imply subsidies to a relatively privileged group of consumers and producers in the fertilizer industry, amounting to nearly 0.6 percent of GDP according to a recent World Bank study. Part of this subsidy is borne by the gas sector where the PPL and Mari gas companies charge less than market prices, part is borne by the industrial sector which cross-subsidizes consumers. Accordingly, before end-March, the government will establish a new pricing framework for the gas sector. The new framework will provide successive, semi-annual adjustments in PPL wellhead prices to bring these to market levels over a period of about five years, according to a pre-determined and announced plan. The first price adjustment under the plan will take place in March 2002. We will also, in March 2002, resume the six-monthly gas tariff adjustments that were suspended last fall in the wake of September 11, to reflect a gradual elimination of industry/consumer cross subsidization over three years. Subsidies will eventually be limited to the poor with consumption levels below a minimum threshold. Feedstock gas prices, under the new fertilizer policy adopted in August 2001, will be gradually brought to the Middle East reference price over a five-year period, with the first adjustment in July 2002. New investments in the sector will however still be granted a 10 percent discount over 10 years on feedstock gas prices (as compared to the Middle East reference price). We are discussing with the World Bank further reforms in this area.

Agriculture reforms

30. **We are taking further steps to reduce government intervention in agricultural marketing and pricing, while strengthening the institutional support to farmers.** In particular, in the context of an AsDB-supported program, the government has announced a policy limiting the government's role in wheat marketing to the management of a strategic security stock, of a size to be determined in March/April each year. Procurement prices for wheat and any other commodities for which the government intervenes (cotton, rice, and sugar) will broadly reflect international prices; issue prices will cover the cost of storage and transportation. Private operators are free to buy or sell any product at freely determined prices. In addition, the federal and provincial governments have abolished all restrictions on inter-provincial or inter-district trade of agricultural commodities and seeds, and confirmed that private operators may freely export and import any agricultural commodity (except edible oil), without any nontariff barriers. In line with this policy change, the provincial food departments and PASSCO will be scaled down over time, and public corporations involved in agricultural marketing are being privatized or liquidated. At the same time, the program will streamline extension services and agricultural research while supporting an ambitious building of feeder-roads to allow farmers better access to markets.

Financial sector reforms

31. Our financial sector reform strategy has made major strides in recent months; we greatly hope for an early opportunity to review and discuss our approach with the long-awaited FSAP mission. The strategy is built on encouraging the development of an Islamic

financial system side by side with the traditional financial system. The SBP is currently preparing appropriate rules and regulations for Islamic banking. The restructuring and privatization of the three large nationalized commercial banks will further advance with the closure of additional branches during the second half of FY 2001/02. We are actively pursuing our dialogue with the Fund (MAE) on putting in place best practices against money-laundering, an issue that we hope can be further discussed during the FSAP mission now planned for May/June 2002.

D. Financing Issues

32. **We are confident that the program remains fully financed**. We hope 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. We are also firmly determined to meet the conditionality attached to AsDB and World Bank program loans to ensure disbursements are fully in line with the revised projections. Official bilateral grants are expected to accrue broadly as originally programmed.

III. Data Issues

33. We have nearly completed the studies for the project for the revision and change of base of the national accounts and 10 studies have been completed as scheduled and sent to STA for comments. Five additional studies had to be outsourced by the Federal Bureau of Statistics and will be ready by the end of March 2002. Three other in-house studies, including one on electricity and gas, will be made available to the staff for comments by end-March. We have discussed with a recent STA technical assistance mission the steps to be undertaken in order to subscribe to the SDDS, examine to what extent Pakistan data and dissemination practices are consistent with SDDS requirements and review the country external sector statistics. On this basis, we have set up an "SDDS committee" chaired by the Ministry of finance and involving other relevant ministries, the FBS, and the SBP, which will formulate by end-April 2002 an action plan for strengthening statistics in various areas in order to be able to subscribe to the SDDS in 2003. First steps to be implemented by end-April will include publication of an Advance Release calendar for SDDS data categories, where data are available, dissemination of quarterly balance of payments statistics (with one-quarter lag), and dissemination of monthly analytical accounts of the SBP in the degree of detail called for under the SDDS, with a two-week lag. The data ROSC mission, which was cancelled because of the military operations in Afghanistan, has now been rescheduled for August 2002.

IV. Program Monitoring

34. The proposed quantitative performance criteria and indicative targets for end-June 2002 and modifications for end-March 2002 are set out in Table 1. Table 2 reports on the status of the structural performance criteria and benchmarks and includes the actions we intend to take prior to the Board discussion of the first review. The modifications of the original structural performance criteria and benchmarks proposed involve the performance criterion on tax exemptions, to be effective from April 1 onwards, and the timetable for phasing out the GST subsidy on electricity. 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 April 1, 2002, the attached TMU will fully replace the existing one for the definition of performance criteria and for program monitoring purposes. We expect the second review to take place as scheduled; it should focus on the preparation of the 2002/03 budget.

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

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

	Outstanding Stock End-Jun. 2001	Prog. End-Dec. 2001	Adj. Prog. End-Dec. 2001	Act. End-Dec. 2001	Original Prog. End-Mar. 2002	Rev. Prog. End-Mar. 2002	Prog. End-Jun. 2002
Net foreign assets of the SBP (floor in millions of U.S. dollars)*	-253.5	461.5	211.5	1,120.0	93.5	93.5	725.8
			(In billions of Pakistani rupees)				
Net domestic assets of the SBP*	549.4	11.0	27.0	-15.6	28.5	28.5	6.8
Overall budget balance (floor)*	...	-107.8	...	-93.9	-160.5	-160.5	-212.3
Net government bank borrowing*	513.5	-9.6	6.4	-10.9	-4.0	-4.0	-6.9
CBR revenue (floor)*	...	183.3	...	174.5	295.8	277.4	414.3
Net credit to public sector enterprises*	110.6	5.5	...	16.5	14.0	14.0	22.5
Accumulation of budgetary arrears to WAPDA by list of priority connections*	0.25	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	96.6	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	700.0	800.0
Contracting or guaranteeing of noncessional medium-term and long-term debt by the Government* 2/	...	600.0	...	223.0	600.0	600.0	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	300.0	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	320.0	250.0	...	238.9	175.0	175.0	100.0
Of which: other than current account*	200.0	150.0	...	140.4	75.0	75.0	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	...	-187.2	-63.5	-63.5	225.2
External cash budget grants	...	616.5	...	625.5	801.4	801.4	766.5
Poverty alleviation and other programs eligible for additional grant-financed expenditure (in billions of Pakistani rupees) 3/	...	41.3	...	...	63.4	63.4	90.1
Foreign currency deposits with the SBP (including reserve requirements)	399.4	4.0	...	33.6	20.0	20.0	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/ Excluding PRGF loans.

3/ See definition in the TMU, Table 2.

Table 2. Pakistan: Structural Performance Criteria, Benchmarks and Prior Actions for the First Review Under the PRGF (Continued)

Measures	Timing	Status as of end-February 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, 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	
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	

Table 2. Pakistan: Structural Performance Criteria, Benchmarks and Prior Actions for the First Review Under the PRGF (Continued)

Measures	Timing	Status as of end-February 2002
II. Structural Benchmarks		
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 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".	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	First report published in early January 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	
Prepare proposals for revised income and sales tax appeals and dispute resolution process with a view to implement them with the 2002/03 budget.	March 31, 2002	
Bring United Bank Ltd. and PTCL to the point of sale through transparent and open public offer for sale.	May 31, 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	

Table 2. Pakistan: Structural Performance Criteria, Benchmarks and Prior Actions for the First Review Under the PRGF (Concluded)

Measures	Timing	Status as of end-February
III. Prior Actions		
Provide Fund staff with reporting on federal fiscal expenditure (unreconciled data) through end-January 2002, by end-February 2002.		Done. Data provided February 28, 2002.
Cabinet decision on KESC privatization strategy.		Done. Cabinet decision taken on February 27, 2002.
Government approval of the elimination of:		
• The GST exemption on pharmaceuticals (excluding possibly lifesaving drugs) effective April 1, 2002.		

1/ The first and fourth structural performance criteria are modified from the criteria originally set (see MEFP dated November 22, 2001), as explained in the LOI and MEFP.

PAKISTAN

Technical Memorandum of Understanding (TMU) on the Program Supported under the Poverty Reduction and Growth Facility (PRGF)

(March 2002)

1. With effect from April 1, 2002, this memorandum replaces the Technical Memorandum of Understanding (TMU) between the Pakistan authorities and the Fund staff relating to the monitoring of the first year under the PRGF-supported program (October 2001–September 2002), dated November 2001. The revised TMU will apply to the definitions of variables and the monitoring requirements of the program. The main changes from the original TMU are that the revised TMU clarifies the definitions of "debt" and "government" in the context of the external debt performance criteria, specifies the treatment of bond issues in the context of the KESC and nationalized commercial banks' privatization, clarifies reporting requirements on receivables and arrears to WAPDA, and adds reporting requirements for commodity operations, for expenditure categories earmarked for additional grant financing, and for contracting of short-term debt. 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 all local governments, as well as companies and banks that are majority-owned by the government; "public sector enterprises" and "government-owned banks" refer to enterprises or banks in which the government holds a majority ownership interest.

I. Adjustors

2. The floors on the **net foreign assets (NFA) of the SBP** will be adjusted (a) upward/downward by the cumulative excess/shortfall in net external program financing (as defined below; Table 1(a)), downward adjustments will be capped at US$250 million; and (b) upward/downward by the cumulative excess/shortfall in external cash budget grants (as defined below; Table 1(b)).

3. The ceilings on the **net domestic assets (NDA) of the SBP** and on **net bank borrowing by the government** will be adjusted downward/upward by the cumulative excess/shortfall in net external program financing (as defined below) evaluated at the exchange rate as of end-June 2001 (PRs 63.98 per U.S. dollar). The upward adjustment will be capped, however, at US$250 million.

4. The ceilings on the **NDA of the SBP** will also be adjusted downward/upward by the amount of (a) any cumulative excess/shortfall in external cash budget grants above program levels; (b) banks' rupee reserves freed/seized by any reduction/increase of the daily CRR of 4 percent; (c) banks' reserves freed/seized by any reduction/increase in the total reserve requirements on foreign currency deposits of 25 percent; and (d) 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

Table 1(a). Pakistan: Net External Program Financing FY 2001/02 (Cumulative from July 1, 2001)

(In millions of U.S. dollars)

	Prog. Dec. 2001	Act. Dec. 2001	Prog. Mar. 2002	Rev. Prog. Jun. 2002
Program financing (a+b+c+d+e+f-g+h)	**109.7**	**-232.7**	**-63.5**	**225.2**
(a) World Bank	174.0	95.0	208.0	580.9
(b) AsDB loans	300.0	145.0	350.0	370.0
(c) Other multilaterals	0.0	0.0	0.0	0.0
(d) Bilateral loans	0.0	0.0	0.0	0.0
(e) Commercial bank borrowing	532.0	469.0	718.0	913.0
Of which: IDB	234.0	176.0	320.0	420.0
(f) Privatization receipts	0.0	0.0	0.0	0.0
(g) Amortization due	1,586.8	1,413.6	2,385.4	2,890.1
Multilateral creditors	302.9	263.9	440.6	526.1
Bilateral creditors	429.4	377.7	652.1	734.0
Commercial banks	819.0	772.0	1,238.0	1,590.0
Other (Military)	35.5	0.0	54.7	40.0
(h) Debt service rescheduled/arrears	690.5	471.9	1,045.9	1,251.4
Multilateral creditors	0.0	0.0	0.0	0.0
Bilateral creditors (Jan. 2001)	327.1	266.5	327.1	266.5
Bilateral creditors additional debt relief	363.4	205.4	718.8	946.9
Commercial banks	0.0	0.0	0.0	0.0
Other (Military)	0.0	0.0	0.0	38.0

Source: Ministry of Finance.

Table1(b). Pakistan: External Grants for FY 2001/02 (Cumulative from July 1, 2001)

(In millions of U.S. dollars)

	Prog. Dec. 2001	Act. Dec. 2001	Prog. Mar. 2002	Rev. Prog. Jun. 2002
External cash budget grants	**616.5**	**625.5**	**801.4**	**766.5**
United States	600.0	600.0	600.0	600.0
European Union	9.2	0.0	36.6	25.0
Japan	0.0	25.5	150.0	120.5
United Kingdom	7.4	0.0	14.8	21.0
Other	0.0	0.0	0.0	0.0
Saudi Oil Facility	359.1	300.0	544.9	609.0
Project grants	20.2	35.2	32.5	59.6
Memorandum item:				
Grants for Afghan refugees	160.2	10.5	226.5	12.5

Source: Ministry of Finance.

the change in the reserve requirement ratio; and ΔB denotes the change in the reservable deposits as a result of definitional changes.

5. The ceilings on the **consolidated government fiscal deficit (excluding grants)** will be adjusted upward for external cash budget grants in excess of PRs 25 billion. The upward adjustment will be capped at PRs 5 billion at end-December 2001, PRs 10 billion at end-March 2002, and PRs 15 billion at end-June 2002. Upward adjustments in the deficit will have to be matched by identical increases in actual budgetary expenditures above the program levels for the categories listed in Table 2 (with the restriction that additional spending for federal police and civil armed forces will be limited to PRs 1 billion).

6. The ceiling on **net credit to public sector enterprises** will be adjusted downward for the amount of government bonds issued to banks against outstanding credit to KESC, in the context of the financial restructuring of KESC, prior to KESC privatization.

II. Financial Program Reporting Requirements

7. 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 delays indicated:

- Monthly provisional statements on federal tax and nontax revenue, within one month.
- Deposits into and withdrawals from the privatization accounts 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, within one month.
- Quarterly statement on consolidated budgetary expenditure, with federal data approved by the AGPR, within two months.
- Quarterly provisional data (from AGPR and AG) on social sector and poverty-related budgetary expenditures, as defined below (Table 3), 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 two months.

Table 2. Pakistan: Poverty Alleviation and Other Programs Eligible for Additional Grant-Financed Expenditure, 2001/02 1/

(In billions of Pakistani rupees)

	Budget Accounting Code	Budget Year 2001/02	(Cumulative) Prog. Dec. 2001	Est. Dec. 2001	Rev. Prog. Mar. 2002	Rev. Prog. Jun. 2002
Total 2/		90.1	41.3	43.6	65.6	90.1
Recurrent expenditure		12.6	5.8	5.4	8.5	12.6
Food support program	74900	2.9	1.3	1.1	1.8	2.9
Federal assistance to provinces for law and order	22000	9.7	4.5	4.3	6.7	9.7
Development expenditure		77.5	35.6	38.2	57.2	77.5
Khushal program 3/	2100	7.0	3.2	8.5	10.2	7.0
Devolution	2100	3.0	1.4	1.5	2.2	3.0
On-farm water management	52100	0.7	0.3	0.9	1.1	0.7
Primary education	41500	31.0	14.2	12.6	20.2	31.0
Secondary education	41400	18.4	8.5	7.6	12.1	18.4
General hospitals and clinics	42200	9.1	4.2	5.0	7.2	9.1
Other health facilities and preventive measures	42500	2.5	1.2	1.0	1.7	2.5
Population planning	43000	1.8	0.8	0.6	1.0	1.8
Social security and other welfare	47000	3.9	1.8	0.4	1.4	3.9

Source: Ministry of Finance.

1/ Federal and provincial expenditure.

2/ Includes releases but not actual (lower) expenditure under the Khushal Program.

3/ Federal releases, not actual (lower) expenditure.

Table 3. Pakistan: I PRSP Expenditure, 1999/2000–2001/02

(In billions of Pakistani rupees)

	Year			(Cumulative)	
	Act. 1999/2000	Prov. 2000/01	Rev. Prog. 2001/02	Prel. Act. Dec. 2000	Prov. Dec. 2001
Total	114.4	119.3	136.4	52.9	45.9
Education	54.0	56.4	63.2	29.9	26.0
Current	51.6	54.4	59.0	29.1	25.6
Development	2.4	2.0	4.1	0.8	0.4
Health	17.3	17.5	19.3	7.7	6.8
Current	14.3	15.0	15.9	6.7	5.8
Development	3.0	2.5	3.4	1.0	1.0
Population planning	3.4	1.6	2.1	0.6	0.6
Current	0.0	0.0	0.0	0.1	0.0
Development	3.4	1.5	2.1	0.5	0.5
Social security & other welfare	2.1	1.6	1.7	0.5	0.4
Current	2.0	1.5	1.6	0.4	0.4
Development	0.1	0.1	0.1	0.0	0.0
Natural calamities	1.2	0.9	1.0	0.2	0.1
Rural development 1/	6.5	12.0	15.2	3.9	3.3
Current	1.3	3.9	2.8	1.1	1.7
Development	5.3	8.1	12.5	2.8	1.6
Land reclamation	0.9	1.4	1.5	0.4	0.9
Food subsidies	9.9	8.2	8.7	2.5	1.7
Water supply and sanitation	5.6	4.5	5.5	2.0	1.8
Current	1.9	2.1	2.0	0.9	0.7
Development	3.7	2.4	3.5	1.0	1.2
Other	13.4	15.3	18.2	5.3	4.4
Irrigation	8.3	8.2	9.4	3.2	2.8
Current	5.4	5.8	4.8	2.5	2.2
Development	2.9	2.4	4.6	0.7	0.6
Roads	5.1	7.1	8.9	2.1	1.6
Current	1.9	3.0	1.3	0.9	0.8
Development	3.3	4.2	7.6	1.2	0.8
Memorandum item:					
Khushal program	3.5	5.2	7.0	2.4	...

Source: Ministry of Finance.

1/ Includes the Khushal program.

- Quarterly data on WAPDA receivables, and arrears from priority connections (see Table 4 below), within one month.

- Monthly provisional data on external budget financing and net external program financing proceeds from the Saudi oil facility, and cash external grants for budget support (as defined below), within one month.

- Quarterly data on the revenues and expenditures of the five public enterprises as per Tables 5(a) to 5(e), within two months (WAPDA, KESC, PIA, Pakistan Steel Mill Corporation, Pakistan Railways).

- 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; and
  (iv) banks' lending to the government;

- 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 six weeks.

- Daily data on SBP's sales and purchases in the kerb 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 one month. 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.

- Quarterly data on bank credit to the nine major public enterprises (with breakdown), and on SBP bridge loans to nationalized banks in the context of the BSAC and any other quasi-fiscal operations undertaken by the SBP, within six weeks.

- Quarterly data on credit for commodity operations, with separate subcategories for PASSCO and TCP operations.

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

  (i) 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

Table 4. Pakistan: Position of Billing/Receivables Vis-à-Vis WAPDA for the Quarter of January 1, 2002 to March 31, 2002[1]

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 Govt. and AJK							
I.	Federal Govt. agencies	4,915						
	Of which: Defense	3162						
II.	AJK	2,781						
	Subtotal	7,696						
B	Provincial Govt.							
I.	Punjab	0						
II.	NWFP	636						
III.	Sindh	0						
IV.	Baluchistan	0						
	Subtotal	636						
C	Total Govt (A+B)	8,332						
	Of which: Overdue receivables on priority connections							
D	FATA and Agri. T/wells in Baluchistan							
I.	FATA	7,431						
II.	Agri. T/wells in Baluchistan	1,896						
	Subtotal	9,327						
E	KESC and other private consumers							
I.	KESC	10,916						
II.	Other private consumers	16,440						
	Subtotal	27,356						
	Grand total (C+D+E)	45,015						
WAPDA debt service liabilities to government		12,921						

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

and publicly guaranteed), and for Paris Club debt, with breakdown in pre- and post-cutoff date stock.

(ii) Loan-by-loan detail of the contraction of short-term debt as well as of nonconcessional medium- and long-term public and publicly-guaranteed external debt, with separate identification of the contraction of debt with an initial maturity of over one year and up to and including five years; grace periods and scheduled repayments; currency denominations; and interest rates.

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

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

- 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 CBR and SBP website.

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

III. Definitions of Monitoring Variables

Valuation of Foreign Exchange Denominated Assets and Liabilities

8. 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 June 30, 2001, as published in the IFS. The U.S. dollar value of all foreign assets and liabilities will be converted into Pakistan rupees at the end–June 2001 exchange rate of PRs 63.98 per U.S. dollar.

Reserve money

9. 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 SBP; and deposits of the rest of the economy with the SBP excluding those held by the federal and the provincial governments.

Net foreign assets (NFA) of the SBP

10. The 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 fully consistent with the Data Template on International Reserves and Foreign Currency Liquidity. Gold will be valued at SDR 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, and international organizations.[1]

Net domestic assets of the SBP

11. The NDA of the SBP are defined as the difference between RM and the NFA of the SBP.

Net borrowing from the banking system by the government

12. 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 Zakat deposits. Government bonds issued to banks after April 1, 2002 in the context of the recapitalization of KESC and to clear claims on CBR arising from over-payment of income tax on book profits accrued on nonperforming loans between 1992 and 2000 will be excluded from net borrowing from the banking system, for the purposes of program monitoring.

Overall budget deficit (excluding grants)

13. The definition of the budget deficit under the program will be the consolidated budget deficit excluding grants. It will be measured from below the line 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, and the cash external grants for budgetary support.

14. **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), bilateral, and private sector sources; and rescheduled government debt service and debt service arrears net of government debt amortization due on foreign loans. It includes foreign loans onlent to financial institutions and companies (public or private), emergency relief lending, and the

[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.

World Bank's BSAC. Program financing excludes all external financing counted as reserve liabilities of the SBP (defined to include all net deposits of foreign banks and agencies with the SBP, and net purchases and disbursements from the IMF). Amounts assumed for net external program financing and external grants are provided in Tables 1(a) and 1(b).

Net domestic nonbank financing of the budget

15. Net domestic nonbank financing is defined as domestic privatization receipts plus the change, during each fiscal year, in the stock of (a) permanent debt, which consists of non-bank holdings of prize bonds, all federal bonds and securities (including the new Pakistan Investment Bonds); plus (b) floating debt held by nonbanks; plus (c) public account (or unfunded debt), which consists of National Savings Scheme (NSS) debt, Postal Life Insurance, and the Provident Fund; plus (d) stock of deposits and reserves received by the government; plus (e) suspense account; plus (f) any other government borrowing from domestic nonbank sources net of repayments; minus (g) government deposits with nonbank financial institutions (NBFIs). Government bonds issued after April 1, 2002 in the context of the recapitalization of KESC and to clear claims on CBR arising from over-payment of income tax on book profits accrued on nonperforming loans between 1992 and 2000 will be excluded from domestic nonbank financing for the purposes of program monitoring.

16. 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.

Net credit to public sector enterprises

17. Net credit to public sector enterprises comprises the banking system's credits to all public sector enterprises, net of outstanding deposits on the special account with the SBP for payments on public enterprises' rescheduled debt.

External debt

18. The performance criteria on contracting or guaranteeing of external debt by the government or the SBP apply 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 these performance criteria are (a) foreign currency deposit

[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, i.e., 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, i.e., 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

(continued)

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). Short-term external debt comprises debt 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 June 30, 2001 as published in International Financial Statistics (IFS).

Nonconcessional borrowing

19. 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.

Arrears to WAPDA by Priority Connections

20. Arrears to WAPDA by priority connections are defined as electricity bills overdue by more than 30 days and will be reported by WAPDA as part of its reporting of receivables (Table 4). Priority connections comprise: President Secretariat/President House, Chief Justice of Pakistan (office/residence), Chairman's Senate (office/residence), provincial Governors (office/residence), and federal and provincial government hospitals.

21. 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, as defined in Table 2.

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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, i.e., 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, i.e., 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."

Table 5(a). Pakistan: Financial Accounts of Water and Power Development Authority (Power Wing), 1998/99–2001/02

(In millions of Pakistani rupees)

				(Cumulative)				
	1998/99	1999/2000	Prel. Est. 2000/01	Q1 2001/02	Q2 2001/02	Q3 2001/02	Q4 2001/02	Proj. 2001/02
Operating revenue and expenditure								
Revenue	129,016	137,145	150,500	47,111	85,884			171,570
Sale of electricity	127,753	131,046	146,260	46,019	83,555			167,033
Other operating revenues	1,263	6,099	4,240	1,092	2,329			4,537
Expenditure	109,993	129,969	165,591	41,987	82,806			201,488
Cost of fuel	19,536	26,457	29,895	8,867	17,132			33,662
Purchase of power from IPPs	42,532	54,150	84,612	24,677	46,970			113,595
Capacity payments	22,602	23,563	33,340	11,456	24,219			66,772
Energy payments	19,930	30,587	51,272	13,221	22,751			46,823
Operating, maintenance, administative expenses	12,960	15,151	15,674	4,871	9,518			17,782
Hydel profit to provinces	6,000	6,000	6,000	0	0			6,000
Interest charges	18,413	16,444	16,850	358	2,771			17,619
Other operating expenditures	10,552	11,767	12,560	3,214	6,415			12,830
Net operating balance including interest charges	19,023	7,176	-15,091	5,124	3,078			-29,918
Savings, investment, and net borrowing								
Gross savings	35,049	21,287	91	8,727	10,392			-9,226
Net operating balance including interest charges	19,023	7,176	-15,091	5,124	3,078			-29,918
Other income	5,474	2,383	2,622	389	899			7,862
Other operating expenditures	10,552	11,728	12,560	3,214	6,415			12,830
Capital expenditure	17,391	24,654	23,833	1,247	2,983			29,382
Net borrowing	-17,658	3,367	23,742	-7,480	-7,409			38,608
Financing	-17,658	3,367	23,742	-7,480	-7,409			38,608
Net cash collection from operations	1,301	-17,214	-31,885	-4,836	-7,813			1,500
Change in accounts receivables (- = increase)	-10,448	5,299	-5,805	-6,795	-5,643			3,000
Changes in current liabilities (+ = increase)	11,749	-22,513	-26,080	1,959	-2,170			-1,500
External borrowing (capital expenditure)	7,970	12,246	14,216	103	791			14,934
Debt amortization	-13,953	-22,398	-19,644	-924	-4,446			-15,697
Rural electrification (budget CD loan)	1,129	1,151	713	0	0			1,037
Capital contributions	2,618	2,935	3,140	236	706			3,360
Debt-equity conversion	0	36,383	0	0	0			1,639
Other	-16,723	-9,736	57,202	-2,059	3,353			31,835
Memorandum items:								
Production (in GWh)	54,222	56,259	58,352	17,217	30,879			60,472
Units generated	38,334	38,395	37,065	12,647	20,900			37,951
Power purchased	15,888	17,864	21,287	4,570	9,979			22,521
Unit sold	38,906	40,910	43,757	12,733	23,428			46,382
Average tariff (in Pakistani rupees per kWh)	3.3	3.2	3.3	3.6	3.6			3.6
Average cost (in Pakistani rupees per kWh)	2.8	3.2	3.8	3.3	3.5			4.3
Of which: fuel and electricity	1.6	2.0	2.6	2.6	2.7			3.2
operational	0.3	0.4	0.4	0.4	0.4			0.4
Total bank credit outstanding								
Of which: guaranteed by the government								
TFC outstanding								
Of which: guaranteed by the government								

Source: Pakistani authorities.

Table 5(b). Pakistan: Financial Accounts of the Karachi Electricity Supply Corporation, 1998/99–2001/02

(In millions of Pakistani rupees)

	1998/99	1999/2000	2000/01	Cumulative Q1 2001/02	Q2 2001/02	Q3 2001/02	Q4 2001/02	Proj. 2001/02
Operating revenue and expenditure								
Revenue	23,782	26,042	28,860	8,170	15,891			36,115
Sale of energy	23,285	25,035	28,118	7,966	15,486			35,300
Other income	496	1,007	742	204	405			815
Expenditure	31,146	38,829	45,072	13,037	24,582			51,722
Fuel and electricity	20,713	26,118	31,497	8,801	16,616			34,511
Fuel and oil consumed	9,312	13,916	17,717	5,282	9,999			19,898
Electricity purchased (including capacity charges)	11,401	12,202	13,780	3,519	6,617			14,613
Operation and maintenance expenses	3,452	3,314	3,366	959	1,677			4,000
Financial charges	3,042	5,481	5,725	2,253	4,270			9,014
Other operating expenses	3,939	3,916	4,484	1,024	2,019			4,197
Of which: depreciation	2,726	2,821	2,755	785	1,419			3,138
Net operating revenue including interest charges	-7,363	-12,787	-16,212	-4,867	-8,691			-15,608
Savings, investment, and net borrowing								
Gross savings	-4,637	-9,966	-13,457	-4,082	-7,272			-12,470
Net operating balance including interest charges	-7,363	-12,787	-16,212	-4,867	-8,691			-15,608
Depreciation	2,726	2,821	2,755	785	1,419			3,138
Capital expenditure	2,386	2,451	1,552	545	569			2,807
Net borrowing	7,023	12,417	15,009	4,627	7,841			15,277
Financing								
Net financing from the budget								
Scheduled repayments of CDL (-)								
Scheduled repayments of onlent foreign loans (-)								
Debt for equity swaps (+)								
Arrears to budget								
Change in outstanding liabilities to suppliers (+ = increase)								
Change in receivables (+ = decrease) (+ = increase)								
Net bank financing								
Amortization on existing loans								
New loans								
Other 1/								
Memorandum items:								
Production (in GWh)								
Units generated	6,613	7,745	7,989	2,325	4,449			8,712
Power purchased	4,007	3,701	3,688	915	1,685			3,572
Unit sold	6,131	6,430	6,924	1,804	3,482			7,854
Sale of electricity (in millions of Pakistani rupees)	23,285	25,035	28,118	7,966	15,486			35,300
Average tariff (in Pakistani rupees per kWh)	3.8	3.9	4.1	4.4	4.4			4.5
Average cost (in Pakistani rupees per kWh)	5.1	6.0	6.5	7.2	7.1			6.6
Of which: fuel and electricity	3.4	4.1	4.5	4.9	4.8			4.4
Total bank credit outstanding								
Of which: guaranteed by the government								
TFC outstanding								
Of which: guaranteed by the government								

Source: Pakistan authorities.

1/ Please provide explanation for this residual item.

Table 5(c). Pakistan: Financial Accounts of Pakistan International Airlines, 1999–2002

(In millions of Pakistani rupees)

	1999	2000	(Cumulative) Q1 2001	Q2 2001	Q3 2001	Q4 2001	Proj. 2002
Operating revenue and expenditure							
Operating revenue	35,492	39,228	12,274	21,966	32,899	43,905	47,240
Operating expenditure	38,202	44,470	12,894	24,251	35,162	45,887	45,223
Operating costs	35,870	42,033	12,269	23,031	33,390	43,452	42,586
Of which: salaries and pensions	7,988	7,766	2,162	4,356	6,313	8,086	8,302
Of which: fuel	6,883	12,296	3,560	6,536	9,681	12,079	10,274
Interest expenses	2,332	2,437	625	1,220	1,772	2,435	2,637
Net operating balance including interest charges	-2,710	-5,242	-620	-2,285	-2,263	-1,982	2,017
Savings, investment, and net borrowing							
Gross savings	989	-2,576	160	-687	49	978	4,828
Net operating balance including interest charges	-2,710	-5,242	-620	-2,285	-2,263	-1,982	2,017
Other income (net)	1,257	97	160	366	479	430	410
Depreciation	2,442	2,569	620	1,232	1,833	2,530	2,401
Capital expenditure	1,285	1,022	100	210	350	490	750
Net financing requirements	-296	-3,598	60	-897	-301	488	4,078
Financing							
Financing from federal government (net)							
Gross lending							
Amortization							
Of which: onlent foreign loans							
Net bank financing							
Repayments							
New loans							
Of which: guaranteed by the government							
TFC							
Other 1/							
Memorandum items:							
Total bank credit outstanding	11,139	9,281	9,212	10,814	13,046	12,411	
Of which: guaranteed by the government							
TFC							
Of which: guaranteed by the government							

Source: Pakistani authorities.

1/ Please provide explanation for this residual item.

Table 5(d). Pakistan: Financial Accounts of Pakistan Railways, 1998/99–2001/02

(In millions of Pakistani rupees)

				Cumulative				
				Q1	Q2	Q3	Q4	Proj.
	1998/99	1999/2000	2000/01	2001/02	2001/02	2001/02	2001/02	2001/02
Operating revenue and expenditure								
Revenue	11,443	13,340	16,339	4,172	8,296			17,170
Revenue receipts	9,292	9,572	11,939	3,145	6,242			12,370
Passengers	4,447	4,779	5,602	1,576	3,190			5,850
Goods	3,698	3,760	4,576	1,132	2,264			4,900
Others 1/	1,147	1,033	1,761	436	788			1,620
Transfers from the budget 2/	2,151	3,767	4,400	1,027	2,054			4,800
Expenditure	15,215	15,537	16,390	3,056	7,256			16,451
Operating expenditure	11,892	12,395	13,877	2,496	6,011			14,233
Of which: salaries and pensions	6,327	6,657	7,206	1,603	3,387			7,477
Interest charges	3,323	3,142	2,513	559	1,245			2,219
Net operating balance including interest charges	-3,772	-2,197	-51	1,116	1,040			719
Savings, investment, and net borrowing								
Gross savings	-3,772	-2,197	-51	1,116	1,040			719
Net operating balance including interest charges	-3,772	-2,197	-51	1,116	1,040			719
Capital expenditure	3,450	457	2,553	458	1,377			6,369
Net borrowing	7,222	2,654	2,604	-658	337			5,650
Financing	7,222	2,654	2,604	-658	337			5,650
External financing net	1,287	-518	494	115	524			2,081
Amortization	621	668	690	180	360			719
New loans	1,908	150	1,184	295	884			2,800
Of which: guaranteed by the government	1,908	150	1,184	295	884			2,800
Budget investment transfer	997	306	1,369	163	493			3,569
SBP overdraft	4,429	2,866	741	-936	-680			0
Other	510	0	0	0	0			0
Memorandum items:								
Overall balance (cash basis)	-7,222	-2,654	-2,604	658	-337			-5,650
Passenger traffic								
Number of passengers (in million)	64.9	67.5	68.8	16.1	33.8			71.0
Number of kilometers travelled (in million)	18,980	18,495	19,590	5,208	10,216			21,000
Average kilometer per passenger	292.4	274.0	284.7	324.5	302.7			295.8
Average rate per passenger kilometer (in rupees)	0.23	0.26	0.29	0.30	0.31			0.28
Freight traffic								
Number of tons (in thousands)	5,500	4,800	5,890	1,440	2,860			5,900
Number of kilometers travelled (in million)	3,967	3,612	4,520	1,120	2,261			4,800
Average kilometers per ton	721	753	767	778	791			814
Average rate per ton per kilometer (in rupees)	0.93	1.04	1.01	1.01	1.00			1.02
Number of employees	100,643	94,243	92,500	91,103	90,552			90,000

Source: Pakistani authorities.

1/ Includes public service obligation, which are transfers from the budget to cover the cost of public services provided by Railways.

2/ Transfers from the budget to cover operational shortfalls.

Table 5(e). Pakistan: Financial Accounts of Pakistan Steel Mills, 1998/99–2001/02

(In millions of Pakistani rupees)

	1998/99	1999/2000	Prel. Est. 2000/01	(Cumulative) Q1 2001/02	Q2 2001/02	Q3 2001/02	Q4 2001/02	Proj. 2001/02
Operating revenue and expenditure								
Operating revenue	12,525	14,307	16,000	3,659	6,704			15,919
Net sales	12,525	14,307	16,000	3,659	6,704			15,919
Operating expenditure	13,616	15,710	17,033	3,476	7,473			16,559
Raw material costs	5,803	6,958	6,975	1,749	3,835			7,422
Salaries and pensions	3,741	3,912	3,041	633	1,384			3,010
Depreciation	820	771	729	172	344			700
Other operating expenses	2,991	3,652	4,946	916	1,862			4,005
Interest charges	261	417	1,342	6	48			1,422
Net operating balance including interest charges	-1,091	-1,403	-1,033	183	-769			-640
Savings, investment, and net borrowing								
Gross savings	140	-43	782	491	-154			510
Net operating balance including interest charges	-1,091	-1,403	-1,033	183	-769			-640
Other income	411	589	1,086	136	271			450
Depreciation	820	771	729	172	344			700
Capital expenditure	134	58	23	35	144			850
Net financing requirements	-6	101	-759	-456	298			340
Financing								
Net budgetary financing								
Amortization (due basis)								
New loans								
Net bank financing								
Amortization (due basis)								
New loans								
Of which: guaranteed by the government								
Other 1/								
Memorandum items:								
Tons of steel produced (in thousands)	834	1,001	944	232	461			880
Tons of steel sold (in thousands)	759	830	921	186	336			845
Number of employees	20,625	16,102	14,407	14,066	13,795			13,000

Source: Pakistani authorities.

1/ Please provide explanation for this residual.

Statement by the IMF Staff Representative
March 26, 2002

1. This statement summarizes information which has become available since the staff report (EBS/02/43) was circulated to the Executive Board on March 12, 2002. It does not change the thrust of the staff appraisal.

Prior Actions and progress towards end-March Structural PCs and Benchmarks

2. The information provided by the authorities since the issuance of EBS/02/43 indicates that all prior actions listed in the Memorandum of Economic and Financial Policies (MEFP) have been implemented.

3. The authorities' letter of intent includes a request for modification of the end-March 2002 performance criterion regarding adoption of a timetable for the phasing out of the GST subsidy on electricity and various sales tax exemptions. For the reasons set out in the staff appraisal, staff supports the changes in program conditionality contemplated by the proposed modification. However, the authorities have already adopted this modified timetable, as specified in the MEFP. Since the authorities have already met the measure proposed to be set as a performance criterion, staff proposes that the relevant performance criterion be deleted from the arrangement. Staff regards deletion as the most appropriate course of action because: (a) it no longer views the performance criterion in its original form as appropriate; and (b) it would not be appropriate to modify this performance criterion in a manner that has already been complied with by the authorities. Staff therefore proposes for the consideration of the Board the deletion of the performance criterion pertaining to the adoption of a timetable for the phasing out, during the program period, of the GST subsidy on electricity and GST exemptions for edible oil, vegetable ghee, and pharmaceuticals (except lifesaving drugs) as a condition for the PRGF disbursement related to the end-March 2002 test date. A revised proposed decision incorporating these changes has been circulated to the Board.

Recent Economic Developments

4. The consumer price index rose in the year through February 2002 by 3.3 percent, compared to 2.3 percent through January 2002. The average CPI for the period July 2001–February 2002 was 2.8 percent higher than in the same period in the previous fiscal year. The pick-up in the 12-month rate of inflation in February is mostly explained by higher prices for domestically produced food, and for diesel. Available trade data for the period July 2001–February 2002 indicate that both exports and imports continued to decline with respect to the same period in fiscal year 2000/01. In February 2002, exports were 13 percent and imports were 10.7 percent lower than in February 2001. However, there are indications that export orders are now starting to pick up. Remittances and private capital inflows continued strongly, and allowed the SBP to further accumulate foreign exchange reserves. During the period January 1–March 21, 2002, the SBP purchased foreign exchange for US$0.7 billion on the interbank market and US$0.4 billion on the kerb market. Official reserves stood at US$3.4 billion on March 21, 2002. Over the same the period, the Pakistan rupee was

virtually stable, and the spread between the kerb and interbank market remained below 2 percent.

5. Provisional data on revenue and expenditure for January 2002 indicate that the fiscal deficit target remains within reach. Preliminary data on CBR revenue indicate that for July 2001–February 2002, CBR revenue reached PRs 234.9 billion, 3.7 percent less than during the corresponding period in the previous fiscal year. CBR tax collection in February 2002 was lower than anticipated, reflecting the continued decline in imports but also some shortfall in direct taxes. Revenue from petroleum and gas surcharges are on track to slightly exceed program projections. Despite some pick up in defense expenditure in January, other current expenditure were lower than projected. Development expenditure increased to PRs 9 billion in January 2002, against a monthly average of PRs 6 billion during the period July–December 2001. This in part reflects a faster pace of implementing investment projects at the local government levels, where accounts became effectively operational only in December 2001. Given the high share of I-PRSP expenditure in local government outlays, this would point to an acceleration of I-PRSP spending as well.

6. The growth rate of reserve money in the year through January 2002, corrected to eliminate the impact of the special cash reserve requirement on foreign currency deposits introduced in April 2001, decreased to 10.7 percent (from 14.8 percent in December 2001). This decline reflects active open market operations during January 2002 to absorb liquidity introduced during the preceding Ramadan period. The authorities have started to strengthen the monitoring of bank credit to public enterprises. A major reconciliation and updating of the list of public enterprises between the Ministry of Finance, the SBP, and commercial banks is underway to ensure public enterprise credit is classified correctly and consistently across banks. The data reconciliation process is not yet completed, but preliminary information suggests that it will lead to substantive downward revisions in the data on public enterprise credit, and corresponding upward revision in private sector credit. The final data are expected to be available in April/May 2002, and are expected to indicate that the end-December 2001 performance criterion was missed by a small margin only.

7. The Karachi stock exchange market continued its upward trend, and the main index reached 1884 level on March 21, 2002 (42 percent increase over end-March 2001). The authorities made progress in the implementation of the privatization program by selling in early March 2002 a 90 percent stake in Pak-Saudi Fertilizer for about PRs 8 billion to domestic investors.

INTERNATIONAL MONETARY FUND

NEWS BRIEF

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Washington, D. C. 20431 USA

IMF Completes First Review of Pakistan's PRGF Supported Program, Approves US$107 Million Disbursement

The Executive Board of the International Monetary Fund (IMF) has completed the first review of Pakistan's performance under a three-year Poverty Reduction and Growth Facility (PRGF) arrangement (see Press Release No. 01/51). Completion of this review enables the release of a further SDR 86.1 million (about US$107 million), which will bring total disbursements under the IMF-supported program to SDR 172.3 million (about US$215 million).

To complete the review, the Executive Board approved two waivers for the non-observance of performance criteria on tax revenue and credit to public enterprises, and modification of the tax revenue performance criterion for end-March 2002 and of one structural performance criterion on tax issues.

The PRGF is the IMF's concessional facility for low-income countries. It is intended that 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.

After the Executive Board's discussion of Pakistan, Anne Krueger, First Deputy Managing Director and Acting Chair, issued the following statement:

"The Fund commends the authorities for the broadly satisfactory progress towards the program's macroeconomic objectives in a difficult context. However, growth prospects had to be scaled down, reflecting drought and repercussions from September 11 on export orders, and tax revenue was lower than targeted. Inflation was lower than expected, and strong private capital inflows and low imports contributed to a large accumulation of official reserves and a nominal appreciation of the rupee. Progress on the structural front was broadly in line with program expectations. Most performance criteria and benchmarks through end-2001 were observed. In view of the economic performance so far, the authorities' strong commitment to reform, and their recent implementation of corrective measures, waivers were granted for the non-observance of two end-2001 performance criteria.

"Looking ahead, the uncertainties surrounding the economic outlook on account of September 11 and related events have decreased and with the recent buildup of international reserves the economy is now better equipped to deal with adverse shocks. The planned cautious monetary policy, under a flexible exchange rate regime, will help consolidate the gains made in reducing inflation and building reserves.

"On the fiscal side, a significant improvement in tax revenue remains a key challenge. The recent tax measures taken by the authorities are welcome, but looking ahead, a significant improvement in the fiscal position will be needed to ensure debt sustainability, while raising allocations for basic social services. This will require the further reduction of tax exemptions, subsidies, and unproductive expenditure, and improved tax administration, in particular through a vigorous reform of the Central Board of Revenue.

"Building on the progress in stabilization, the authorities will need to shift emphasis towards the reforms that will be critical for achieving higher growth, poverty reduction, and improved governance. A sustained increase in spending on human development, especially basic health and education, should be feasible now that the newly elected local governments are in place and can contribute to a better monitoring of expenditure and outcomes. The vigorous pursuit of reforms such as the ongoing overhaul of the tax administration and the planned privatization program will be critical in improving governance and the investment climate. Another important challenge will be to further enhance accountability and transparency in the public enterprise sector, and to address the financial imbalances of the two public utilities. Such a reform strategy should help to stimulate the private sector-driven growth and investment process that is critical if sustained progress is to be made in the fight against poverty," Ms. Krueger said.

Statement by Mohammed Daïri, Alternate Executive Director and Meekal A. Ahmed, Advisor to the Executive Director for Pakistan
March 26, 2002

Key Points

- *The Pakistan authorities have stayed the course and implemented their PRGF program in line with expectations;*
- *A shortfall in growth performance has been more than counterbalanced by overperformance on the fiscal deficit target, inflation and the external front and structural reforms have been implemented as planned;*
- *Nevertheless, challenges remain, most notably with respect to CBR, effecting a shift towards pro-poor spending, public enterprise restructuring and privatization;*
- *The recent actions in the petroleum and gas pricing area and the announcement of the timetable for the elimination of sales tax exemptions on highly sensitive items bear testimony to the authorities' on-going commitment to the program.*

The Pakistani authorities thank staff for a concise and well-written report, which they consider to be a fair and balanced assessment of recent economic performance, and the challenges they face in the period ahead. They share the thrust of the staff's analysis and conclusions.

In broad terms, performance under the PRGF has been satisfactory with macroeconomic policies having been implemented in line with program expectations. The ongoing drought and the lingering effects of post-September 11 events on net exports suggest that economic growth in 2001/02 will be lower than previously expected. However, this unfortunate growth shortfall will be more than counterbalanced by the continued excellent performance on the inflation front and much better than expected external sector developments. Indeed, the tight stance of macroeconomic policies and favorable supply effects have helped keep the headline rate of inflation at a subdued level. The combination of a trade surplus, a significant pick-up in workers' remittances through the banking system, and better performance in the capital account—reflecting higher portfolio and direct investment inflows—led to a large accumulation of external reserves. Despite aggressive purchases of foreign exchange by the State Bank of Pakistan (SBP) on the inter-bank market, the rupee strengthened while the kerb-market premium virtually disappeared.

The target for the fiscal deficit for the first six months was comfortably met as shortfalls in revenue were more than offset by lower than programmed expenditures. Central Board of Revenue (CBR) tax revenue shortfalls were attributable to the slower pace of activity and imports, a large increase in refund payments, and an appreciating exchange rate. The increase in the petroleum development levy on diesel and other oil products in early January 2002 should help recoup some of the revenue loss in the period ahead. On the expenditure side, the more appreciated exchange rate and lower fuel prices and defense imports helped keep defense outlays some Rs. 8 billion below the program. Less propitiously, there was a large shortfall in pro-poor expenditures as the newly-established local governments—which did not become fully operational before end-January 2002—were thrust into the hitherto unfamiliar and challenging task of executing their devolved budgets.

The pace of implementation of structural reforms was maintained. The CBR reform was on track, helped by a World Bank project preparation grant and significant FAD technical assistance. A new office of Controller General of Accounts (CGA), separate from the Auditor General of Accounts (AGPR), was established. The PRSP process was carried forward with a well-attended national conference on Human Development, and a new unit was created within the Ministry of Finance to guide and oversee work in this critically important area. Despite concerted efforts to improve performance, the financial situation of two large public enterprises—the Karachi Electric Supply Corporation (KESC) and the Water & Power Development Authority WAPDA)—came under strain, highlighting the importance of moving boldly ahead with key reforms in this sector.

Assuming that the worst of post-September 11 effects have subsided and export orders are also boosted by the projected upturn in global activity, the authorities are hopeful of better growth performance in the second half of the year. The modest easing of the fiscal stance implied by the revised budget deficit target should provide some stimulus to domestic demand. The targeted CBR tax revenue ratio has been lowered to reflect revenue shortfalls to date but still implies a significant pick-up in the remaining part of the year. In this regard, the recently enacted actions to remove sales tax exemptions, combined with the increase in petroleum taxation noted above, should help underpin revenue. The continued patrolling of the Afghanistan border and tensions on Pakistan's eastern front will, unfortunately, necessitate higher defense outlays—only partly offset by savings elsewhere.

The Pakistan authorities recognize that fiscal management presents them with two major challenges. First, on the revenue side, is the challenge presented by persistent shortfalls in CBR tax revenue. While the package of measures introduced recently will help the tax effort, it will need to be complemented by sustained and vigorous pursuit of the CBR restructuring process. Implementing an action program, which strengthens the sales tax and customs duty refund system and makes it less susceptible to abuse would also help tax compliance. Second, as the staff report rightly highlights, Pakistan's poverty reduction objectives will not be met without a sustained shift of public expenditures towards human development. With the elected local governments now in charge of their devolved budgets, the authorities believe the foundations for a meaningful increase in public spending are in place. While risks to underspending remain, the authorities are confident that the impact of training in budget execution and improved governance that is being imparted to local governments will gradually make themselves felt.

Monetary and exchange rate policy will be guided by prudence and flexibility, respectively. Monetary policy will need to be vigilant, given the uncertainties in money demand while safeguarding an enviable inflation record. The SBP will respond to exchange market pressures with a "more aggressive absorption of liquidity" should that be warranted, so as not to complicate the hoped-for recovery in exports. The planned enactment of a legal and regulatory framework for transforming moneychangers into foreign exchange companies will mark a further step towards unification of the interbank and kerb markets.

In the structural area, the authorities are committed to tighter monitoring of credit to all public sector enterprises in the light of recent experience and undertake, for a few large public enterprises, to publish quarterly performance targets and outcomes to strengthen public scrutiny of their performance. Mindful of the fact that the continued financial difficulties of KESC and WAPDA could pose a major risk for the budget, they are firmly committed to bringing KESC to the point of sale by July 2002. Concurrently, the restructuring of WAPDA will continue, in close consultation with the World Bank, with financing from a possible Structural Adjustment Credit (SAC) II. Despite a difficult regional environment, the first round of substantive privatization is expected in take place in April/May 2002. The authorities are actively discussing with MAE the elements of best-practice against money laundering and look forward to fuller discussions of all financial sector issues in the context of the up-coming FSAP mission later this year. The new gas-pricing framework, which aims at a gradual elimination of subsidies, will give renewed impetus to reforms in this sector.

The staff report notes the various risks to the program. While these risks are less stark than only a few months ago, the authorities believe that the economy is better placed to deal with these risks if they should materialize. Moreover, the government has built up a strong record of policy implementation and has shown a willingness to take tough decisions to deliver on their commitments and keep the program on track. The new gas pricing formula, the increase in petroleum prices, and the bold announcement of the timetable for the elimination of exemptions on highly sensitive items—notably pharmaceuticals and edible oils—attest to that commitment.