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

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

- the staff report for the fourth review under the three-year arrangement under the Poverty Reduction and Growth Facility and request for waiver of performance criterion, prepared by a staff team of the IMF, following discussions that ended on **November 20, 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 February 14, 2003**. 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 **February 28, 2003** updating information on recent developments.

- a Press Release summarizing the **views of the Executive Board as expressed during its February 28, 2003 discussion** of the staff report that completed the review.

- a statement by the Executive Director for Pakistan.

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

Letter of Intent sent to the IMF by the authorities of Pakistan*
Memorandum of Economic and Financial Policies by the authorities of Pakistan*
Amendments to the Technical Memorandum of Understanding*
*May also be included in Staff Report

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

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PAKISTAN

Fourth Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility and Request for Waiver of Performance Criterion

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

(In consultation with other departments)

Approved by George T. Abed and Michael T. Hadjimichael

February 14, 2003

- Discussions for the fourth review under the Poverty Reduction Growth Facility (PRGF) arrangement were held in Islamabad and Lahore from November 8–20, 2002. The staff team consisted of Mr. Enders (head), Messrs. Joly and Martin (all MED); Mr. Schimmelpfennig (FAD); Mr. Sobolev (PDR); and Ms. Tomilloso (staff assistant, MED). The mission was assisted by Mr. Ghesquiere (Senior Resident Representative). Mr. Panzer (World Bank) participated in the discussions.

- The mission held meetings with Finance Minister Shaukat Aziz, the Governor of the State Bank of Pakistan (SBP) Ishrat Husain, the Secretary Finance, and other senior officials dealing with economic and financial matters. The mission also met with representatives of the All Pakistan Federation of Labor and visited school projects of a nongovernmental organization.

- Mr. Abed (Director, MED) visited Islamabad in mid-January 2003. He held meetings with President Musharraf, Prime Minister Jamali, and the cabinet's new economic team.

- In the last Executive Board discussion (November 1, 2002), Executive Directors commended the authorities for consolidating macroeconomic stability over the past two years, despite various adverse shocks. They noted that the accumulation of unprecedented levels of official reserves reduced the economy's vulnerability to external shocks. Executive Directors stressed that the key policy challenges for the medium term were to further improve the public debt dynamics through fiscal adjustment, address Pakistan's "social gap" through enhanced provision of basic social services, and ensure broader and deeper ownership of the reform program. Progress on these fronts will critically depend on stronger tax collection efforts and improved financial performance of public enterprises, especially the power companies. Directors viewed Pakistan's near-term economic outlook as broadly encouraging and considered the macroeconomic policy mix appropriate, with monetary policy geared toward keeping inflation low, within the current flexible exchange rate system, and continued fiscal adjustment. Directors welcomed the focus of the structural reform agenda on improved governance across a broad range of areas, and strongly supported the continuation of efforts to improve conditions for private sector development and growth. Directors commended the recent efforts to restructure public enterprises, but noted that a considerable agenda remains. They urged the authorities to accelerate the reform of the two power utilities to contain their drain on the budget.

- The principal authors of this report are Klaus Enders, Hervé Joly, and Edouard Martin, with inputs from Alina Milasiute, Axel Schimmelpfennig, and Yuri Sobolev.

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List of Acronyms

AsDB	Asian Development Bank
CBR	Central Board of Revenue
CNG	Compressed Natural Gas
CPI	Consumer Price Index
DFID	U.K. Department for International Development
FATA	Federally Administered Tribal Areas
FESCO	Faisalabad Electric Supply Company
FIBR	Floating Interbank Market Exchange Rate
FIP	Financial Improvement Plan
FSAP	Financial Sector Assessment Program
GDDS	General Data Dissemination System
GPF	General Provident Fund
GST	General Sales Tax
I-PRSP	Interim Poverty Reduction Strategy Paper
JSA	Joint Staff Assessment
KESC	Karachi Electric Supply Corporation
MCA	Monopoly Control Authority
MEFP	Memorandum of Economic and Financial Policies
NAM	New Accounting Model
NBP	National Bank of Pakistan
NDA	Net Domestic Assets
NEPRA	National Electric Power Regulatory Authority
NFA	Net Foreign Assets
NHA	National Highway Authority
NPL	Nonperforming Loan
NSS	National Saving Schemes
NTDC	National Transmission and Dispatch Company
NWFP	North West Frontier Province
OGDC	Oil and Gas Development Corporation
OGRA	Oil and Gas Regulatory Authority
PBS	Pakistan Bureau of Statistics
PIA	Pakistan International Airlines
PIFRA	Pakistan Improvement of Financial Reporting and Accounting
PIHS	Pakistan Integrated Household Survey
PRGF	Poverty Reduction and Growth Facility
PRSP	Poverty Reduction Strategy Paper
PSDP	Public Sector Development Program
PSO	Pakistan State Oil
ROSC	Report on the Observance of Standards and Codes
SAC	Structural Adjustment Credit
SBP	State Bank of Pakistan
SDDS	Special Data Dissemination Standard
TMU	Technical Memorandum of Understanding
WAPDA	Water and Power Development Authority

Executive Summary

Recent economic developments indicate further progress on stabilization. The recovery observed since last spring is gathering momentum, while inflation remains low. Tax revenue collected by the Central Board of Revenue (CBR) during the first half of the fiscal year were in line with projections. Pro-poor (I-PRSP) expenditures, while lower than expected, rose significantly during the first quarter over the same period of 2001, notably for education, health, and rural development. High remittances and private capital inflows contributed to a strong increase in official reserves and a slight appreciation of the Pakistani rupee vis-à-vis the U.S. dollar. Despite massive sterilization by the State Bank of Pakistan (SBP), the strong increase in the banking system's foreign assets resulted in high broad money growth.

Progress on the structural front through November 2002 was broadly in line with the program, except for the power sector, but weakened in the subsequent months. Reform of tax administration is broadly on track. The Poverty Reduction Strategy Paper (PRSP) is being prepared and is expected to be finalized by mid-2003. The performance of the large public enterprises through September was generally in line with their respective financial improvement plan (FIP) targets for the first quarter, except for the Water and Power Development Authority (WAPDA), whose financial situation deteriorated due to difficulties in improving operational performance and lower-than-expected tariff increases.

All quantitative performance criteria for end-September 2002 were met. The authorities have requested a waiver for the nonobservance of the continuous structural performance criterion regarding tax exemptions. The nonobservance of this criterion results from the extension of a sales tax and customs duty exemption for equipment to convert motor vehicles to compressed natural gas (CNG) and the restoration of a few tax exemptions that were inadvertently abolished with the last budget.

The authorities are confident that they will meet the fiscal deficit targets. They plan to reduce nonpriority expenditures, so as to offset the impact on the budget of the unexpectedly large financial imbalances of WAPDA and the lower-than-expected profit transfer from SBP resulting from high sterilization costs, along with measures to contain WAPDA's losses. In order to contain money growth and to reduce the need for costly sterilization, the SBP will slow the pace of foreign exchange purchases.

The authorities are committed to implementing a broad range of structural reforms. These include: further rationalization of the tax system, with in particular the removal of a significant number of tax exemptions; improving fiscal governance, including submission to parliament of a draft fiscal responsibility law; further liberalization of the financial sector, with the privatization of Habib Bank and the reform of the National Savings Schemes (NSS); and the completion of the corporatization/unbundling of WAPDA.

The main risks to the program, and in particular to the fiscal objectives, arise from: (a) continued tensions with India; (b) the impact of a possible Middle East crisis; and (c) the need to build consensus within the coalition government and in parliament, where the government enjoys only a small majority, for reforms that threaten well-entrenched interest groups, in a context of a relatively comfortable macrofinancial situation that has led to growing siren calls for relaxation of the adjustment effort.

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 to 100 percent of quota (SDR 1.03 billion) and endorsed the country's Interim Poverty Reduction Strategy Paper (I-PRSP).[1] The Executive Board completed the third review of the program and the 2002 Article IV Consultation on November 1, 2002 (IMF Country Report No. 02/246), thus enabling Pakistan to draw SDR 86 million. As of December 31, 2002, total Fund credit and loans outstanding to Pakistan amounted to SDR 1.5 billion (144.6 percent of quota).

2. In the attached letter dated February 8, 2003 and Memorandum of Economic and Financial Policies (MEFP) (Attachment I), the government of Pakistan requests completion of the fourth review under the PRGF arrangement and a waiver for the nonobservance of the continuous structural performance criterion regarding tax exemptions. A fifth disbursement (SDR 86 million) is conditional on the completion of this review. The PRSP preparation status report and a joint staff assessment (January 30, 2003 and January 31, 2003, respectively) are expected to be considered by the World Bank Executive Board by end-February.

II. Performance Under the Program from July–December 2002[2]

3. **After the October general elections, a new civilian government has been formed.** Mr. Jamali, leader of the strongest party (PML-Q) in the National Assembly, was elected Prime Minister by a coalition including several smaller groups and independents. The security situation has improved in the past months. Both Pakistan and India are reportedly implementing a partial withdrawal of troops deployed along the border.

4. **As detailed in the MEFP, all quantitative performance criteria for end-September 2002 were met** in a context of accelerating economic activity and strong foreign exchange inflows. Available data on manufacturing, agriculture (water availability), trade flows,[3] and tax collection all suggest a continuation of the recovery observed since last spring. The 12-month change in the consumer price index (CPI) decreased to 3.3 percent in December from its July peak of 4.0 percent.

5. **The current account and overall balance of payments overperformed during the first quarter of FY 2002/03 by about \$1 billion**, due mainly to higher-than-expected private inflows. The SBP continued to purchase foreign exchange on the interbank market, building foreign exchange reserves to \$8 billion at end-January 2003, equivalent to about seven months of projected imports of goods and nonfactor services. In addition, the central bank accumulated foreign assets of about \$1 billion earmarked for repayment of certain

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

[2] Tables 1–11 and Figures 1–6.

[3] Exports and imports of goods in U.S. dollar terms in July–December 2002 were higher than during the corresponding period of 2001 by 17 percent and 19 percent, respectively.

expensive short-term debts. Given this strong balance of payments situation, Pakistan from late February 2003 is expected to meet forthcoming repurchase expectations corresponding to the Stand-By Arrangement approved in November 2000. The Pakistani rupee slightly appreciated against the dollar in early FY 2002/03, but depreciated somewhat in real effective terms, due to the appreciation of the euro against the dollar.

6. **The fiscal deficit target for end-September 2002 was met, despite significant shortfalls in payments to the budget by public enterprises.** As detailed in the MEFP, overall revenue was better than projected, despite nonpayment of interest by WAPDA and the National Highway Authority (NHA). Total expenditures were lower than expected, largely as a result of reduced interest payments on the domestic debt, and despite higher-than-programmed net lending as WAPDA and NHA also failed to make scheduled amortization payments. According to preliminary unreconciled data, I-PRSP expenditures were below the indicative target, but rose by 39 percent over the same period in 2001, with strong increases for education, health, and rural development (up 26, 44, and 70 percent, respectively).[4] The authorities recently announced that each member of parliament would be able to select local projects for his/her constituency within the development budget, as was the practice under previous parliaments. These projects and their total costs (PRs 10 million per parliamentarian, on the whole 0.08 percent of GDP on a full-year basis) would be implemented and accounted for through the normal channels. The authorities also announced an extension of the food support program that will impact the budget mainly in FY 2003/04.

7. **Despite the SBP's sterilization efforts, broad money growth remained strong.** Reserve money increased only slightly during the quarter (but by 11 percent year-on-year at end-September 2002) owing to massive sterilization of the SBP's foreign exchange purchases. However, at the banking system's level, the contraction of net domestic assets (NDA) , reflecting weak credit to the private sector and further reduction of bank credit to the government and public enterprises, was insufficient to offset the surge in net foreign assets (NFA). Overall, broad money increased year-on-year by 19 percent at end-September 2002, somewhat more than projected. The increase in the multiplier reflects, to some extent, the reduction of cash reserve requirements on foreign currency deposits. Similar trends continued during the months of October and November, although private credit growth accelerated to 8 percent in the year through November. That same month, the SBP reduced the rediscount rate by 1.5 percent, to 7.5 percent, in a move aimed at stimulating exports and overall economic activity. Rates on 6-month treasury bills fell to 3.8 percent in mid-January 2003, while 10-year bond yields dropped to 5.5 percent in late December, triggering a reduction of NSS rates by about 1.5 percentage points.

8. **Through November, structural reforms were broadly on track (MEFP, para. 5 and Table 2(a)) with two exceptions, but performance has weakened since.** In nonobservance of a continuous performance criterion, a few tax exemptions were restored, for reasons detailed in MEFP, para. 6. Amendments to the SBP Act promulgated on

[4] Some concerns remain regarding the comparability of I-PRSP expenditure data across provinces.

October 31, 2002 only partly meet the relevant benchmark under the program. They provide for the appointment (and removal, if incapacitated) of the Governor by the President, and no longer by the federal government. They also strengthen the autonomy of the SBP's Central Board in the formulation and conduct of monetary policy, but do not explicitly grant the SBP greater responsibility in managing reserves, as recommended by the Fund's Safeguards Assessment. De facto, the SBP currently seems to exercise full control over reserve management. A new NSS instrument was introduced for government pensioners in January 2003, with a substantial subsidy element (see MEFP, para. 20).

9. **The performance of the large public enterprises during the first quarter was broadly in line with their respective FIP targets, except for WAPDA**. The first FIP progress reports, covering July–September 2002, were published in November 2002. WAPDA incurred higher cash shortfalls than anticipated (Box 1), and its financial outlook was further weakened by the government, which only, effective November 18, 2002, notified the delayed formula-based electricity tariffs adjustment reflecting the increase in fuel costs in July–September 2002, and already, effective from December 10, 2002, notified a tariff reduction, based on lower average fuel costs during October–December 2002, despite an understanding with the World Bank that tariff decreases would be suspended as long as the baseline tariff was not at a level ensuring financial viability.

10. **Privatization made only limited progress**. Only one (foreign) company maintains interest in buying the Karachi Electric Supply Corporation (KESC) and it has not yet initiated its due diligence. Privatization of Habib Bank was delayed because of a lack of interest of qualified investors. However, shares in the National Bank of Pakistan (NBP) (10 percent of capital) and the remaining government stake in Muslim Commercial Bank (9 percent) were sold. Bidding for Pakistan State Oil (PSO), the main oil marketing company, is expected in early 2003. Expressions of interest for Faisalabad Electric Supply Company (FESCO), a regional distribution company spun off WAPDA, were invited in early January.

III. Report on the Discussions

11. **The new government has endorsed the main goals set out in the I-PRSP** of achieving higher sustainable growth and reducing poverty through the pursuit of a wide range of structural reforms aimed at stimulating private sector growth and improving social service delivery. An explicit reform agenda will be laid out in the full PRSP by mid 2003. The macroeconomic framework for FY 2002/03 was kept broadly unchanged, and discussions therefore focused on (a) how to meet the budget deficit target given the deterioration in the financial situation of the public power utilities and unexpectedly high sterilization costs; and (b) how monetary and exchange rate policies should respond to sustained large capital inflows. The mission and the authorities also discussed the structural reform agenda for the first half of 2003 as well as the risk that reforms could slow down significantly. This could occur because of the need to build consensus in the coalition government and—for reforms requiring legislation—within parliament, where the government enjoys only a small majority. In addition, provincial governments might be tempted to take measures within their jurisdiction that are inconsistent with the reform

Box 1: The Water and Power Development Authority's (WAPDA) First Quarter Performance

1. WAPDA's Financial Improvement Plan (FIP)[1/] is aimed at restoring financial viability by addressing its structural weaknesses: weak bill collection; line losses that exceed 26 percent of generated units (about twice as high as international standards); and insufficient pass through to consumers of changes in cost.[2/] Under the FIP, assuming a reduction in line losses to 23.5 percent, 100 percent bill collection, and full implementation of formula-based fuel cost pass-through, WAPDA was expected to balance its books in FY 2002/03 while paying more than PRs 20 billion of debt service to the government. This compares with a PRs 13 billion net cash deficit in FY 2001/02, when WAPDA did not honor debt service liabilities of PRs 25 billion to the government.[3/]

2. WAPDA's first quarter results fell short of the FIP's targets (see Table). While the net cash surplus was higher than expected, that was mainly owing to the nonpayment of dues to the government. Revenues were significantly lower, and other current expenditures higher than targeted. At the same time, progress in unbundling WAPDA into several independent power generation companies (GENCOs), a national transmission and dispatch company (NTDC), and regional distribution companies (DISCOs) has been uneven. On the one hand, transfer of personnel to corporate entities is almost complete, the new corporate entities have been granted licenses, and the government took a decision regarding the DISCO's retail tariffs. On the other hand, the allocation and transfer of assets and liabilities to the new entities have still to be completed.

3. WAPDA's poor financial performance results, to a large extent, from difficulties in improving operational performance. Higher sales did not translate into higher operational revenues, due to the shift of consumption towards subsidized categories. While unchanged from last year, line losses were higher than targeted. Attempts to collect electricity bills in the Federally Administered Tribal Areas (FATA) have so far been unsuccessful, with actual payments at less than 1 percent of billing, due to severe law enforcement problems in this semi-autonomous region along the Afghan border. The reasons for the particularly high per capita consumption in FATA, as compared to the national average, are not clear.[4/] While it could result from the fact that, for most FATA consumers, electricity is de facto free,[5/] it could also result from the parking of losses in the FATA accounts and/or of the sale of electricity from FATA to neighboring areas.

4. The poor financial results are also explained by lower-than-expected tariff increases. The structural increase granted in August 2002 by the National Electric Power Regulatory Authority (NEPRA) was limited to 33 paisas/kWh, equivalent to PRs 14.9 billion in additional annual revenues, about PRs 8.1 billion less than assumed by the FIP on the basis of WAPDA's estimate of its structural cash shortfall. In fact, NEPRA estimated WAPDA's structural cash shortfall at only PRs 18.9 billion and, in response to a government request to limit the impact on consumers, recommended that it be partly financed through a reduction of the price of electricity bought by WAPDA from the Chasma Nuclear Power Unit and additional measures to be determined.

5. On the basis of the first quarter results, and if no corrective action is taken, the cash shortfall for FY 2002/03 could amount to PRs 34 billion. This incorporates the impact of the timing of the formula-based electricity tariff adjustment during the second quarter, and assumes a continued negligible bill collection in FATA, in line with trends observed so far.

6. Electricity tariffs have become a sensitive political and social issue in Pakistan. Electrification is relatively widespread, and thus price increases affect many poor directly, especially in urban areas. The government has kept the price for lifeline consumption (below 50 kWh per month) constant for many years, implying a decline in prices in real terms that benefits also all nonpoor users (see Figure). By contrast, real prices for "middle-wage" consumers have risen since mid-2000 by up to 40 percent, while real industrial tariffs have been steadily reduced since 1998. Even so, rates in none of the tariff categories has kept pace with the surge in fuel prices since 1999, despite some catch-up in recent years, highlighting the "structural" aspects of WAPDA's deficit. At the same time, electricity prices in Pakistan are relatively high in international comparison (see Table), especially for industrial units.

1/ WAPDA's FIP was detailed in Box 3 of IMF Country Report No. 02/141.

2/ From November 1999 to November 2002, the lifeline rate remained unchanged, while the average tariff for a 300 kWh domestic consumption increased by 33 percent. During this period, oil prices doubled (see Figure).

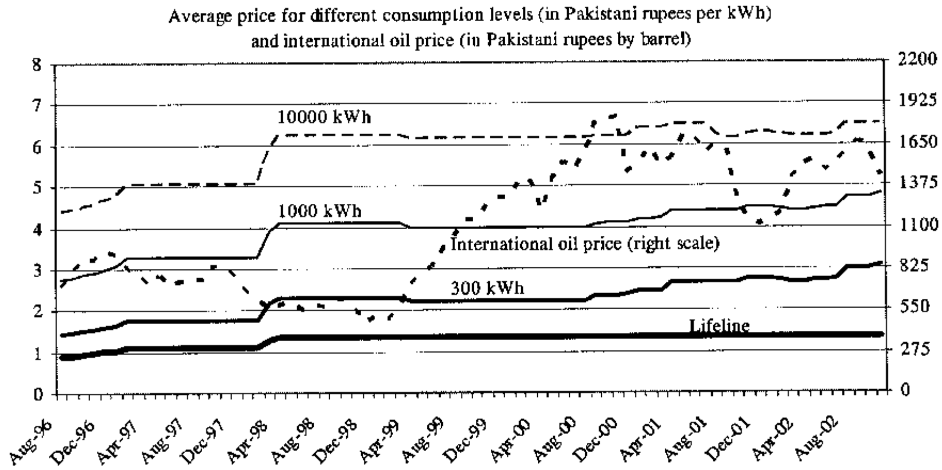
3/ In WAPDA's presentation, this net cash deficit is limited to PRs 8.5 billion, as the payment by the government of PRs 4.5 billion of KESC arrears to WAPDA, a financing item, is subtracted from cash outflows.

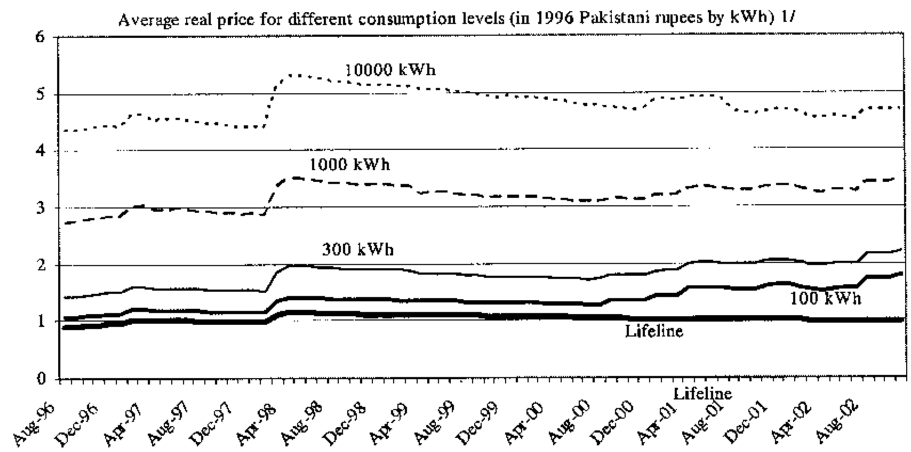
4/ During the first quarter, FATA billing amounted to 6.3 percent of total billing, while FATA's population represents about 2.3 percent of Pakistan's population.

5/ Anecdotal evidence points to a relocation of industries into FATA to enjoy zero-electricity cost.

Box 1: The Water and Power Development Authority's (WAPDA) First Quarter Performance (continued)

Pakistan: Electricity Prices, 1996–2002





1/ Deflated by the consumer price index.

International Electricity Tariffs (in U.S. dollar by 100kWh), first quarter of 2002

	Industrial tariff	Household tariff
Czech republic	4.68	6.11
Hungary	5.21	6.98
India	8.01	3.88
Mexico	4.75	7.78
Pakistan	6.85	4.5(300kWh)-10.7(higher rate)
Poland	4.76	8.34
South Africa	1.72	3.99
Turkey	8.05	8.49

Sources: International Energy Agency; Pakistani authorities; and Fund staff estimates.

Box 1: The Water and Power Development Authority's (WAPDA) First Quarter Performance (concluded)

Pakistan: Financial and Operational Targets for WAPDA and Successor Companies, 2002–03 1/

(In millions of Pakistani rupees, unless otherwise indicated)

	1997/98	1998/99	1999/2000	2000/01	2001/02	Target Q1 2002/03	Prel. Est. Q1 2002/03	Proj. 2002/03	Rev. Proj. 2002/03
Main assumptions									
International oil prices (U.S. dollar per barrel) 2/	16.2	13.1	24.4	28.1	22.6	...	27.0	...	...
Average exchange rate (Pakistani ruppes per U.S. dollar)	43.3	46.8	51.9	58.3	61.0	61.6	59.6	62.6	60.0
Average structural tariff increase (in percent)	21.0	6.5	-4.2	2.5	2.2	12.8	6.6	12.8	6.6
Units generated (in GWh)	53,261	53,683	56,259	58,416	60,849	17,552	18,204	61,929	61,631
Share of thermal units (in percent of units generated)	58.6	58.2	65.7	70.6	68.7	53.1	49.9	67.2	67.1
Units purchased (in GWh)	13,580	15,326	17,864	24,446	23,242	4,672	4,750	21,326	22,098
Main operational and financial targets									
Technical and nontechnical losses 3/ 4/	26.0	27.5	27.3	25.7	25.8	23.8	25.6	23.5	23.5
Debt service coverage ratio 5/ 6/	0.9	1.6	0.9	0.6	0.2	...	...	1.2	0.9
Total receivables (as a percentage of billings) 3/	39.9	39.2	45.8	26.7	27.1	20.7	23.7	16.0	19.1
Public sector receivables (as a percentage of billing) 3/	73.7	81.7	115.0	59.6	61.4	36.4	48.9	16.0	35.3
Stock of payables to fuel suppliers and IPPS 3/	23,876	14,224	10,669	3,209	18,065	9,103	9,883	14,571	28,861
Administrative expenses increase (in percent)	12.1	-14.0	11.8	2.2	11.6	...	...	10.0	10.0
Summary cash flow statement									
Total cash receipts (excluding GST, ED, & W/Tax)	98,319	127,546	129,560	159,598	177,409	57,529	52,116	218,711	208,597
Total cash outflows	90,707	114,524	120,687	152,711	178,649	48,941	42,050	205,232	209,356
Purchase of power from IPPs	53,148	42,532	54,150	84,612	109,101	25,462	25,319	106,454	108,508
Cost of fuel	23,085	19,536	26,457	29,892	37,365	8,657	9,279	38,238	40,627
Debt service to GOP paid	4,818	21,379	19,452	20,231	3,423	5,745	3	22,978	22,066
Debt service other than to GOP paid	11,586	11,239	20,390	9,096	11,684	2,000	1,564	10,753	11,346
Hydel profit payment	6,000	6,000	6,000	6,000	6,000	1,500	0	6,000	6,000
Operations and maintenance	14,825	12,960	15,151	15,674	17,261	4,827	4,150	19,309	19,309
Other cash outflows 7/	-22,755	878	-20,913	-12,794	-6,185	750	1,735	1,500	1,500
Net cash available before investment program	7,611	13,022	8,872	6,687	-1,240	8,588	10,066	13,479	-759
Investment program	16,433	14,738	21,118	17,014	20,618	5,406	2,651	28,681	28,949
Foreign component	8,822	7,270	12,246	10,127	13,034	3,000	0	15,915	11,511
Local component	7,611	7,468	8,872	6,887	7,584	2,406	2,651	12,766	17,438
Cash surplus (+)/deficit(-)	0	5,554	0	0	-8,824	6,181	7,415	713	-18,197

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

1/ Actuals for 1997/98–2001/02.

2/ WEO data, defined as the simple average of U.K. Brent, Dubai, and West Texas Intermediate. The FIP projections are made on the basis of international prices prevalent on December 16, 2001 (for information, the price of Brent crude was $18.8/barrel).

3/ Ceiling under FIP.

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

5/ Floor.

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

7/ Negative "other cash outflows" appears to reflect bond financing and government support, including through debt-equity swaps in the past, and is not strictly comparable with the 2002/03 presentation.

program, including the ongoing devolution process. The mission (as well as Mr. Abed during his visit) therefore strongly emphasized the need to more forcefully explain the rationale and constraints underlying the I-PRSP and PRGF-supported program, and to debate more openly a dangerous view now gaining momentum among the Pakistani public that the return of civilian government and a relatively comfortable macrofinancial position would allow a relaxation of fiscal discipline.

A. Macroeconomic Framework for the Remainder of FY 2002/03

12. **In view of recent developments, the economic growth projections and inflation targets for FY 2002/03 were kept unchanged.** Real GDP at factor costs is still expected to grow by 4.5 percent (compared with 3.6 percent in FY 2001/02), reflecting an acceleration in manufacturing production and improved outlook for major agricultural crops. The inflation target, defined as the annual increase in the CPI, was kept at 4 percent. Recent trends indicate that the target is well within reach, barring any major exogenous shock such as a surge in international oil prices.

13. **Balance of payments projections were revised, mainly to reflect stronger-than-anticipated foreign exchange inflows in early FY 2002/03, which are expected to slow in 2003.** Despite a strong performance in July–December, the export growth projection for the whole year was cautiously kept unchanged (at about 8 percent in U.S. dollar terms) to reflect the risk of continued weakness of the global economy and binding quotas on textile exports. Import growth was revised upward, mainly on account of first quarter developments. The continued high level of recorded remittances/private capital inflows likely reflects a combination of a shift of inflows to official channels and a still ongoing portfolio reallocation. The latter involves the repatriation of savings by nonresident Pakistanis and the return of flight capital, both likely due to better prospects for the domestic economy, as well as increased scrutiny abroad. The assumption of a one-off portfolio reallocation is reflected in the balance of payments projections by a tapering off of remittance flows[5] in 2003. Overall, these changes result in a large upward revision in the projected annual accumulation of gross official reserves, which are projected at $7.8 billion at end-June 2003.

14. **With continued high private capital/remittances inflows, the original monetary and exchange rate policy mix of heavy sterilized intervention to build official reserves and prevent an appreciation of the Pakistani rupee has resulted in large fiscal costs.** Assuming the inflows continue at high levels, the authorities' monetary/exchange rate policy mix will therefore aim at less intervention to reduce money growth and the need for costly sterilization, and also to avoid a growing public perception of an implicit peg taking hold. Anecdotal evidence of asset price inflation for equities and real estate points to the need to monitor closely monetary developments and exercise caution in further relaxing interest rate

[5] Since these likely portfolio reallocation flows are currently recorded as remittances, as no data exist to allow a meaningful separation of private capital flows from remittances, their assumed decrease is also reflected in lower remittances in the balance of payments projection (Table 2).

policy.[6] At the same time, low inflation and the strength of the exchange rate may indicate a sustained increase in money demand. The revised monetary program reflects a higher accumulation of NFA, which mostly occurred already by end-December 2002, along with a sharp tightening of NDA expansion for January–June 2003, including lower private credit growth on the assumption that higher capital inflows partly substitute for domestic credit. To offset any sizable real exchange rate appreciation that could hamper export growth and prevent the needed development of nontraditional exports, the authorities concurred on the need for accelerated structural reform to strengthen competitiveness of the economy.

15. **Sterilization costs and unexpected financing needs of the two power utilities will significantly strain the budget**. First, revised projections for WAPDA indicate additional need for budgetary support in the order of 0.4 percent of GDP. This assumes that WAPDA will cut nonpriority investment by PRs 4 billion, and issue government-guaranteed bonds for up to PRs 13 billion (less if WAPDA were able to reduce its projected cash shortfall). The authorities acknowledged that the latter will strain the ceiling for public enterprise credit (PRs 20 billion for the year), and the resulting build-up of contingent liabilities will weaken the government's debt reduction strategy. Second, KESC will need additional budget support (0.1 percent of GDP) reflecting the delay in privatization. Third, the erroneous budgeting of payment of debt service liabilities to the government by NHA and KESC implies a shortfall in budget inflows by 0.2 percent of GDP. Fourth, projected SBP profit transfers have been revised downward on account of the unforeseen sterilization costs (0.5 percent of GDP). Some offsetting developments (amounting to 0.7 percent of GDP; see MEFP, para. 10) include a downward revision to domestic interest payments due to significantly lower interest rates, savings linked to the more appreciated exchange rate, and collection of arrears and higher dividends from several public enterprise that are performing better than expected.

16. **Accordingly, achieving the fiscal deficit target requires savings in nonpriority expenditures of about 0.6 percent of GDP**. The authorities were confident that about half of this could be achieved by reducing spending on major investment projects and grants to public enterprises; the other half would come from current operations, mostly via better controls of telephone and power use. It would be implemented by managing appropriately fund releases to departments and preventing a reappropriation of budgetary savings already being realized, without affecting social- and poverty-reducing expenditures. The mission was less confident, especially about the second half of the expected savings, and stressed that utmost emphasis should be placed also on containing the financial imbalances of public enterprises, and if needed on additional revenue measures. The authorities agreed that the situation of large public enterprises needed to be addressed more forcefully (see below). They concurred that other risks include (a) possibly higher defense outlays should the unwinding of the stand-off with India proceed more slowly than hoped for; and (b) a sharp increase in international oil prices linked to tensions in the Middle East (although a spike in oil prices for a few weeks could most likely be accommodated in the current framework). In

[6] Despite a probably declining risk premium, bank lending rates still exceed 5 percent in real terms and are viewed by the authorities as hampering a pickup in investment activity.

addition, the mission saw a major challenge in maintaining a consensus on fiscal consolidation and reform within a government comprising many different parties and viewpoints. Beyond the fiscal impact, materialization of any of these risks may also negatively affect capital flows. If this were to occur, the authorities plan to respond with allowing a market-based exchange rate adjustment and financial tightening (MEFP, para. 10).

B. Structural Issues

Tax policy and tax administration

17. **The authorities are committed to further reducing tax exemptions with the next budget**. They indicated that they would prepare by end-March 2003 specific proposals for further tax policy reforms to be implemented with the 2003/04 budget, including the elimination of many of the remaining income tax and withholding exemptions. The mission regretted the recent renewal of various tax exemptions, even though financial implications are negligible. Specifically, the mission argued that a reduction of air pollution from diesel engines in large cities would be more effectively achieved by reducing the relative price of CNG through higher diesel taxation; that little evidence indicated a particularly strong infant industry argument to justify special protection for bus assembly; and that level playing field for oil exploration could have been better created by dropping all exemptions. The mission expressed its concern that the tax exemptions could encourage further requests by special interests, and thus weaken the thrust of the tax reform strategy. In this regard, the mission also expressed concern about plans in provincial governments to reduce taxes, such as the Punjab's government's plan to raise the threshold for agricultural land taxes.

18. **The authorities look forward to the conclusions of FAD missions on tax and customs administration in early 2003 to formulate the next steps in the CBR reform agenda**. Recently opened pilot tax offices experiment with greater functional specialization in tax administration. The authorities' intention to further reduce the number of tax exemptions with the next budget should help in streamlining the tax system. However, the mission expressed concern that tax collection on income from financial and land assets seemed considerably weakened by the "benami" practice, under which a single person holds assets under different names. This practice also seems to hamper efficient enforcement of loan contracts. While the authorities plan to prepare a strategy to address this issue, they emphasized that the practice was deep-rooted in local tradition and could only gradually be reformed.

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

19. **The program aims at further improving transparency and data quality in public finances, and parliament is expected to take up in 2003 the draft fiscal responsibility law**. The latter would establish clearly specified budget reporting requirements and would define a multi-year framework for reducing public debt. The mission emphasized that accounting problems at local government levels had become more acute with the devolution process and must be forcefully addressed. The mission also expressed concern that the involvement of members of parliament in the selection of local development programs could

constitute a setback for fiscal management and transparency. The authorities plan to further develop the PRSP monitoring system as detailed in the MEFP (para. 15).

20. **The recent establishment of the actuarial office in the ministry of finance will allow the authorities to formulate the next phase of public pension reforms**. These reforms will include the introduction of a contributory pension scheme for new civil servants in the course of FY 2003/04 and reform of the General Provident Fund (GPF), a mandatory supplementary pension scheme for government employees with a notional interest rate far above market levels. The authorities plan as a first step to improve GPF targeting and reduce its costs to the budget by tying its rate of return closer to market interest rates.

Privatization and public enterprise reform

21. **Privatization has been slow, mostly due to limited investor interest**. The authorities regretted that, in some cases, privatization may require a negotiated sale given the lack of bidders (MEFP, para. 12). In other cases, privatization seemed unlikely in the near future and reform will have to be implemented by the government (MEFP, para. 17). Especially for these cases, the recent publication of quarterly progress reports is expected to improve transparency and accountability of public enterprises, and help foster public support for reform.

22. **The authorities shared the mission's concerns regarding WAPDA's poor operational and financial performance**. Improvements will only result from coordinated and forceful action jointly by WAPDA and the government. On the operational level, WAPDA needs to reduce line losses and enforce bill collection, if needed, by cutting off nonpayers more aggressively. The mission suggested carrying out a long-term marginal cost analysis with World Bank assistance, which would provide a baseline for assessing WAPDA's financial performance, and could provide valuable input in the next annual tariff structure review. The mission urged the government to rapidly find a solution to the Federally Administered Tribal Areas (FATA) bill collection issue and welcomed ongoing discussions with the tribal leaders in FATA in this regard, as well as WAPDA's plan to start metering larger commercial customers in FATA. The mission also urged the authorities to (a) ensure timely implementation of the tariff adjustments determined by the power sector's regulator; and (b) make the long-delayed decisions on assigning assets and liabilities, and implement transparent pricing policies for the new corporate entities, so as to allow completing WAPDA's corporatization and unbundling. This strategy is consistent with World Bank advice and would largely implement outstanding commitments under the last Structural Adjustment Credit (SAC), and facilitate re-engagement of the World Bank on energy sector reform. The mission welcomed the decision in principle to move toward differential pricing of electricity by the new distribution companies, to reflect differences in efficiency, and thereby facilitating privatization, even if it required public financial support for less efficient entities. Looking ahead, as a critical input to formulating a realistic macroeconomic framework and budget for next fiscal year, an FIP for 2003/04 will be prepared in close collaboration with the Bank by mid-April, aiming at a realistic reduction of WAPDA's (and its corporate successors') deficit, underpinned by specific actions and contingency plans.

Financial sector reform

23. **The authorities' reform plans in the financial sector (see MEFP, para. 19) involve clear exit strategies regarding the Industrial Development Bank of Pakistan and Allied Bank of Pakistan**. Any related costs will be reflected in next year's budget. The authorities also plan further reform of the NSS to improve targeting and reduce the costs to the budget. However, they felt that more frequent adjustment of NSS interest rates (currently every six months) was administratively feasible only once computerization of NSS, which has just started, was completed. The mission expressed concern about the recent extension of NSS abroad, with the opening of facilities in the United Arab Emirates targeting expatriate Pakistanis, as well as about the recent creation of a new savings scheme for government pensioners. The mission believes the latter is an indirect and inefficient way to increase pension benefits, which could possibly lead to abuse. The authorities were however confident that abuse could be prevented, and that the new scheme took care of the "social safety net" component under the NSS and would thus allow faster reform of the NSS. The mission urged the authorities to finalize their draft anti-money laundering law and to submit it to parliament as soon as possible.

IV. Other Issues

Statistical issues

24. **Staff welcomed the long-awaited publication of the household survey, and urged the authorities to take the few steps needed to participate in the General Data Dissemination Standard (GDDS)**. Regarding subscription to the Special Data Dissemination Standard (SDDS), the authorities indicated that (a) they were incorporating STA comments into a draft of the International Reserves and Foreign Currency Liquidity template which would be published soon; (b) they planned to publish by end-June 2003 national accounts with the new base year (and quarterly accounts by end-2003); and (c) they were working on a new survey to provide for improved labor market statistics.

Program financing

25. **The program remains fully financed for 2002/03**. Staff welcomed the recent signing of bilateral agreements implementing the Paris Club Agreed Minutes. With respect to private creditors, memoranda of understanding have been signed on the restructuring of a \$100 million loan from foreign branches of a nationalized bank.

Program monitoring

26. Proposed prior actions, quantitative and structural performance criteria and indicative targets, and structural benchmarks are specified in the MEFP (see also Box 2). Amendments to the October 2002 Technical Memorandum of Understanding (TMU) specify the treatment of KESC borrowing in FY 2002/03 and early repayment of government external debt, and update the baseline assumptions for external program financing and external grants. In view of the uncertainties surrounding Pakistan's economic outlook, the program will continue to be monitored through quarterly reviews. The discussions with staff for the fifth review are expected to take place in March 2003.

Box 2. Structural Conditionality [1/]

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

Most of the structural conditionality for FY 2001/02 was met. Structural conditionality for FY 2002/03 is detailed in Tables 2(a) and 2(b) of the MEFP. The focus remains on tax policy and tax administration reforms, public expenditure management reforms, and fiscal transparency. Particular emphasis is also given to the reform of WAPDA, whose financial situation weighs considerably on public finances. Although the World Bank has the lead in the power sector reform, due to ineffectiveness of its conditionality in preventing substantial financial slippages, a structural performance criterion was introduced aimed at limiting WAPDA's financing needs and thereby containing the risks to the macrofinancial objectives under the program. The privatization of a nationalized bank is a structural performance criterion, as privatization is critical to create a sound and efficient financial sector that contributes to growth, and is less vulnerable to government interference. Additional conditionality will be formulated during the next reviews, once needed input, especially from planned technical assistance missions in the area of customs and tax administration reform, is available.

2. Status of structural conditionality from earlier programs

Virtually all structural measures included in the Stand-By Arrangement, which expired in September 2001, were implemented. A benchmark on the establishment of best practice anti-money laundering rules was missed because of repeated postponement of a scheduled Financial Sector Assessment Program (FSAP) mission, which was expected to provide technical advice. The benchmark on the reconciliation of provincial expenditure was only partially met because of limited institutional capacity in managing both the devolution initiative and revising accounting procedures to include the newly created district administrations. Expenditure reconciliation has further improved since the start of the current PRGF program.

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

World Bank program lending for FY 2001/02, as for the previous fiscal year, was delivered under a one-tranche Structural Adjustment Credit (SAC). The IDA-financed $500 million SAC II disbursement (in June 2002) was conditional on (a) accelerating power sector reforms with a view to restoring the sector's financial viability; (b) revamping the tax administration system to improve governance and increase revenues; (c) improving the policy framework in the oil and gas sectors to attract domestic and foreign investment; (d) improving the effectiveness in the delivery of social services through civil service reforms, and enhanced transparency and accountability in the use of public resources; (e) accelerating the implementation of the Education Sector Reforms Action Plan and the National Health Policy; and (f) establishing monitoring and evaluation systems to assess progress in the implementation of the poverty reduction strategy. Overall, conditionality has proved relatively ineffective in the power sector, with the implementation of WAPDA's FIP largely off-track and limited progress in the utility's corporatization/unbundling process. In the petroleum sector, conditionality did not prevent deviations from the fortnightly, formula-based price adjustment mechanism during the run-up to the referendum of April 2002 and the general elections of October 2002. The World Bank approved in July 2002 SACs for two provinces (Sindh and North West Frontier Province (NWFP)) totaling $190 million, in support of provincial reform strategies to improve fiscal transparency, resource management, and strengthen provision of public services by local governments and communities. Conditionality related to the restructuring of three nationalized banks is part of a banking sector project loan approved in October 2001. Successful implementation of reforms have facilitated the privatization of United Bank and should help privatize Habib Bank.

4. The **Asian Development Bank (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), whose disbursement has been delayed due to limited reform progress; 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 the accountability of justice and law enforcement agents, and strengthen the rule of law. In December 2002, the AsDB approved two new program loans: one aimed at improving governance and operational efficiency in financial markets; the other to develop the rural finance sector, including through the restructuring of the Agricultural Development Bank of Pakistan.

1/ Updated from IMF Country Report No. 02/246.

V. Staff Appraisal

27. **The authorities deserve credit for further consolidating macroeconomic stability, despite populist pressures in the run-up to and following the October 2002 elections for the national and provincial parliaments.** With an apparent easing of the stand-off with India, prospects for achieving the real growth target for FY 2002/03 appear good. The rate of inflation remains slightly lower than expected, and external reserves continue to improve faster than programmed. This outcome reflects relatively prudent macroeconomic policies that made good use of favorable exogenous factors, such as strong official support and unexpectedly high and persistent private capital and remittances inflows. Progress in reforming tax administration has been encouraging and appears to be bearing fruit as indicated by the September and December CBR revenue outcomes. Staff welcomes the recent publication of the first quarterly reports on the performance of the main public enterprises, which highlight that progress in reforming the utilities has been slow. These reports should help increase public awareness of the challenges and constraints involved and raise accountability and transparency of public enterprise operations.

28. **The new government is expected to more fully develop its reform agenda in the process of preparing the full PRSP.** In the meantime, the targets for FY 2002/03 remain broadly unchanged, and aim at continued reduction of the public debt to GDP ratio, a meaningful shift in public expenditure toward human development, and substantive progress in tackling a host of governance issues. The latter include tax administration, expenditure control, public service delivery, and management of the public enterprise sector.

29. **On the macroeconomic side, staff urges the authorities to reduce intervention in the foreign exchange market so as to gain better control over monetary policy and to reduce sterilization costs.** Less intervention should also help counter a growing public perception of an implicit peg, with the attendant danger of underestimating exchange rate risks by market participants, and make it easier for the SBP to contain money growth. Anecdotal evidence of sharp increases in asset prices and the usual lags between monetary expansion and inflation highlight the need to monitor monetary developments carefully and tighten policies should inflationary pressures emerge. In this regard, staff recommends caution in further relaxing interest rate policy. Staff shares concerns that reduced intervention carries the risk of a real appreciation that could hamper the recovery of exports and the needed diversification of the export base. The best response is to accelerate structural reforms aimed at strengthening the competitiveness of the economy.

30. **The programmed reduction in the fiscal deficit remains the cornerstone of the adjustment effort, to reduce the burden of public debt that weighs down private investment and constrains needed development expenditure.** The modernization of tax administration needs to be pursued forcefully to reduce the scope for rent seeking and to increase efficiency. In this context, staff urges the authorities to outlaw the "benami" practice, which is likely to impede tax collection on income from various assets and may also complicate enforcement of loan contracts. Achieving the fiscal targets despite likely shortfalls in WAPDA's (and NHA's) payments to the budget will require significant savings in other outlay categories, while preserving priority social expenditure. There is considerable

risk that not all the needed savings can be achieved this way, and staff urges the authorities to make additional efforts to contain WAPDA's deficit, and if needed, raise petroleum taxes. As part of putting public finance on a sounder footing, a comprehensive plan to restructure the NSS will be crucial to avoid abuse of the subsidy element. In this regard, staff regrets the recent establishment of a new subsidized scheme for government pensioners.

31. **To address a main risk to the planned fiscal adjustment for this year and beyond, the government needs to tackle the large deficit of WAPDA more forcefully and quickly**. It needs to better assist WAPDA with the law-and-order issues that impede the collection of bills, especially in the tribal areas, and should allow timely and adequate adjustments in tariffs to fuel cost changes, notwithstanding socio-political concerns about high electricity tariffs. WAPDA needs to redouble efforts to bring down line losses as targeted, and to enforce bill collection. Staff urges the authorities to complete the unbundling of WAPDA through assigning assets and liabilities and implement transparent pricing policies for the successor entities, with differentiated retail tariffs reflecting the relative efficiency of the various regional distribution companies.

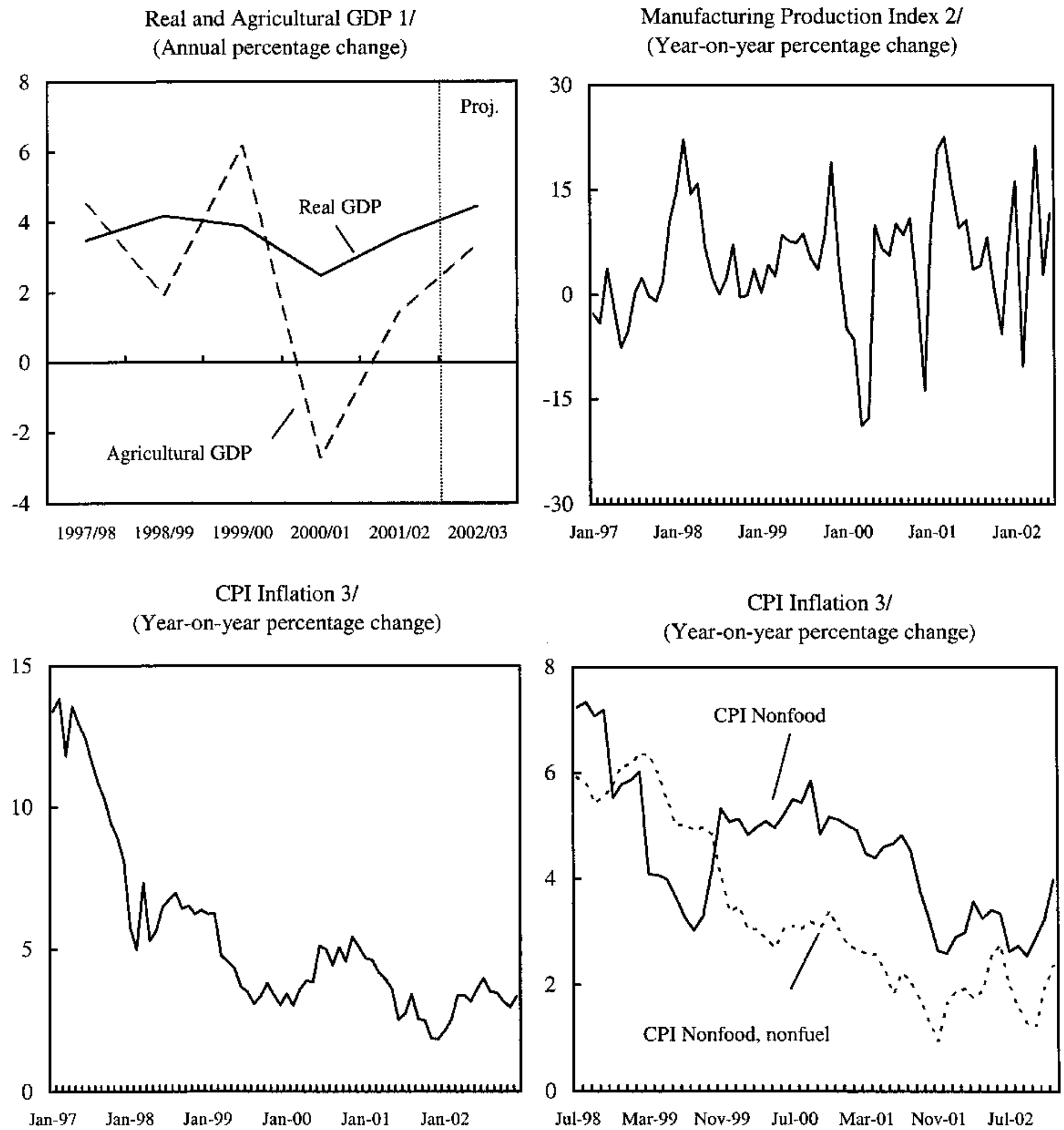
32. **To address the country's huge "social gap," the current budget rightly attaches much greater priority to human development**. To ensure that increased resources translate into better basic social services, it will be important to avoid backtracking on the devolution process and to strengthen the capacity of elected local governments to formulate priorities in light of local conditions and monitor the use of funds. Staff welcomes the progress made toward setting up a system to monitor key intermediate social outcomes and advises the authorities to develop rapidly the planned quick-evaluation survey.

33. **The staff encourages the authorities to consolidate progress in improving governance, transparency, and data quality in public finances**. Improvements in the reconciliation of public expenditure at federal and provincial levels are encouraging, but accounting problems at local government levels have yet to be forcefully addressed. The increased involvement of parliamentarians in the selection of local development projects financed out of the federal budget should be discontinued with the next budget. Staff urges the authorities to work on building a broad consensus in parliament to ensure early promulgation of a fiscal responsibility law to define clearly budget reporting requirements and a multi-year framework for reducing public debt. A law along the lines of the recently published draft would provide an excellent standard in this regard, with scope for appropriate extension to provincial and local governments. Staff urges the authorities to complete the few remaining steps for participation in the GDDS, and address remaining lacunae relative to the Fund's Safeguards Assessments recommendations, with a view to further strengthening SBP autonomy.

34. **Barring major exogenous shocks, and in view of Pakistan's track record over the last two years, staff expects the government to be able to hold the program broadly on course**. Strong reserves and a flexible exchange rate should help cushion the impact of unexpected external shocks. The risk of slippages has clearly risen in the face of mounting populist pressures to relax the adjustment effort. A major challenge will be to maintain a consensus on fiscal consolidation and reform among a government comprising many

different parties and viewpoints, and with a possibly even greater variety of views on economic policies among provincial governments. However, the process of quarterly reviews provides some assurance that an adequate response to unforeseen events will be developed quickly. Staff regrets the nonobservance of the continuous performance criterion on tax exemptions, which sends the wrong signal to various interest groups and will complicate tax administration. However, given that the tax exemptions of concern have only minor financial relevance, and that all macroeconomic targets, including for tax revenue, have so far been achieved, staff recommends the granting of the requested waiver to allow completion of the fourth review.

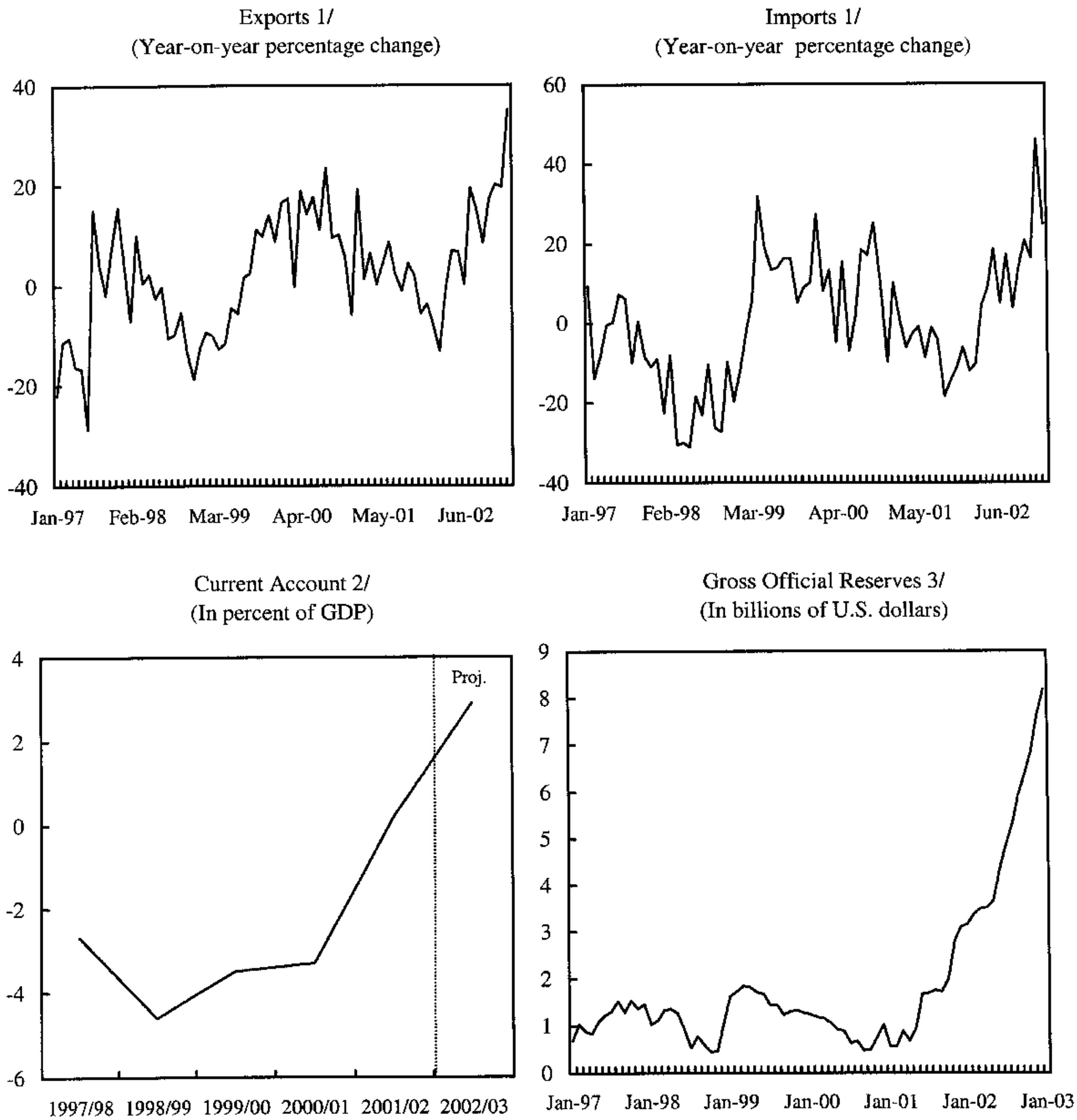
Figure 1. Pakistan: Output and Inflation, 1997/98–2002/03



Sources: Data provided by the Pakistani authorities.

1/ Last observation: projection for 2002/03.
2/ Last observation: June 2002.
3/ Last observation: December 2002.

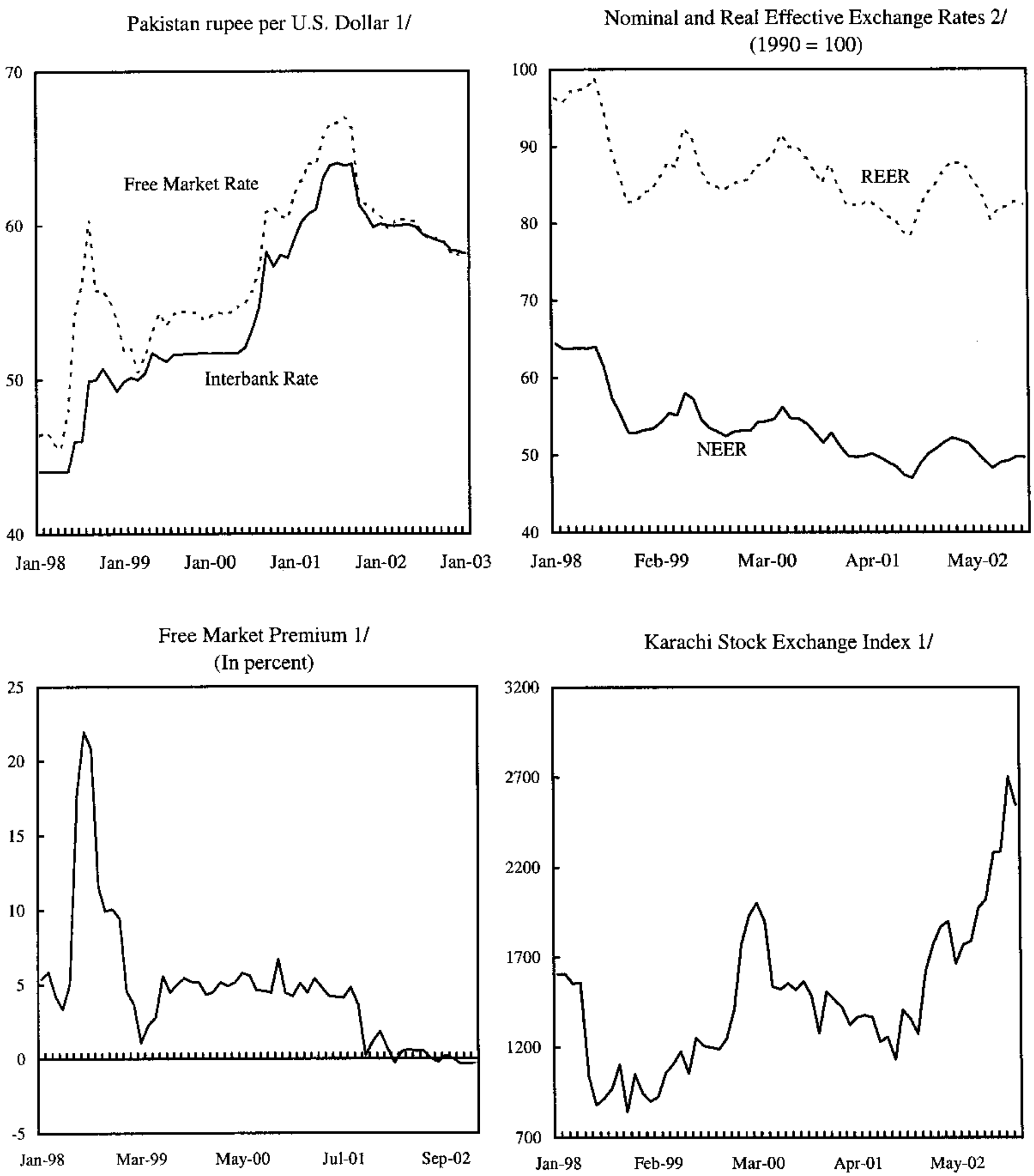
Figure 2. Pakistan: External Sector Developments, 1997/98–2002/03



Sources: Data provided by the Pakistani authorities.

1/ Customs basis, in U.S. dollar terms. Last observation: provisional figures for January 2003.
2/ Excluding official transfers. Last observation: projection for 2002/03.
3/ Excluding gold, foreign deposits held with SBP, short-term swap and forward commitments. Last observation: January 2003.

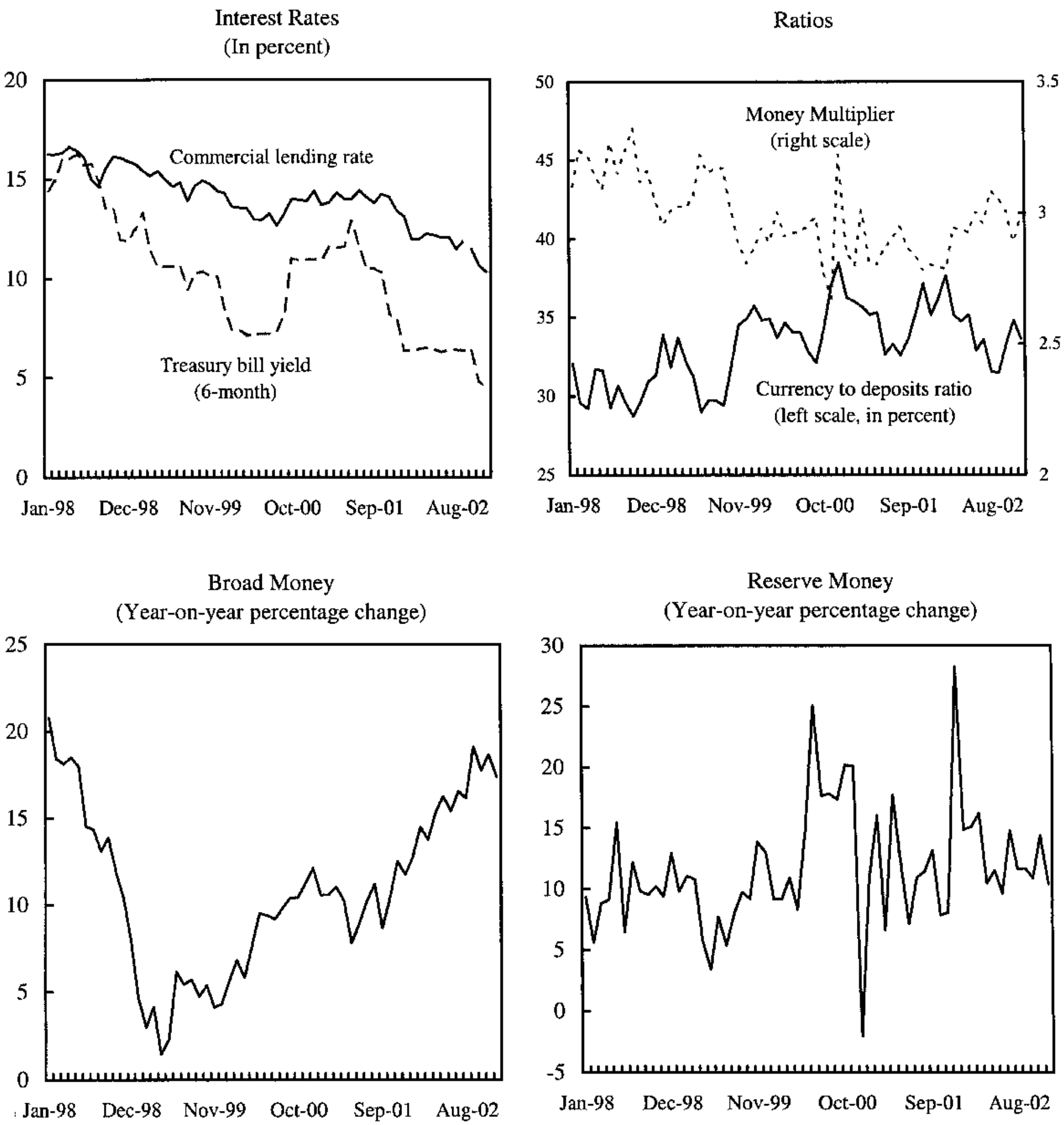
Figure 3. Pakistan: Exchange Rate and Stock Market Developments, 1998–2002



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

1/ Last observation: January 2003.
2/ Last observation: November 2002.

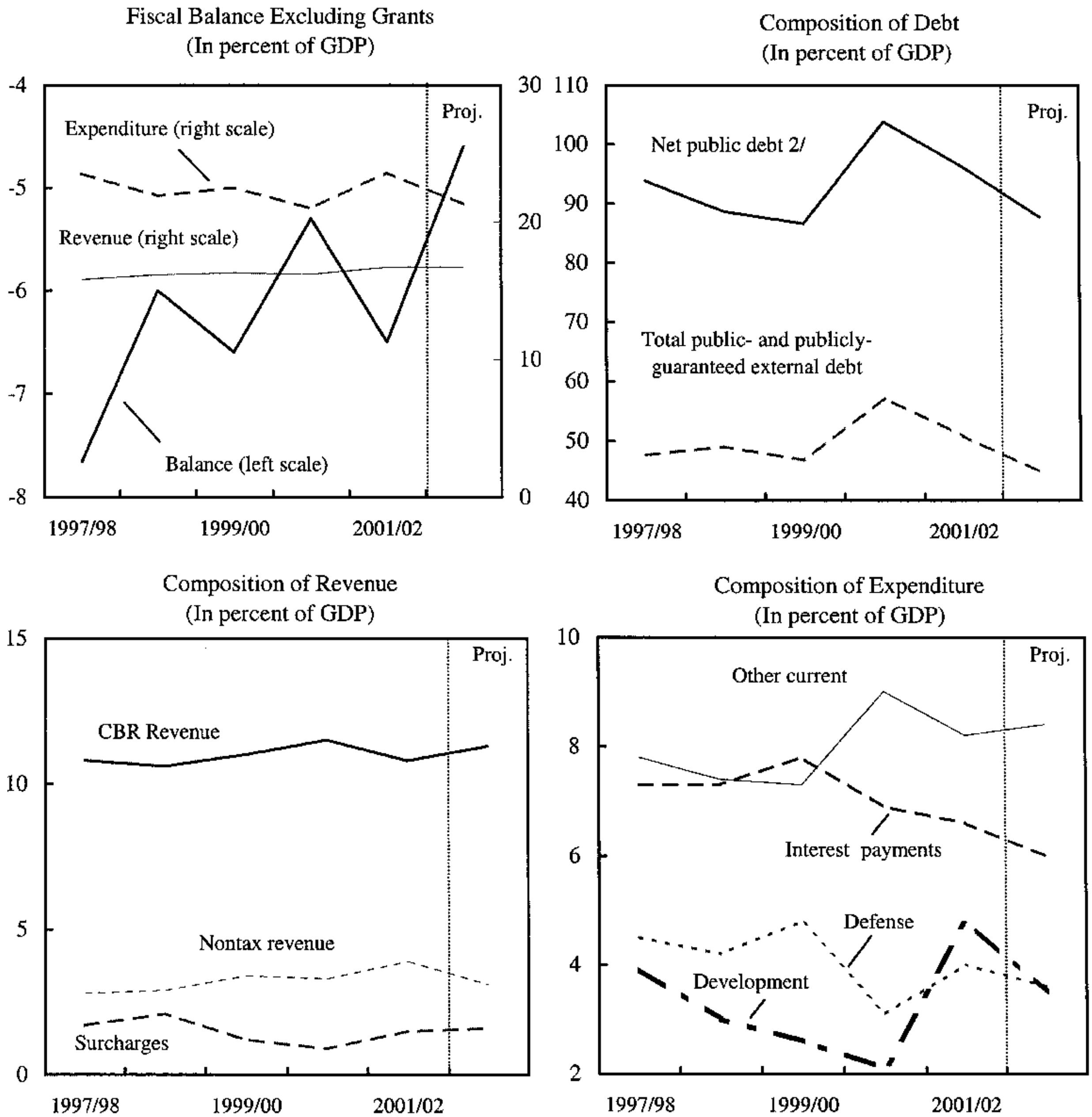
Figure 4. Pakistan: Monetary Developments, 1998–2002 1/



Source: Data provided by the Pakistani authorities.

1/ Last observation: December 2002.

Figure 5. Pakistan: Fiscal Developments, 1997/98–2002/03 1/



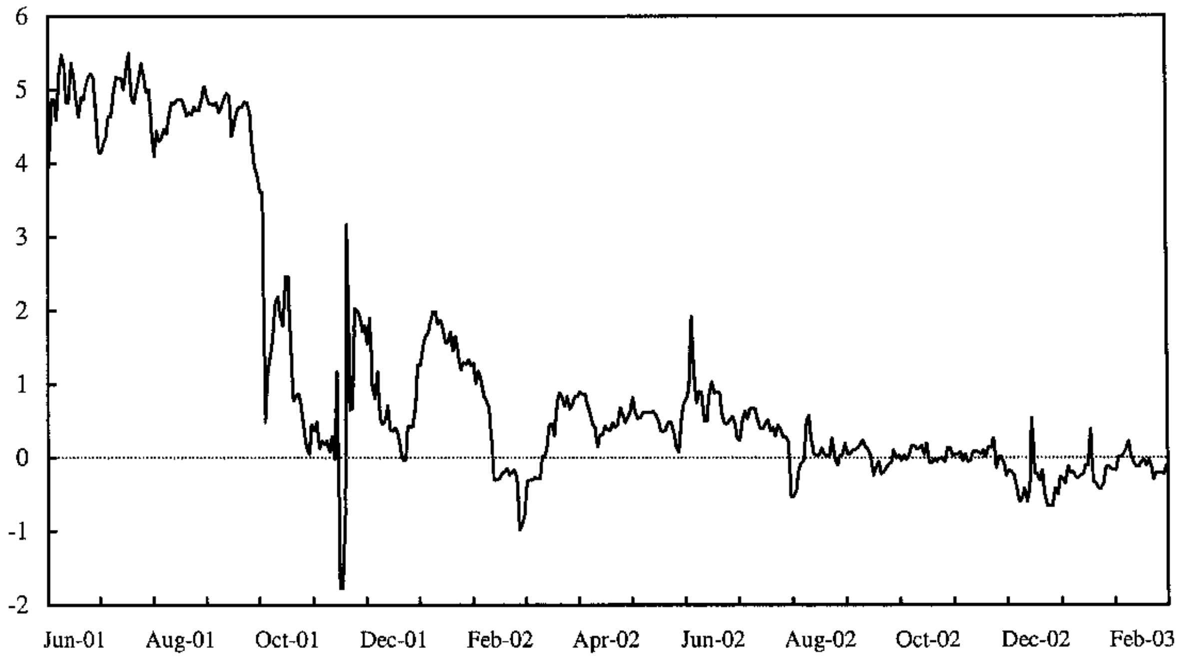
Sources: Data provided by the Pakistani authorities.

1/ Last observation: projection for 2002/03.

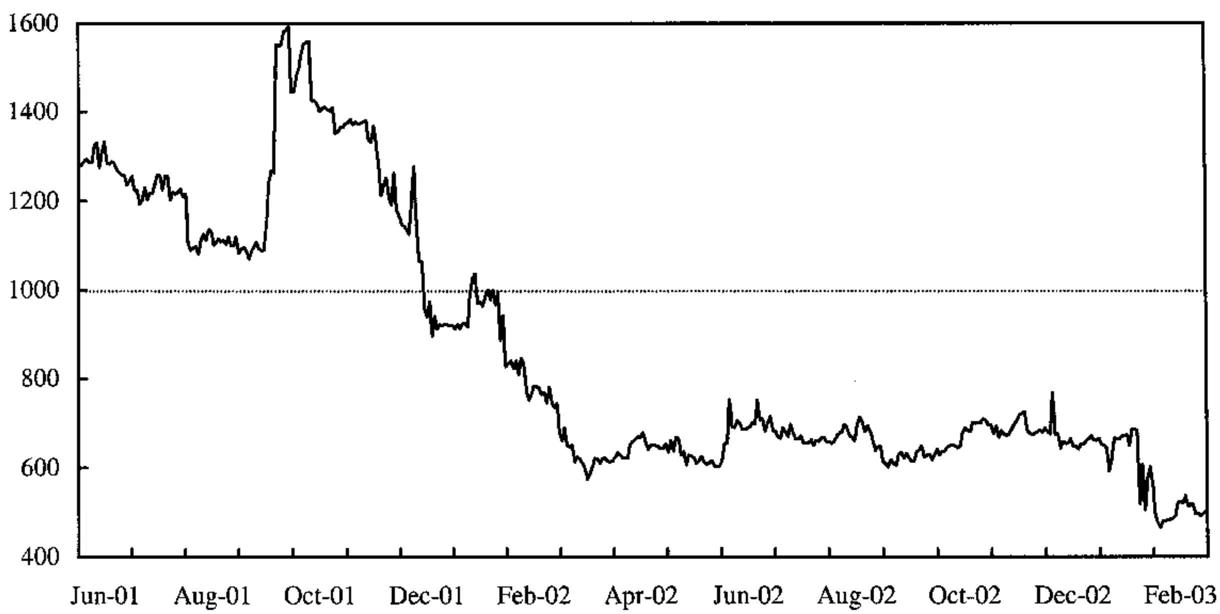
2/ Net public debt is the sum of net domestic government debt and external public- and publicly-guaranteed debt.

Figure 6. Pakistan: Recent Financial Market Developments, 2001–2002 1/

Exchange Rate Premium in Free Market Over Interbank Market
(Pakistani rupee per U.S. Dollar, in percent)



Spread Over Generic U.S. Treasury Bond 2/



Sources: Data provided by Pakistani authorities; and Datastream.

1/ First observation: June 1, 2001; last observation: February 7, 2003.
2/ Calculated for Pakistan Islamic Republic 10 percent bond maturing on December 13, 2005.

Table 1. Pakistan: Medium-Term Macroeconomic Framework, 2000/01–2003/04

	2000/01	2001/02	Prog. 1/ 2002/03	Rev. Prog. 2002/03	Proj. 2003/04
	(Annual changes in percent)				
Output and prices					
Real GDP at factor costs	2.5	3.6	4.5	4.5	5.0
Real GDP at market prices	2.7	4.4	4.9	4.9	5.1
Partner country demand (WEO definition)	3.1	1.7	2.5	2.5	3.4
Consumer prices (p.a.)	4.4	2.7	4.0	4.0	4.0
Pakistani rupees per U.S. dollar (p.a.)	12.8	5.2	...	...	...
	(In percent of GDP)				
Savings and investment					
Gross national savings	14.0	16.5	15.2	19.7	15.9
Government	-1.5	0.2	0.1	0.2	1.5
Nongovernment 2/	15.6	16.3	15.1	19.5	14.4
Gross capital formation	15.9	13.9	15.0	15.0	16.0
Government 3/	2.6	3.4	3.5	3.3	3.8
Nongovernment 2/	13.3	10.5	11.5	11.7	12.2
	(In percent of GDP)				
Public finances					
Revenue (including grants)	17.4	19.0	18.6	18.1	18.4
Expenditure 4/ 5/	21.4	23.2	21.9	21.3	20.7
Overall balance (excluding grants)	-5.3	-5.1	-4.6	-4.6	-3.5
Overall balance (including grants) 5/	-4.1	-4.2	-3.3	-3.2	-2.3
Primary balance (including grants)	2.8	3.7	2.9	2.8	3.3
Net public debt 6/	103.8	96.2	91.2	88.5	81.6
Net domestic government debt 7/	42.6	42.9	40.5	41.2	39.0
Implicit interest rate on public debt (in percent) 8/	8.6	6.9	7.0	6.8	6.9
	(Annual changes in percent of initial stock of broad money)				
Monetary sector 9/					
Net foreign assets	5.1	13.4	5.1	15.4	...
Net domestic assets	3.9	2.0	4.4	0.6	...
Of which: credit to the private sector	3.5	2.5	5.2	2.9	...
Of which: net claims on the government 5/	-3.3	1.5	-1.9	-2.5	...
Broad money	9.0	15.4	9.5	16.0	...
Six-month treasury bill rate (in percent, p.a.)	10.4	8.1	...	...	...
	(In percent of GDP)				
External sector					
Merchandise trade balance	-2.2	-0.5	-0.9	-1.2	-1.2
Merchandise exports	15.2	15.0	14.9	14.2	14.0
Merchandise imports	17.4	15.5	15.8	15.4	15.2
Current account excluding official transfers	-3.3	0.2	-1.1	3.2	-1.4
Current account including official transfers	-1.9	2.6	0.2	4.7	-0.1

Table 1. Pakistan: Medium-Term Macroeconomic Framework, 2000/01–2003/04 (concluded)

	2000/01	2001/02	Prog. 1/ 2002/03	Rev. Prog. 2002/03	Proj. 2003/04
	(In percent of exports of goods and nonfactor services)				
External public- and publicly-guaranteed debt	318.4	300.0	286.6	274.3	260.9
Debt service 10/	28.2	34.0	33.5	32.7	33.3
Implicit interest rate (in percent) 11/	4.4	3.9	3.9	3.9	4.2
Gross reserves (in millions of U.S. dollars) 12/	1,679	4,330	5,292	7,776	7,856
In months of next year imports of goods and services	1.7	4.0	4.6	6.7	6.4
In percent of short-term external debt 13/	23.7	72.1	103.4	156.7	195.3
Memorandum items:					
Real effective exchange rate (percentage change)	-2.6	-1.2	...	...	...
Terms of trade (percentage change)	-1.6	-0.7	0.9	-1.9	0.4
Real per-capita GDP (percentage change)	0.5	2.2	2.6	2.6	2.9
GDP at market prices (in billions of Pakistani rupees)	3,416	3,727	4,063	4,063	4,440

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

1/ As published in IMF Country Report No. 02/246.
2/ Includes public sector enterprises.
3/ Expenditures included in the Public Sector Development Program.
4/ Including the statistical discrepancy.
5/ Including KESC recapitalization and CBR bonds in 2001/02.
6/ Defined as the sum of net domestic government debt and external public- and publicly-guaranteed debt.
7/ Gross domestic government debt, including U.S. dollar bonds, net of government deposits with the banking system.
8/ 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.
9/ Program data for 2001/02 and revised program for 2002/03 are evaluated at program exchange rates.
10/ Including interests on short-term debt.
11/ 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.
12/ Excluding gold, foreign deposits held with the SBP, and net of outstanding short-term foreign currency swap and forward contracts.
13/ Short-term debt is defined on the basis of remaining maturity.

Table 2. Pakistan: Balance of Payments, 2001/02–2003/04

(In millions of U.S. dollars)

	2001/02	Q1 Prog. 2002/03	Q1 Prel. 2002/03	Q2 Rev. Prog. 2002/03	Q3 Rev. Prog. 2002/03	Q4 Rev. Prog. 2002/03	Prog. 2002/03	Rev. Prog. 2002/03	Proj. 2003/04
Current account (excluding official transfers)	96	99	1,018	988	489	-284	-759	2,211	-1,023
Current account balance (including official transfers)	1,591	358	1,290	1,304	722	-93	164	3,222	-77
Trade balance	-292	-101	-164	-85	-68	-534	-588	-851	-893
Exports f.o.b.	9,140	2,426	2,606	2,454	2,534	2,252	9,864	9,846	10,553
Imports f.o.b.	-9,432	-2,527	-2,770	-2,539	-2,602	-2,786	-10,452	-10,697	-11,446
Services (net)	-2,617	-655	-220	-792	-733	-796	-2,718	-2,541	-3,184
Of which: interest payments	-1,579	-343	-297	-444	-322	-428	-1,536	-1,492	-1,508
Private transfers (net)	3,005	855	1,402	1,865	1,290	1,046	2,547	5,603	3,054
Official transfers (net) 1/	1,495	259	272	316	234	190	923	1,011	947
Of which: Saudi Oil Facility	579	164	189	161	160	161	642	671	694
Of which: additional grant pledges	742	73	50	132	51	6	197	239	111
Capital account	-2,322	-564	-418	-402	-658	-341	-2,051	-1,818	-1,910
Public medium- and long-term capital	-1,613	-577	-637	-489	-185	-166	-1,429	-1,476	-1,375
Project and nonproject loans	-983	-175	-228	-167	-149	-134	-637	-677	-797
Disbursements	531	186	151	190	190	191	744	722	697
Amortization	-1,514	-361	-378	-357	-339	-325	-1,381	-1,399	-1,494
Commercial banks and IDB (net)	-224	-14	-14	-114	-15	-15	-158	-158	-33
Other	-407	-388	-395	-208	-21	-17	-634	-641	-545
Public sector short-term (net)	-1,064	46	-40	-77	20	-1	-51	-97	-523
Private medium- and long-term	-80	-77	-80	50	-56	0	32	-86	378
Of which: FDI	368	100	160	90	80	70	360	400	500
Private short-term (including errors & omissions) 2/	435	44	339	114	-437	-175	-602	-159	-390
Overall balance (before debt relief)	-731	-206	872	902	65	-434	-1,886	1,404	-1,986
Financing	731	206	-872	-902	-65	434	1,886	-1,404	1,986
Reserve assets (increase -)	-3,082	-771	-1,758	-1,717	-607	-109	-1,365	-4,191	-455
State Bank of Pakistan (including FE-25s)	-2,717	-680	-2,227	-1,796	-412	64	-1,002	-4,371	-155
Deposit money banks	-365	-91	469	79	-195	-173	-363	180	-300
Fund repurchases	-194	-84	-89	-60	-114	-136	-324	-399	-632
Net exceptional financing	4,007	1,061	975	875	656	679	3,575	3,186	3,073
Arrears (increase +)	0	0	0	0	0	0	0	0	0
Rescheduling 3/	1,210	271	270	313	246	194	1,025	1,023	1,031
Of which: Private Sector Involvement	0	0	0	100	0	0	100	100	100
Rollover of foreign deposits with banking system 4/	1,314	250	250	150	300	200	900	900	500
Program financing from IFIs	1,367	490	445	238	110	185	1,451	979	1,342
World Bank	698	200	202	0	0	0	550	202	500
AsDB	185	175	128	128	0	75	455	331	400
IMF	484	115	115	110	110	110	446	446	442
Privatization receipts	117	50	10	174	0	100	200	284	200
Financing gap	0	0	0	0	0	0	0	0	0
Memorandum items:									
Current account (excluding official transfers)	0.2	0.1	1.5	1.4	0.7	-0.4	-1.1	3.2	-1.4
Current account balance (including official transfers)	2.6	0.5	1.9	1.9	1.0	-0.1	0.2	4.6	-0.1
Exports f.o.b. (growth rate, percent)	2.3	10.1	18.3	5.9	18.6	5.4	8.0	7.7	7.2
Imports f.o.b. (growth rate, percent)	-7.5	4.8	14.8	14.7	16.5	24.8	10.1	13.4	7.0
End-period gross official reserves 5/	4,330	5,039	5,933	7,475	7,863	7,776	5,292	7,776	7,856
(In months of next year imports of goods and nonfactor services)	4.0	4.4	5.1	6.4	6.7	6.7	4.6	6.7	6.4

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 2002/03.
2/ Includes repayment of foreign currency deposits held in NBFIs and banks (reschedulings shown as exceptional financing).
3/ Includes rescheduling of bilateral debt in 1999 and 2001, and rescheduling of commercial bank credit and Eurobonds in 1999.
4/ Includes rollover of FE-45 deposits with the banking system, of Kuwait's and U.A.E.'s deposits with the SBP, and Bank of China's deposits with the NBP.
5/ Excluding gold, foreign currency deposits held with the SBP, cash reserve requirement, and net of and outstanding short-term swap and forward contracts and the sinking fund.

Table 3. Pakistan: Consolidated Government Budget, 1999/2000–2003/04

(In billions of Pakistani rupees)

	Prov. Act.		Prog.	Prov. Act.	Q1		FY		
	1999/2000	2000/01	2001/02	2001/02	Prog. 1/ 2002/03	Prel. Act. 2002/03	Prog. 1/ 2002/03	Rev. Proj. 2002/03	Proj. 2003/04
Revenue and grants	546.0	593.5	714.4	707.2	160.1	162.2	756.7	736.2	819.0
Revenue	512.6	553.0	625.4	624.1	144.7	147.9	702.1	678.7	765.3
Tax revenue	405.6	441.5	486.0	478.1	111.4	112.7	546.6	551.6	618.9
Federal	386.8	422.5	464.6	459.3	105.2	106.8	523.5	528.5	592.6
CBR revenue	346.6	392.1	414.3	403.9	90.0	90.4	458.9	458.9	518.4
Direct tax	112.6	124.6	146.5	142.6	29.0	23.6	148.4	148.4	162.2
Federal excise duty	55.6	49.0	47.1	46.9	9.3	9.6	47.5	47.5	51.9
Sales tax	116.7	153.5	170.1	166.3	40.2	43.8	204.0	204.0	239.8
Customs duties	61.6	65.0	50.5	48.1	11.5	13.4	59.0	59.0	64.5
Petroleum surcharge	25.4	17.9	34.0	36.6	11.6	10.8	48.0	48.0	53.4
Gas surcharge	13.5	12.3	15.0	17.7	3.2	5.2	15.0	18.0	16.8
Other	1.4	0.2	1.3	1.1	0.5	0.4	1.7	3.7	4.1
Provincial	18.8	19.0	21.4	18.8	6.2	6.0	23.1	23.1	26.3
Nontax revenue	106.9	111.4	139.4	146.0	33.4	35.2	155.5	127.1	146.4
Federal	90.8	91.5	117.3	124.7	30.2	31.4	132.7	104.3	122.8
Provincial	16.1	19.9	22.1	21.3	3.2	3.8	22.7	22.7	23.6
Grants	33.4	40.5	89.0	83.1	15.3	14.3	54.6	57.5	53.8
Expenditure	709.1	717.9	837.6	826.2	209.1	193.8	891.3	865.0	920.2
Current expenditure	626.4	645.7	705.5	700.2	188.1	164.2	751.3	728.0	753.3
Federal	477.9	479.0	535.4	524.6	142.4	118.7	561.2	542.9	...
Interest payments	245.1	234.5	257.0	245.3	59.1	50.7	252.1	242.3	...
Domestic	198.4	183.5	195.4	184.6	47.6	41.0	191.7	185.9	...
Foreign 2/	46.7	51.0	61.6	60.6	11.5	9.7	60.5	56.4	...
Defense	150.4	104.7	149.6	149.0	39.4	32.6	146.0	146.0	...
Running of the civil government	47.5	70.7	52.0	56.3	14.5	11.3	57.9	52.9	...
Pensions for defense and civil government	...	30.9	33.6	27.2	8.7	5.9	34.8	34.8	...
Subsidies 3/	14.7	19.9	15.7	23.7	14.2	13.7	40.4	41.0	...
Grants	12.6	18.1	19.6	22.8	5.8	4.3	27.5	25.5	...
Other	7.5	0.3	7.9	0.3	0.6	0.1	2.5	0.5	...
Provincial	148.5	166.7	170.1	175.6	45.7	45.4	190.1	185.1	...
Development expenditure and net lending	82.7	72.2	132.1	125.9	21.0	29.6	140.0	141.0	166.9
Public Sector Development Program	95.6	89.8	127.0	126.2	22.0	24.5	144.0	134.0	166.9
Federal	59.3	66.9	97.0	98.4	14.0	14.6	96.0	90.0	...
Provincial	36.3	22.9	30.0	27.8	8.0	9.9	48.0	44.0	...
Net lending	-12.9	-17.6	5.1	-0.2	-1.0	5.1	-4.0	7.0	0.0
Unallocated exchange rate savings	...	...	...	...	...	...	...	-4.0	...
Statistical discrepancy ("+" = additional expenditure)	9.7	14.8	...	-13.0	...	-1.4	...	...	...
Federal government	7.0	29.8	...	13.9	...	2.3	...	...	...
Provinces	2.7	-15.0	...	-26.9	...	-3.7	...	...	...
Budget balance (excluding grants) 3/	-206.3	-179.7	-212.3	-189.1	-64.3	-44.4	-189.2	-186.3	-155.0
Budget balance (including grants)	-172.9	-139.2	-123.3	-105.9	-49.0	-30.1	-134.6	-128.8	-101.2
KESC recapitalization and CBR bonds 4/	...	...	...	52.0	...	...	...	...	...
Augmented budget balance (including grants)	...	...	...	-157.9	...	...	...	...	...
Financing	172.9	139.2	123.2	157.9	49.0	30.1	134.6	128.8	101.2
External (incl. privatization receipts)	36.3	80.2	59.0	51.7	33.5	24.6	73.8	39.8	34.7
Domestic	136.5	59.0	57.7	97.9	11.5	4.7	48.8	77.0	56.5
Bank	39.9	-33.0	-6.9	12.9	-4.4	-12.7	-29.2	-29.2	-14.0
Nonbank	96.6	92.0	64.6	85.0	15.9	17.4	78.0	106.2	70.5
Privatization proceeds	0.0	0.0	6.5	8.4	4.0	0.8	12.0	12.0	10.0
Memorandum items:									
Adjusted revised cumulative program deficit ceiling	...	...	...	...	-64.4	-64.4	-189.4	-186.4	-8
Revised cumulative program deficit ceiling					-56.4	-56.4	-178.4	-178.4	0
Cumulative program deficit ceiling	...	...	-212.3	-212.3	-56.4	-56.4	-178.4	-178.4	-178.4
Expenditure incl. statistical discrepancy and one-off	718.8	732.7	837.6	865.1	209.1	192.4	891.3	865.0	920.2
Primary balance (including grants)	72.2	95.3	133.7	139.3	10.1	20.6	117.5	113.5	...
Social and poverty-related expenditure	114.4	122.3	136.4	133.5	...	27.7	161.0	161.0	185.1
Nominal GDP at market prices	3,147.2	3,416.3	3,695.0	3,726.6	1,015.8	1,015.8	4,063.0	4,063.0	4,440.3

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

1/ Program as agreed during the third review (IMF Country Report No. 02/246)

2/ Accrued payments. Excludes interest expenditure on military debt which is included in the defense allocation.

3/ In 2002/03, subsidies projections include arrears settlement on behalf of KESC amounting to PRs 11 billion in the initial program and PRs 8 billion in the revised projections.

4/ KESC recapitalization in 2001/02 was PRs 32 billion. Bonds for PRs 20 billion were issued for the settlement of excess taxes paid by banks to the CBR on unrealized profits through 2000.

Table 4. Pakistan: Consolidated Government Budget, 1999/2000–2003/04

(In percent of GDP; unless otherwise indicated)

	Prov. Act.		Prog.	Prov. Act.	Q1		FY		Proj.
					Prog. 1/	Prel. Act.	Prog. 1/	Rev. Proj.	
	1999/2000	2000/01	2001/02	2001/02	2002/03	2002/03	2002/03	2002/03	2003/04
Revenue and grants	17.3	17.4	19.3	19.0	15.8	16.0	18.6	18.1	18.4
Revenue	16.3	16.2	16.9	16.7	14.2	14.6	17.3	16.7	17.2
Tax revenue	12.9	12.9	13.2	12.8	11.0	11.1	13.5	13.6	13.9
Federal	12.3	12.4	12.6	12.3	10.4	10.5	12.9	13.0	13.3
CBR revenue	11.0	11.5	11.2	10.8	8.9	8.9	11.3	11.3	11.7
Direct tax	3.6	3.6	4.0	3.8	2.9	2.3	3.7	3.7	3.7
Federal excise duty	1.8	1.4	1.3	1.3	0.9	0.9	1.2	1.2	1.2
Sales tax	3.7	4.5	4.6	4.5	4.0	4.3	5.0	5.0	5.4
Customs duties	2.0	1.9	1.4	1.3	1.1	1.3	1.5	1.5	1.5
Petroleum surcharge	0.8	0.5	0.9	1.0	1.1	1.1	1.2	1.2	1.2
Gas surcharge	0.4	0.4	0.4	0.5	0.3	0.5	0.4	0.4	0.4
Other	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.1
Provincial	0.6	0.6	0.6	0.5	0.6	0.6	0.6	0.6	0.6
Nontax revenue	3.4	3.3	3.8	3.9	3.3	3.5	3.8	3.1	3.3
Federal	2.9	2.7	3.2	3.3	3.0	3.1	3.3	2.6	2.8
Provincial	0.5	0.6	0.6	0.6	0.3	0.4	0.6	0.6	0.5
Grants	1.1	1.2	2.4	2.2	1.5	1.4	1.3	1.4	1.2
Expenditure	22.5	21.0	22.7	22.2	20.6	19.1	21.9	21.3	20.7
Current expenditure	19.9	18.9	19.1	18.8	18.5	16.2	18.5	17.9	17.0
Federal	15.2	14.0	14.5	14.1	14.0	11.7	13.8	13.4	...
Interest payments	7.8	6.9	7.0	6.6	5.8	5.0	6.2	6.0	...
Domestic	6.3	5.4	5.3	5.0	4.7	4.0	4.7	4.6	...
Foreign 2/	1.5	1.5	1.7	1.6	1.1	1.0	1.5	1.4	...
Defense	4.8	3.1	4.0	4.0	3.9	3.2	3.6	3.6	...
Running of the civil government	1.5	2.1	1.4	1.5	1.4	1.1	1.4	1.3	...
Pensions for defense and civil government	...	0.9	0.9	0.7	0.9	0.6	0.9	0.9	...
Subsidies 3/	0.5	0.6	0.4	0.6	1.4	1.4	1.0	1.0	...
Grants	0.4	0.5	0.5	0.6	0.6	0.4	0.7	0.6	...
Other	0.2	0.0	0.2	0.0	0.1	0.0	0.1	0.0	...
Provincial	4.7	4.9	4.6	4.7	4.5	4.5	4.7	4.6	...
Development expenditure and net lending	2.6	2.1	3.6	3.4	2.1	2.9	3.4	3.5	3.8
Public Sector Development Program	3.0	2.6	3.4	3.4	2.2	2.4	3.5	3.3	3.8
Federal	1.9	2.0	2.6	2.6	1.4	1.4	2.4	2.2	...
Provincial	1.2	0.7	0.8	0.7	0.8	1.0	1.2	1.1	...
Net lending	-0.4	-0.5	0.1	0.0	-0.1	0.5	-0.1	0.2	0.0
Unallocated exchange rate savings	...	...	...	...	...	...	...	-0.1	...
Statistical discrepancy ("+" = additional expenditure)	0.3	0.4	...	-0.4	...	-0.1	...	...	...
Federal government	0.2	0.9	...	0.4	...	0.2	...	...	...
Provinces	0.1	-0.4	...	-0.7	...	-0.4	...	...	...
Budget balance (excluding grants) 3/	-6.6	-5.3	-5.7	-5.1	-6.3	-4.4	-4.7	-4.6	-3.5
Budget balance (including grants)	-5.5	-4.1	-3.3	-2.8	-4.8	-3.0	-3.3	-3.2	-2.3
KESC recapitalization and CBR bonds 4/	...	...	...	1.4	...	...	...	...	...
Augmented budget balance (including grants)	...	...	...	-4.2	...	...	...	...	...
Financing	5.5	4.1	3.3	4.2	4.8	3.0	3.3	3.2	2.3
External	1.2	2.3	1.6	1.4	3.3	2.4	1.8	1.0	0.8
Domestic	4.3	1.7	1.6	2.6	1.1	0.5	1.2	1.9	1.3
Bank	1.3	-1.0	-0.2	0.3	-0.4	-1.3	-0.7	-0.7	-0.3
Nonbank	3.1	2.7	1.7	2.3	1.6	1.7	1.9	2.6	1.6
Memorandum items:									
Expenditure incl. statistical discrepancy and one-off	22.8	21.4	22.7	23.2	20.6	18.9	21.9	21.3	20.7
Primary balance (including grants)	2.3	2.8	3.6	3.7	1.0	2.0	2.9	2.8	...
Social and poverty-related expenditure	3.6	3.6	3.7	3.6	...	2.7	4.0	4.0	4.2
Total Government debt	93.3	109.2	...	98.3			93.2	90.0	84.8
Domestic debt	46.4	52.0	...	47.4			44.7	45.1	42.5
External debt	46.8	57.2	...	50.8			48.5	44.9	42.3
Nominal GDP (market prices, billions of Pakistani rupees)	3,147	3,416	3,695	3,727	1,016	1,016	4,063	4,063	4,440

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

1/ Program as agreed during the third review (IMF Country Report No. 02/246)

2/ Accrued payments. Excludes interest expenditure on military debt which is included in the defense allocation.

3/ In 2002/03, subsidies projections include arrears settlement on behalf of KESC amounting to PRs 11 billion in the initial program and PRs 8 billion in the revised projections.

4/ KESC recapitalization in 2001/02 was PRs 32 billion. Bonds for PRs 20 billion were issued for the settlement of excess taxes paid by banks to the CBR on unrealized profits through 2000.

Table 5. Pakistan: Monetary Survey, 1999/2000–2002/03

	Act.			Monetary Program 2002/03 1/				
				Sep.		Dec.	Mar.	Jun.
	1999/2000	2000/01	2001/02	Prog. 2/ 2002	Act. 2002	Rev. Prog. 3/ 2002	Rev. Prog. 3/ 2003	Prog. 2003
	(End-of-period stocks; in billions of Pakistani rupees)							
Net foreign assets	-45	26	231	277	348	454	498	508
Net domestic assets	1,446	1,500	1,531	1,515	1,463	1,509	1,479	1,533
Net claims on government	616	570	592	586	576	553	524	548
Of which:								
Net bank borrowing	532	500	514	510	501	498	476	485
Commodity operations	107	95	101	99	96	79	71	85
Net claims on nongovernment	843	902	922	916	886	963	962	992
Private sector	753	802	840	825	809	886	874	890
Public sector	90	100	82	90	77	77	88	102
Privatization account	-3	-3	-3	-3	-3	-3	-3	-3
Other items, net	-10	31	20	16	4	-4	-4	-4
Total liquidity (broad money)	1,401	1,526	1,761	1,791	1,811	1,963	1,977	2,041
Of which:								
Pakistani rupee liquidity	1,288	1,372	1,604	1,632	1,646	1,796	1,804	1,862
	(Changes in percent of stock of broad money at the beginning of the fiscal year)							
Net foreign assets	2.0	5.1	13.4	2.5	6.3	12.3	14.9	15.4
Net domestic assets	7.4	3.9	2.0	-0.7	-3.4	-0.7	-2.5	0.6
Of which:								
Net claims on the government	5.0	-3.3	1.5	-0.3	-0.9	-2.2	-3.9	-2.5
Net claims on private sector	1.4	3.5	2.5	-0.7	-1.7	2.6	1.9	2.9
	(Changes over 12 months; in percent)							
Broad money	9.4	9.0	15.4	18.0	19.3	19.0	18.5	16.0
Net claims on private sector	2.5	6.5	4.7	5.8	3.7	4.0	4.2	6.0
Memorandum item:								
Indicative program exchange rate	...	...	...	60.07	60.07	60.07	60.07	60.07

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

1/ At indicative program exchange rate.
2/ Stocks as reported in IMF Country Report No. 02/246.
3/ Revised projection based on: (a) program flows set during the second and third reviews for variables subject to performance criteria; and (b) revised assumptions.

Table 6. Pakistan: Accounts of the State Bank of Pakistan, 1999/2000–2002/03

	Act.			Monetary Program 2002/03 1/				
				Sep.		Dec.	Mar.	Jun.
	1999/2000	2000/01	2001/02	Prog. 2/ 2002	Act. 2002	Rev. Prog. 3/ 2002	Rev. Prog. 3/ 2003	Prog. 2003
	(End-of-period stocks; in billions of Pakistani rupees)							
Net foreign assets	-55.6	-19.1	133.5	178.5	271.7	376.6	401.6	399.3
Net domestic assets	553.4	552.3	451.1	421.8	321.0	264.8	245.7	264.2
Net claims on government	369.0	335.6	226.2	201.4	99.6	43.2	24.2	42.7
Of which:								
Budgetary support	392.7	361.1	249.2	224.0	121.1	66.7	46.7	64.3
Claims on nongovernment	51.2	40.1	22.7	22.7	17.4	17.6	17.6	17.6
Claims on scheduled banks	193.4	198.0	195.8	201.4	175.8	163.8	163.8	163.8
Privatization account	-2.9	-2.9	-2.9	-2.9	-2.9	-2.9	-2.9	-2.9
Other items, net	-57.3	-18.4	9.4	-0.8	31.1	43.1	43.1	43.1
Reserve money 4/	497.8	533.2	584.6	600.3	592.7	641.4	647.3	663.5
Of which:								
Banks' reserves	114.7	127.3	110.5	119.0	127.3	121.7	123.5	128.1
Currency	375.1	394.6	460.2	468.7	454.3	508.6	512.7	524.3
	(Changes in percent of stock of reserve money at the beginning of the fiscal year)							
Net foreign assets	-3.3	7.3	28.6	6.7	22.6	40.6	44.8	44.4
Net domestic assets	28.4	-0.2	-19.0	-3.8	-21.3	-30.9	-34.1	-31.0
Of which:								
Budgetary support	28.4	-6.3	-21.0	-4.2	-21.6	-31.3	-34.5	-31.4
	(Changes over 12 months; in percent)							
Reserve money 5/	25.1	3.3	9.6	12.9	11.5	8.7	13.9	13.5
Currency	22.4	5.2	16.6	17.4	13.8	12.6	12.5	13.4
Memorandum item:								
Indicative program exchange rate	...	...	...	60.07	60.07	60.07	60.07	60.07

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

1/ At indicative program exchange rates.
2/ Stocks as reported in IMF Country Report No. 02/246.
3/ Revised projection based on: (a) program flows set during the second review for variables subject to performance criteria; and (b) revised assumptions.
4/ Starting in April 2000/01, reserve money includes special reserves on foreign currency deposits.
5/ 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 7. Pakistan: Gross Financing Requirements, 2001/02–2003/04

(In millions of U.S. dollars)

	2001/02	Rev. Prog. 2002/03	Proj 2003/04
Gross financing requirements	-7,889	-5,225	-5,120
External current account deficit	1,591	3,222	-77
Debt amortization	-6,204	-3,857	-3,957
Medium- and long-term debt	-2,657	-2,798	-2,482
Public sector	-2,261	-2,222	-2,082
Multilateral (excluding IMF)	-604	-612	-673
Bilateral	-817	-658	-581
Bonds (net)	-35	-195	-183
Other (including SBP liabilities)	-805	-757	-645
Private sector	-396	-576	-400
Short-term debt	-3,547	-1,059	-1,475
Public sector	-2,188	-932	-1,423
Private sector	-1,359	-127	-52
Repayment of arrears	0	0	0
Gross reserves accumulation	-3,082	-4,191	-455
Of which: official reserves	-2,717	-4,371	-155
IMF repurchases and repayments	-194	-399	-632
Available financing	7,889	5,225	5,120
FDI and portfolio investment (net, excluding public securities) 1/	475	682	800
Debt financing from private creditors	2,988	1,562	1,250
Medium- and long-term financing	487	202	188
To private sector	185	202	188
To public sector	302	0	0
Short-term financing	2,501	1,360	1,062
To public sector	1,378	1,236	900
To private sector	1,123	124	162
Official creditors	2,623	2,178	2,528
Project lending	531	722	697
Balance of payments support	2,092	1,456	1,831
AsDB and World Bank	883	533	900
Debt relief from bilateral creditors 2/	1,210	923	931
Private sector involvement	0	100	100
IMF	484	446	442
Other net capital flows 3/	1,319	258	0
Financing gap	0	0	0

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

1/ Includes privatization receipts.
2/ Debt relief agreed in January 2001 and in December 2001.
3/ For 2001/02, includes SBP purchases in the kerb market.

Table 8. Pakistan: Summary of Public External Debt and Debt Service, 1999/2000–2003/04

	1999/2000	2000/01	2001/02	Proj. 2002/03	Proj. 2003/04
	(In millions of U.S. dollars)				
Total public- and publicly-guaranteed external debt	29,757	32,743	33,167	32,661	31,676
Medium- and long-term debt	26,009	28,165	29,433	29,036	29,023
Project and nonproject aid	24,792	26,647	28,199	28,055	28,158
Commercial banks and IDB	560	634	383	325	392
Other (including securities and frozen foreign currency accounts)	657	885	851	656	473
Short-term debt (by initial maturity)	2,253	3,075	1,795	1,640	857
Commercial banks and IDB	671	834	212	303	298
FEBCs and DBCs	147	72	53	37	19
SBP liabilities (including swaps)	1,435	2,169	1,530	1,300	540
Fund credit and loans	1,496	1,503	1,939	1,986	1,796
Service of medium- and long-term public- and publicly-guaranteed debt	4,175	2,616	3,556	3,763	3,929
Amortization	3,113	1,540	2,455	2,621	2,713
Interest	1,062	1,076	1,101	1,143	1,215
Interest on public- and publicly-guaranteed short-term debt	319	284	198	129	121
	(In percent of GDP)				
Total public- and publicly-guaranteed external debt	54.6	55.8	54.5	47.0	42.0
Long-term	47.8	48.0	48.4	41.8	38.5
Of which: project and nonproject aid	45.5	45.4	46.4	40.4	37.4
Short-term	4.1	5.2	3.0	2.4	1.1
Fund credit and loans	2.7	2.6	3.2	2.9	2.4
Service of medium- and long-term public- and publicly-guaranteed debt	7.7	4.5	5.8	5.4	5.2
Amortization	5.7	2.6	4.0	3.8	3.6
Interest	1.9	1.8	1.8	1.6	1.6
Interest on public- and publicly-guaranteed short-term debt	0.6	0.5	0.3	0.2	0.2
	(In percent of exports of goods and nonfactor services)				
Total public- and publicly-guaranteed external debt	310.7	318.4	300.0	274.3	260.9
Service of medium- and long-term public- and publicly-guaranteed debt	43.6	25.4	32.2	31.6	32.4
Amortization	32.5	15.0	22.2	22.0	22.3
Interest	11.1	10.5	10.0	9.6	10.0
Memorandum items:					
Implicit interest on public- and publicly-guaranteed external debt	4.7	4.4	3.9	3.9	4.2
Public debt service in percent of government revenue (incl. grants)	44.2	25.7	31.1	29.1	28.2
Total external debt	34,047	36,140	36,007	35,700	34,577
(In percent of GDP)	62.5	61.6	59.2	51.4	45.9

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

Table 9. Pakistan: Indicators of External Vulnerability, 1998/99–2002/03

	1998/99	1999/2000	2000/01	2001/02	Latest available observation	2002/03
Financial indicators						
Net public debt (in percent of GDP)	93.6	91.6	100.9	95.5	...	...
Broad money (12-month percentage change)	6.2	9.4	9.0	15.4	18.7 2/	16.0
Private sector credit (12-month percentage change)	8.5	2.5	6.5	4.7	7.8 2/	6.0
180-day treasury bill yield (in percent)	12.9	8.8	10.4	8.1	4.4 3/	...
180-day treasury bill yield, real (in percent)	7.4	5.1	6.0	5.4	0.9 3/	...
Karachi Stock Exchange index, end-of-period	1,055	1,521	1,366	1,770	2,545 4/	
External Indicators						
Exports (12-month percentage change, in U.S. dollars)	-10.7	8.8	9.1	2.3	6.0 5/	7.7
Imports (12-month percentage change, in U.S. dollars)	-6.7	-0.1	6.2	-7.5	-1.2 5/	13.4
Terms of trade (12-month percentage change)	4.1	-9.2	-1.6	-0.7	...	-1.9
Current account balance (excluding official transfers in percent of GDP)	-4.7	-3.9	-3.3	0.2	...	3.2
Gross Official Reserves (in millions of U.S. dollars)	1,680	908	1,679	4,330	8,177 4/	7,776
In weeks of imports of goods and nonfactor services	1.7	0.9	1.7	4.0	...	6.7
In percent of broad money	6.6	3.3	7.0	14.8	...	24.3
In percent of total short-term debt at remaining maturity	22.1	10.9	23.7	72.1	...	156.7
Total external debt (in millions of U.S. dollars)	34,046	34,047	36,140	36,007	...	35,700
In percent of exports of goods and nonfactor services	385.1	355.5	351.4	325.7	...	299.8
Actual debt service (in percent of exports of goods and services) 1/	76.7	80.1	60.4	60.7	...	40.1
Exchange rate (Pakistani rupees per U.S. dollar, period average)	50.1	51.6	58.3	61.3	58.1 4/	...
Real exchange rate (12-month percentage change)	-9.1	-0.6	-2.6	-1.2	-1.7 2/	...

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

1/ Scheduled debt service on total debt minus rescheduled debt service plus debt service on previously rescheduled debt.
2/ November 2002.
3/ December 2002.
4/ January 31, 2003.
5/ Third quarter of calendar year 2002.

Table 10. Pakistan: Indicators of Fund Credit, 2000/01–2007/08 1/

			Proj.					
	2000/0	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08
Outstanding Fund credit								
In millions of SDRs	1,207	1,524	1,442	1,304	1,201	1,103	1,022	914
In millions of U.S. dollars	1,503	1,939	1,986	1,796	1,654	1,519	1,408	1,259
In percent of:								
Quota	116.7	147.5	139.5	126.1	116.2	106.7	98.9	88.4
GDP	2.6	3.2	2.9	2.4	2.1	1.8	1.5	1.4
Exports of goods and nonfactor services	14.6	17.5	16.7	14.8	12.9	11.0	9.6	8.1
Public- and publicly-guaranteed debt	4.6	5.8	6.1	5.7	5.3	5.0	4.8	4.3
Debt service to the Fund								
In millions of SDRs	228	194	322	503	297	113	90	117
In millions of U.S. dollars	294	247	444	694	408	156	124	162
In percent of:								
Exports of goods and nonfactor services	2.9	2.2	3.7	5.7	3.2	1.1	0.8	1.0
Gross official reserves	17.5	5.7	5.7	8.8	5.0	1.8	1.3	1.6

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

1/ Assuming PRGF disbursements as scheduled and debt service according to the expectations schedule.

Table 11. Pakistan: Social Indicators, 1970–2004

	Latest single year				I-PRSP Target	South Asia	Lower-income (world-wide)
						Latest single year (1990–2001)	
	1970–75	1980–85	1993–99	2000–01	2003/04		
Population							
Total population, mid-year (in millions)	71.0	94.8	134.8	141.5	...	1,379.5	2,511.4
Growth rate (percent annual average)	3.2	2.7	2.4	2.4	1.8	1.8	1.8
Urban population (percent of population)	26.4	29.8	44.8	47.5	...	27.8	31.0
Total fertility rate (births per woman)	7.0	6.5	4.8	4.7	4.1	3.3	3.6
Unemployment (as percentage of total labor force)	...	3.7	5.9	5.9	...	...	...
Income							
GNI per capita (U.S. dollars) 1/	150.0	330.0	450.0	420.0	...	450.0	430.0
Consumer price index (percentage change)	20.9	5.6	4.1	3.1	5.0	4.4	2.1
Food price index (percentage change)	...	4.4	3.9	1.7	5.0	...	...
Social indicators							
Public expenditure							
Health (percent of GDP)	...	...	0.5	0.5	0.5	0.9	1.2
Education (percent of GNP)	2.2	2.9	1.6	1.8	1.8	3.1	3.3
Education 2/							
Gross primary school enrollment rate (in percent of age group)							
Total	39.5	43.7	73.5	...	100.0	101.4	95.8
Male	52.7	55.7	100.6	...	119.0	109.4	103.4
Female	25.5	30.4	45.4	...	76.0	92.9	87.9
Gross secondary school enrollment rate (in percent of age group)	14.7	17.2	25.6	...	68.0	48.1	42.3
Illiteracy rate (as percentage of population aged 15 and above)	75.8	68.2	57.6	56.8	41.0	45.2	37.6
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 of children 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	61.7	63.0	64.4	62.4	58.9
Male	52.1	56.9	60.8	61.9	...	61.7	57.9
Female	52.5	58.0	62.6	64.1	...	63.0	60.0
Mortality							
Children under 5 years (per thousand live births)	183.0	157.0	118.0	110.3	65.0	96.5	114.9
Adult (15–59 years)							
Male (per 1,000 population)	339.5	282.5	190.0	194.0	...	227.3	294.0
Female (per 1,000 population)	381.1	290.9	158.0	164.0	...	212.2	260.9

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

1/ Gross national income divided by midyear population. The impact of exchange rate fluctuations in the cross-country comparison of national income is reduced notably by using three-year averages for exchange rates (World Bank's Atlas conversion factor).

2/ 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 December 31, 2002

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

II. **General Resources Account:**	SDR Million	%Quota
Quota	1,033.70	100.00
Fund Holdings of Currency	1,859.22	179.86
Reserve position in Fund	0.12	0.01

III. **SDR Department:**	SDR Million	%Allocation
Net cumulative allocation	169.99	100.00
Holdings	1.57	0.92

IV. **Outstanding Purchases and Loans:**	SDR Million	%Quota
Stand-by arrangements	465.00	44.98
Extended arrangements	140.20	13.56
Contingency and Compensatory	220.44	21.33
ESAF/PRGF arrangements	668.72	64.69

V. **Latest Financial Arrangements:**

Type	Approval Date	Expiration Date	Approved Amount (SDR Million)	Amount Drawn (SDR Million)
PRGF	12/06/2001	12/05/2004	1,033.70	344.58
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 Expectations Assumptions** (SDR Million; based on existing use of resources and present holdings of SDRs):

	Overdue 12/31/02	2003	Forthcoming 2004	2005	2006	2007
Principal	0.0	420.3	383.0	163.9	72.0	97.9
Charges/Interest	0.0	24.6	15.2	8.8	6.7	5.9
Total	0.0	444.9	398.2	172.7	78.7	103.8

Repurchase Obligations: Repurchases in the credit tranches including the Compensatory Financing Facility, are to be completed in 3¼–5 years. Repurchases under the Extended Fund Facility are due in 4½–10 years.

A. Nonfinancial Relations

VII. Exchange System

Prior to mid-1998, Pakistan implemented a fixed exchange rate system with periodic step devaluation to compensate for the inflation differential with major trading partners. On July 21, 1998, a dual exchange system was introduced consisting of a fixed official exchange rate at PRs 46 per $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 Pakistani 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 December 13, 2002, the FIBR was PRs 58.40 per $1. Pakistan's exchange regime is classified as managed floating with no predetermined path for the exchange rate.

VIII. Last Article IV Consultation

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

IX. Safeguards Assessments

A Stage One Safeguards Assessment of the State Bank of Pakistan (SBP) was completed on October 26, 2000. The assessment concluded that high risks may exist in the area of external audit mechanism, financial reporting, and internal control, and recommended a Stage Two (on-site) assessment. The Stage Two (on-site) assessment was completed on February 13, 2001 and staff's findings and recommendations were reported to Fund management (IMF Country Report No. 01/58, Appendix IV) and to the authorities. A monitoring exercise related to safeguards developments at the SBP has been undertaken. All the recommended remedial actions arising from the initial safeguards assessment have been implemented and no new critical vulnerabilities have been identified. The Stage Two recommendations included in the Stand-By Arrangement conditionality remain applicable to Pakistan's PRGF arrangement, which was approved on December 6, 2001 and is scheduled to expire on December 5, 2004.

X. ROSCs

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

XI. Recent Technical Assistance

a. FAD: In 1997-1999, missions reviewed the public expenditure management system, the operation of the GST, and recommended measures to improve tax administration and increase tax compliance. In April 1999, a mission reviewed the income tax system and developed a strategy to improve its efficiency, potential for long-term development and ease of administration. A mission in January–February 2000 assisted with the revision of fiscal data and advised on measures to strengthen the fiscal reporting and accounting systems. In May 2000, a mission assisted with the preparation of the fiscal module of the Report on the Observance of Standards and Codes (ROSC). In August 2000, a joint FAD-STA mission reviewed progress in the strengthening of the fiscal reporting and accounting systems and assisted authorities in the preparation of revised fiscal data for 1993/94–1998/99. In September 2000, a mission provided technical assistance on overhauling the income tax law. In January 2001, a mission provided advice on priorities and strategies for improving the tax collection operations of the CBR. A follow-up mission on income tax policy took place in May 2001. In August 2001, a mission assisted the authorities in the preparation of tax administration reforms. In January 2002, another mission advised the authorities on fiscal data management, quality, and transparency. In January 2003, a mission assisted the authorities in reviewing and preparing tax administration reforms.

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

c. STA: In May/June 2000, a mission reviewed the compilation of data considered most important for program design and monitoring. A follow-up mission in July helped develop a series of time-bound measures to improve the national accounts statistics. In January 2001, an expert from STA provided technical advice and training to the Federal Bureau of Statistics for a three-stage development of producer price indices. In February 2002, a mission reviewed external sector statistics and provided advice on steps to be undertaken to subscribe to the SDDS.

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

XII. Resident Representative

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

Pakistan: Fund-Bank Relations

Partnership in Pakistan's development strategy

1. The government of Pakistan's development strategy is set forth in its Interim Poverty Reduction Strategy Paper (I-PRSP). The I-PRSP focuses on: (a) strengthening governance and the integrity of the civil service; (b) creating opportunities through accelerating growth of agriculture, small and medium scale industries, information technology, and oil and gas sectors; and (c) reducing poverty through revival of growth and re-orienting public expenditure towards human development and poverty reduction. A Joint Staff Assessment (JSA) on the I-PRSP was discussed by the Boards of the World Bank and the Fund on December 4 and 6, 2001, respectively. The full PRSP is expected to be completed this year.

2. The Fund is supporting Pakistan's poverty reduction efforts in the context of the three-year arrangement under the Poverty Reduction and Growth Facility (PRGF). The Fund's program supports the continued pursuit of sound macroeconomic policies, in particular sustained fiscal adjustment, while increasing the share of poverty reduction-related public spending; strengthening governance; tax policy and administration reform; public enterprise restructuring and privatization; and financial sector and foreign exchange market reforms. The Fund takes the lead in the policy dialogue on macroeconomic policies including overall fiscal and monetary policy. In addition to macroeconomic targets, the Fund has established structural performance criteria relating to reforms in the areas of tax policy and administration, power sector reform, foreign exchange market liberalization, and public expenditure management. As outlined more fully below, the World Bank has complemented the Fund's work through support to structural reforms in the social sectors and support of the growth agenda through deregulation of key sectors such as power, oil and gas, and banking reforms whose performance have a strong bearing on growth and public finances.

World Bank Group strategy

3. The objective of the World Bank Group's assistance strategy is to help Pakistan reduce poverty through support of the government's implementation of its Interim Poverty Reduction Strategy (PRSP). The World Bank Group's program priorities are focused on the reforms to (a) strengthen macroeconomic stability and government effectiveness; (b) improve the business environment for growth; and (c) improve equity through support for pro-poor and pro-gender equity policies. The 2002 Country Assistance Strategy (CAS), which was presented to the World Bank's Board of Executive Directors on June 11 2002, sets out a strategy in support of these objectives for the period FY 2003–05.[1]

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[1] http://www.worldbank.org/pakistancas

4. The World Bank works closely with the Fund and the government on structural reforms underpinning macroeconomic stability, particularly in areas with an impact on the balance of payments and public finances. In this context, the FY 2002 IDA-financed $500 million Structural Adjustment Credit (SAC) supports the government's actions in the areas of improving public expenditure management and supporting reforms of tax administration, safe and sound banking, efficient public utilities, and structural fiscal and governance reforms. The World Bank has also approved SAC credits for two provinces (Sindh and NorthWest Frontier Province (NWFP)) totaling $190 million supporting provincial reform strategies to improve resource management and strengthen provision of public services by local governments and communities.

5. The World Bank Group's support to strengthening the investment climate includes a combination of analytical work and financial assistance targeted to reforms in key sectors. The World Bank Group continues to encourage the federal and provincial governments to further pursue the ongoing liberalization and modernization of trade, industrial, business and labor regulations. To build the knowledge base to underpin the policy dialogue on private sector development, the World Bank Group plans to carry out a significant program of analytical work. In addition to a Development Policy Review (completed in FY 2002), the World Bank will complete in FY 2003 an Investment Climate and Economic Performance Study. In addition to the governance reforms which have a direct bearing on the investment climate, the World Bank Group continues to support financially and through policy advice reforms of the governance and regulatory environment for power, gas, oil, financial sector, pricing and tariffs reforms, and privatization.

6. In the social sectors, the World Bank Group's assistance is geared toward support to the implementation of the Education Sector Reform (ESR) Strategy and the government's priority of strengthening public health programs and maternal and child health and family planning. Accordingly, the World Bank is focusing on: (a) programmatic support to the National Education Sector Reform Strategy; (b) support to the National Education Assessment System; (c) a program of analytical work to underpin the policy dialogue during the implementation of the ESR; and (d) province-based support to implementing the ESR within the fiscal and economic reforms of Sindh and NWFP to start with. Prior actions related to the recently-approved SAC included an increase in budget allocations for human development and pro-poor expenditures to 4.4 percent of GDP. In FY 2003, the World Bank Group's assistance to health sector reforms will also include the HIV/AIDS Prevention Project, as well as analytical work, technical assistance, and policy dialogue, as appropriate.

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

8. IBRD and IDA have approved 84 loans and 116 credits to Pakistan since 1952, totaling $6,975.3 million and $7,109.2 million, respectively. Of these amounts, $3,530.0 million has been repaid and $640.5 million remains undisbursed. Current total obligations to the World Bank stand at $8,020.3 million, of which $5,294.8 million are IDA and $2,725.5 million are IBRD, as of November 30, 2002. IDA credits constitute 66 percent and IBRD loans 34 percent of the World Bank portfolio. (See table below)

World Bank-Fund collaboration in specific areas

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

10. **Financial sector reforms**. Pakistan has been engaged in far-reaching reforms of the financial sector for five years. Considerable progress has been made, particularly with respect to reform of the banking sector. Regulations have been strengthened, loan recoveries increased, and the quality of management improved. Privatization of the three nationalized commercial banks—the core of the government's reform strategy—is well advanced. The vision for the sector is for a market-oriented, predominantly private system that operates under a strong regulatory framework supported by an effective banking court system. The World Bank and the Fund have worked closely together to support needed policy reforms. The World Bank has maintained close dialogue with the government on banking sector reform following the Banking Sector Adjustment Loan in December 1997, through technical assistance to the Central Bank and preparation of a financial sector update in 2000. The World Bank support is also being provided through implementation of two ongoing projects: the Banking Sector Restructuring and Privatization Project, and the Banking Sector Technical Assistance Project. A joint World Bank/Fund Financial Sector Assessment is planned for FY 2004.

11. **Power sector reforms**: Losses in the power sector have been an ongoing source of macroeconomic instability in Pakistan, threatening achievement of fiscal deficit targets and preventing reorientation of public expenditure toward poverty reduction programs. In the context of the structural adjustment operations approved in FY 2001 and FY 2002, the World Bank has taken the lead in working with the government of Pakistan to unbundle and privatize the state-owned Water and Power Development Authority (WAPDA). During the transition toward privatization, the government of Pakistan aims to restore WAPDA's financial viability through implementation of a medium-term financial improvement plan developed in consultation with the World Bank. The plan aims to sharply reduce the level of budget support to WAPDA through a combination of tariff increases and other measures. Given the importance of this initiative to ensuring achievement of Pakistan's macroeconomic targets, progress in implementing the financial improvement plan is being monitored closely by both the World Bank and Fund.

12. **Public expenditure management**. The quality of Pakistan's public expenditures has long been compromised by poor financial management practices. The government has made one of its top priorities to accelerate reforms towards achieving a modern public accounting and integrated financial management system at the federal, provincial and district level. The World Bank, the Fund and the government have been working closely in this area for more than two years. Under a policy framework agreed with the government and the Fund, the World Bank is taking the lead in supporting implementation of the reform program while the Fund is providing related technical assistance. The World Bank support is being provided in the context of the ongoing Pakistan Improvement of Financial Reporting and Accounting (PIFRA) project through which the national accounting and audit systems are being modernized. A follow-on PIFRA II project will further these efforts, to improve the accuracy, completeness, reliability, and timeliness of intra-year and year-end government financial reports in Pakistan at the national, provincial, and district levels. Analytical and diagnostic support is being provided in the form of a Country Financial Accountability Assessment (CFAA) planned to be completed in FY 2003. Policy measures relating to financial management have been included as prior actions for World Bank structural adjustment lending at both the national and provincial levels.

13. **Tax policy and administration reforms**. The failure to improve tax administration has probably been Pakistan's most severe weakness in economic management. The Fund has taken the lead in supporting tax policy reforms, providing technical assistance leading, inter alia, to the formulation of an income tax reform package which became effective July 1, 2002. In consultation with the Fund and the World Bank, Pakistan has also launched a program for the Fundamental restructuring of the Central Board of Revenues (CBR) in order to improve the efficiency of tax administration. The CBR reform effort is being supported by both the World Bank and the Fund. The Fund has stressed the importance of improved revenue collection performance by CBR as key element in ensuring the sustainability of Pakistan's considerable achievements in fiscal consolidation. The structural performance criteria of the PRGF include adoption of tax policy changes and implementation of CBR reform. Through the Project Preparation Facility, the World Bank is supporting preparation of a Tax Administration Reform Project which is scheduled for approval in FY 2004. This support includes financing of consultants to develop a detailed reform strategy for restructuring of CBR in the areas of human resource management, information technology, business process re-engineering, and tax payer facilitation.

14. **Social impact analysis**. As part of the preparation of the World Bank structural adjustment lending and the Fund PRGF program, the World Bank and the Fund have agreed to review closely the social impact of reforms in a pilot program of collaboration. Work is being led by the World Bank's Social Development Unit. Two areas of reform will receive close scrutiny during implementation: (a) devolution and its impact on the quality of service delivery, especially to the poor, and (b) tariff and policy reforms in the gas and power sectors. This work is now underway.

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

As of November 30, 2002

(In millions of U.S. dollars)

	IBRD	IDA	TOTAL
Original principal:	6,975.25	7,109.19	14,084.44
Cancellations:	1,163.49	875.05	2,038.54
Disbursements to date	5,773.84	5,927.41	11,701.25
Repayments	2,885.80	644.19	3,529.99
Undisbursed:	175.42	465.04	640.46
Exchange adjustment:	(129.12)	0.00	(129.12)
Borrower's obligation:	2,725.47	5,294.81	8,020.28

Tom Buckley, SACPA, 473-0075

February 8 , 2003

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

Dear Mr. Köhler:

As you know, a new federal government was formed on November 23, 2002, following the general elections on October 10, 2002. The government fully supports the broad economic strategy set out in the Interim Poverty Reduction Strategy Paper (I-PRSP) and the Poverty Reduction and Growth Facility (PRGF) arrangement, and is working to articulate its longer-term vision for a set of policies aimed to allow higher sustainable growth and job creation, while reducing poverty. This vision will be reflected in the full Poverty Reduction Strategy Paper (PRSP) currently under preparation.

The Pakistani authorities held discussions with Fund staff in November 2002–January 2003 for the fourth review under the PRGF Arrangement. Based on these discussions, the attached Memorandum of Economic and Financial Policies (MEFP) reviews economic developments and policy implementation through September 2002 and beyond under the arrangement, updates the macroeconomic framework, and discusses the financial policies and structural reform program for the remainder of the fiscal year 2002/03. It supplements the MEFP dated November 22, 2001 as well as the supplementary MEFPs dated March 12, 2002, June 18, 2002, and October 16, 2002.

All performance criteria for end-September 2002 and for October and November 2002 were met, except for the continuous performance criterion on tax exemptions. For the reasons detailed in the MEFP, we extended or reintroduced certain tax and import duty exemptions. The impact of these exemptions on tax revenue will be negligible. On this basis, and in view of the performance up to September 2002 and the policies set out in the attached memorandum, the government requests a waiver for the nonobservance of the continuous performance criterion and the completion of the fourth review. We expect the fifth and sixth reviews under the arrangement to be completed by end-April 2003 and end-June 2003, respectively.

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

Sincerely yours,

________s________
Shaukat Aziz
Adviser to the Prime Minister on
Finance and Economic Affairs

________s________
Ishrat Husain
Governor
State Bank of Pakistan

Attachment:
Memorandum of Economic and Financial Policies

PAKISTAN

Memorandum of Economic and Financial Policies for January–June 2003

I. Developments During August–December 2002

1. **The new federal government, formed on November 23, 2002, fully supports the continuation of the reform program, and is working to articulate its longer-term vision for a set of policies aimed to allow higher sustainable growth and job creation, while reducing poverty**. Its vision will be reflected in the full Poverty Reduction Strategy Paper (PRSP) currently under preparation, with intense participation by provincial and local governments, as well as institutions of civil society (see the government's PRSP preparation status report prepared in January 2003). The domestic security situation has improved, and the military forces deployed along the border with India are gradually being reduced on both sides.

2. **Macroeconomic developments remain in line with the program, except for a better-than-expected performance of the external accounts.** All quantitative end-September performance criteria were observed with comfortable margins (Table 1). Inflation further slowed in recent months, with a Consumer Price Index (CPI) 12-month increase of 3.3 percent through December 2002. November data confirm the pickup in trade flows observed since last spring. Remittances remain strong, and combined with large bilateral and multilateral support, have allowed the State Bank of Pakistan (SBP) to build official reserves to \$7.6 billion by end-December 2002, equivalent to about 6.5 months of next year's projected imports of goods and nonfactor services, as well as about \$0.9 billion of foreign assets earmarked for the repayment of various expensive debts. The Pakistani rupee has slightly appreciated against the U.S. dollar in recent months. The main stock market index further rose by about 18 percent in November–December 2002.

3. **Broad money growth remained strong**, with a 12-month increase of about 19 percent through September 2002, as well as through November. While net foreign assets (NFA) of the banking system continued to grow at a rapid pace, net domestic assets (NDA) contracted on account of weak private credit growth and further reduction of bank credit to the government. Reserve money growth was held to 12 percent in the year through September, and increased to 14 percent through November. In early November, we lowered the discount rate to 7.5 percent; subsequently 6-month treasury bill yields fell to about 4 percent by end-December.

4. **The end-September fiscal deficit target was met**, and the Central Board of Revenue (CBR) met its revenue target for end-September 2002, as well as for end-December 2002, reflecting a relatively buoyant economy, strong imports, and high oil prices. Nontax revenue overperformed relative to the program, owing to larger payments by the coalition against terrorism. Petroleum surcharges through September were slightly below target, reflecting the impact of a temporary cut in rates in late September, as well as lower-than-expected

consumption. Total expenditure was somewhat lower than expected, largely on account of current expenditures, while Public Sector Development Program (PSDP) spending was slightly higher than projected. However, net lending was much higher than programmed on account of nonpayment by public sector enterprises. Even though I-PRSP expenditure increased by about 39 percent over the same period last year, based on preliminary and unreconciled data, the outcome was below the indicative target for the quarter by 17 percent, reflecting some lingering teething problems at the local government level (especially in Balochistan) and unexpected seasonal factors; however, the target for the year (a 21 percent increase over 2001/02) appears still achievable. External financing was lower than projected, and domestic financing was curtailed on account of the reduced financing needs. As more nonbank financing was available than programmed, bank debt could be reduced further than envisaged.

5. **Most structural measures were taken as programmed**. New rules and procedures on General Sales Tax (GST) and customs duties refunds were implemented in late September, with a view to closing loopholes and reducing scope for abuse. A model income tax office for small and medium taxpayers in Lahore started operations in late October to experiment with greater functional specialization within income tax administration. Amendments to the SBP Act increasing central bank independence were promulgated on October 31, 2002. A financial improvement plan (FIP) for the Karachi Electricity Supply Corporation (KESC) was adopted in September, aiming to limit KESC's cash deficit in 2002/03 to about PRs 13 billion, to be entirely covered by the budget. The plan calls for reducing theft/losses through investment in metering equipment, better enforcement of bill payments, and lower cost through greater use of natural gas. Various complementary reforms have been implemented: the monopoly law has been amended to clarify the respective responsibility between the National Electric Power Regulatory Authority (NEPRA) and the Monopoly Control Authority (MCA) regarding KESC, and the government's capital in KESC has been written down as planned to allow privatization. So far, only one large foreign company maintains interest to buy KESC, but has not yet initiated due diligence. As privatization had been expected by October 2002, we had made a net budgetary provision of PRs 4.5 billion to meet the cash shortfall of KESC and we settled in July KESC's arrears to the Water and Power Development Authority (WAPDA) (PRs 8 billion). It was also decided that to make it more responsible, in both operational and financial management, KESC would raise its cash requirement from the commercial banks and pay interest thereon until it was privatized, when the government of Pakistan would repay any bank loans raised by KESC during the current fiscal year. Now that the privatization of KESC is not likely in the near future, the entire cash shortfall of KESC will be met out of the budget and a loan of PRs 4 billion earlier taken by KESC from the banks will be repaid by the government of Pakistan during the current fiscal year. The end-June 2003 floor for the budget balance will be adjusted upward for any outstanding amount of such borrowing.

6. Time-bound sales tax and import duty exemptions for equipment to convert motor vehicles to compressed natural gas (CNG) were partially extended beyond the expiration date on November 1, 2002, as we believe some continued tax incentives are needed to encourage conversion to CNG. Conversion of cars and buses to CNG is a central objective of our

environmental and health policies, given the pollution caused by the use of gasoline and diesel, which has led to a rise in respiratory diseases, especially in cities. The customs duty exemption for pump equipment expired as planned, although the GST exemption remains available (as for any capital equipment to be used for producing taxable supplies). We have also decided to reintroduce, effective December 24, 2002, a customs duty exemption for completely knock-down buses that was mistakenly abolished with the 2002/03 budget. The main goal is to encourage assembly in Pakistan. The impact on tax revenue this fiscal year will be marginal (about PRs 60 million). To recreate a level playing field for all oil companies, we have decided to reinstate a customs duty and sales tax exemption for import of machinery and equipment for the White Oil Pipeline project; due to a clerical error, this exemption had been inadvertently dropped in the last budget. Finally, the exemption from customs duty on sports articles imported for the South Asia Games, which had lapsed a year ago, will be extended for 12 months because the Games themselves have been postponed for one year.

7. **The financial performance of the large public enterprises[1] for the quarter of July–September 2002 was broadly in line with the targets formulated under their respective FIPs, except for WAPDA.** WAPDA defaulted on its entire payment obligations of PRs 7.2 billion to the government (debt service and hydel profits) for the quarter, reflecting substantial shortfalls in cash receipts (of PRs 5.4 billion). Supplier arrears were reduced somewhat more than expected. According to WAPDA's accounts, the shortfall in receipts reflects in the main: the nonpayment of bills by customers in the Federally Administered Tribal Areas (FATA); unchanged technical/nontechnical line losses rather than the programmed improvement; shortfalls resulting from the lower-than-expected structural tariff increase effected in August; and an increase in receivables.

II. Economic and Financial Policies for the Second Half of FY 2002/03

8. The new government is firmly committed to pursue the broad economic strategy set out in the I-PRSP and the PRGF arrangement. The preparation of a PRSP is under way, based on provincial PRSPs to be completed by end-February 2003. We expect to finalize the full PRSP by mid-April 2003.

A. Macroeconomic Framework for 2002/03

9. **Except for some revisions to the monetary/exchange rate policy mix, the macroeconomic framework for 2002/03 remains broadly unchanged from the October MEFP.** It aims at continued budget deficit reduction to enhance public debt sustainability, reduce vulnerability to shocks, and create room over the medium term for the needed increase in human development and infrastructure expenditure.

[1] Water and Power Development Authority (WAPDA), KESC, Pakistan International Airlines (PIA), Pakistan Railways, and Pakistan Steel Mills.

10. **The persistence of unexpectedly high private capital/remittances inflows is putting upward pressure on the exchange rate, posing a dilemma for monetary and exchange rate policy**. We believe that addressing these inflows, in case they persist, requires somewhat greater exchange rate adjustment and a slowing of the pace of foreign exchange purchases in the interbank market (aimed to build up foreign exchange reserves and contain a real appreciation that could adversely affect nontraditional exports). Continued massive sterilization would entail a further compression of domestic credit as well as significant fiscal cost. A modest appreciation against the U.S. dollar should also help to avoid a perception by the market that the SBP pursues an implicit peg. This shift should contribute to slow the growth of broad money in coming months, even though we have revised upward the broad money target for 2002/03, consistent with the much higher-than-expected NFA accumulated through end-2002. We remain alert to the danger that high broad money growth could eventually translate into higher inflation, and will therefore closely monitor inflation developments and prospects, and tighten monetary policy should signs of inflationary pressures emerge. In case of a reversal of the private capital flows, which cannot be excluded if the regional/security environment were to deteriorate, allowing a market-based depreciation and financial tightening will be the first line of defense, with reserves used only to maintain orderly market conditions.

11. **Our fiscal stance remains consistent with the programmed deficit for FY 2002/03 of 4.6 percent of GDP (excluding grants and allowing an adjustment of PRs 8 billion for settling KESC supplier arrears)**. Consistent with recent information, we are confident that the original targets for tax revenue remain achievable, despite the unexpected appreciation of the Pakistani rupee. However, we expect shortfalls in nontax revenue and loan repayments of about PRs 52.3 billion on account of nonpayment of debt service by WAPDA (PRs 16.5 billion for the reasons detailed below), KESC (PRs 6.1 billion erroneously included in the budget), and the National Highway Authority (PRs 9.8 billion), and a lower profit transfer from the SBP (by PRs 20 billion) because of the sterilization cost. On the revenue side, we expect some offset (of altogether PRs 18 billion) through higher-than-expected reimbursements by the coalition against terrorism, some repayment of budget loans to the independent power producers, recovery of arrears from the gas companies and a higher-than-budgeted dividend from the Oil and Gas Development Corporation (OGDC). On the expenditure side, some additional expenditure will be needed for KESC (PRs 3.6 billion) on the assumption that it will not be privatized this fiscal year. At the same time, we expect some offsetting savings on domestic and foreign interest payments (PRs 10 billion) reflecting the more appreciated exchange rate and lower-than-expected T-bill rates, and an additional PRs 4 billion saving on exchange-rate-sensitive expenditure (import intensive development projects, foreign travel/representation, etc.). We will also reduce nonpriority expenditure by PRs 24 billion, largely by locking in savings already made under various heads through not allowing any reappropriation to different heads, and if needed by judiciously managing releases to departments during the remainder of the fiscal year.

12. **The main risk to the outlook, and in particular to the fiscal objectives**, arises from the regional tensions which have not fully wound down by end-2002 as assumed under the program's fiscal projection, even though the recent beginning of a gradual troop withdrawal on the Eastern border is encouraging. An aggravation of tensions in the Middle East could also impact the economy, mostly via a possible surge in oil prices (see below). If any such risks were to materialize, we would seek to protect budget balances by enacting further cuts in low-priority expenditures, while protecting key social spending. Discussions between the federal government and the provinces on the new revenue sharing formula between the federal government, provinces, and districts are ongoing.

B. Structural Policies

13. Building on substantial progress to date in liberalizing the economy and improving governance, we will further deepen our structural reform program and we propose additional structural benchmarks and performance criteria for January–June 2003, as outlined in Table 2(b).

Domestic energy prices

14. **We plan to strictly apply the formula-based pricing for gas and petroleum products and electricity tariffs**, as the existing automatic price adjustment mechanisms have gained broad acceptability, and are transparent and widely understood. The delayed automatic adjustment of electricity tariffs to first quarter fuel price developments has been implemented in November 2002, while a reduction reflecting fuel costs during October-December was made effective in December 2002. We will seek to amend the NEPRA act with a view to streamline procedures, by allowing the power companies to adjust tariffs in response to fuel costs increases automatically, subject to ex-post review of compliance with these rules by NEPRA, and eliminating the need for government notification of such adjustments. In the meantime, the government commits to limit its discretion in notifying adjustments as determined by NEPRA with a view to reduce WAPDA's financial imbalances. The implications of the unbundling of WAPDA on electricity tariffs are detailed below. The gas pricing framework—wellhead prices, the gas distribution company's tariff filings, the Oil and Gas Regulatory Authority's (OGRA) determination of the prescribed prices, and notified final tariffs—will be published on the website of the Ministry of Petroleum and Natural Resources from mid-February 2003 and its implementation will be made as per provisions in the law.

Tax policy and tax administration

15. **The CBR reform process is broadly on track**. Recommendations from consultants currently working with us on the modernization of CBR's internal organization in the context of a World Bank-supported project, as well as from FAD technical assistance (TA) missions to review the reform strategy for customs administration and tax administration planned for January/February 2003, will be incorporated as appropriate in the program during the fifth review. Tax policy reform proposals for the next budget will be prepared by March 2003, and

will include the abolition of a sizable number of income tax exemptions, as well as of all remaining withholding tax exemptions for income from the National Saving Schemes (NSS) investments. Building on work by the National Accountability Bureau, that identifies the "Benami" practice (whereby one person holds assets under different names) as a main source of governance problems, we will formulate by March 2003 a strategy to contain this practice.

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

16. **We plan to finalize the PRSP by mid-April 2003**, incorporating the experience gained from the I-PRSP process. In preparing the PRSP—coordinated by the recently established PRSP secretariat that is being strengthened with World Bank support—we will put additional emphasis on some important institutional causes of poverty, such as lack of assets held by the poor, lack of a functioning justice system, and deep-rooted gender issues; include a first costing of the health and education targets; and adopt a broader participatory approach, including consultation with the national and provincial parliaments and institutions of civil society. Building on recent progress in developing systems to monitor 12 intermediate social outcomes, we will prepare a first report on such outcomes by March 31, 2003, spelling out the underlying baselines, the data collection mechanisms and the format of publication, and quarterly developments (to the extent data are available). The mechanisms for collecting data will include a combination of (a) the existing administrative reporting systems that are being strengthened with support from the U.K. Department for International Development (DFID); (b) the full Pakistan Integrated Household Survey (PIHS) conducted every three years; and (c) an annual core welfare indicator survey being developed with assistance from the World Bank that could be evaluated very quickly and will be timed to provide input in the formulation of local, provincial, and federal budgets, with a pilot to be initiated in February 2003. We will firmly implement expenditure and outcome controls at the local level to ensure that the devolution process actually improves social service delivery, and does not lead to setbacks in terms of fiscal transparency. At the same time, we are preparing a sizable expansion of a cash transfer program to the most destitute to reach about 2 million beneficiaries at an annual cost of PRs 5 billion. With the reconstitution of parliament, the traditional practice of allowing each member of the National Assembly to propose development projects in his constituency (for up to PRs 5 million this fiscal year, and PRs 10 million, thereafter) has been restored. The proposals will be vetted through the normal budgetary mechanisms to ensure they fit the overall development strategy; approved projects will be funded from the PSDP and implementation and accounting will be through normal channels. We are also working on an assessment of the poverty and social impact of energy pricing reforms with assistance from the World Bank.

17. **The government will submit to parliament the draft fiscal responsibility law by June 1, 2003. The implementation of other elements of the Accountable Fiscal Management Framework is proceeding as planned.** The FY 2003/04 budget call for the federal government and the North West Frontier Province (NWFP) was issued on the basis of the New Accounting Model (NAM) for a parallel run with the existing accounting model. This will serve as a pilot for the move of all federal and provincial budgets to the NAM standard

with the FY 2004/05 budget. Progress is also being made via the Pakistan Improvement of Financial Reporting and Accounting (PIFRA) project in strengthening the Controller General of Accounts and ensuring uniform expenditure tracking by districts, and pre-auditing of all transactions through the District Accounts Offices. Various actions are being taken toward establishing a medium-term budget framework. Specifically, as an annex to the FY 2003/04 budget, we will (a) establish overall indicative resource envelopes for the two subsequent years, and specify the underlying macroeconomic and technical assumptions; (b) compare in the Economic Survey actual outcomes with original budget estimates for revenue and expenditures for three previous years; and (c) produce a statement of financial assets in FY 2002/03 of the Federal Government, indicating the underlying valuation principles. We intend to work during the next fiscal year with provincial governments to extend relevant provisions of the fiscal responsibility law to the provinces. A contributory pension scheme for new recruits in the civil service is being prepared as part of a third phase public pension reform package, in collaboration with the World Bank and to be launched in the course of the next fiscal year. In this context, an actuarial cell has been established in the Ministry of Finance, and will become fully functional within a few months.

Public enterprises and privatization

18. **The privatization drive is proceeding,** with Habib Bank and major public enterprises in the oil and gas sector (Pakistan State Oil (PSO) and OGDC) to be sold in the coming months. Regarding KESC, we remain open for discussing a negotiated sale with the only remaining qualified investor (who has however put discussion on hold for the time being). In the meantime, we will continue to forcefully implement the FIP developed in September. In this context, we will further modernize and streamline human resource management, and seek multilateral or bilateral assistance for the restructuring program. A plan to revamp the railways through corporatization, downsizing, and partial privatization is being prepared, with any government financial support to be part of the FY 2003/04 budget, after consultation with the World Bank on the quality of the program. PIA plans to renew its fleet in the next few years, and planned government cash transfers and loan guarantees are consistent with the financial program. We will prepare a strategy for privatization of PIA by 2004, starting with the divestiture of non-core activities (hotels, etc.) in 2003.

19. As indicated above, **WAPDA's financial situation remains unsustainable and will require further reform**. Assuming world oil prices at their mid-November levels, continuation of the trends observed during the first quarter would result in a cash deficit in the order of PRs 34 billion (0.8 percent of GDP) for the year, compared to broad balance targeted under the FIP. Accordingly, the following measures will be taken to contain WAPDA's losses and their impact on the budget: First, electricity supply to FATA will be streamlined and all efforts made to improve bill collection, including by initiating the metering of individual users, to reduce losses on account of FATA. WAPDA will furthermore delay PRs 4.7 billion of nonessential investments. More generally, by mid-April, we will prepare a revised FIP for FY 2002/03 and an FIP for FY 2003/04 for WAPDA (power wing) and its corporate successors, in consultation with the World Bank and Fund staff (structural performance

criterion). The FIPs will be based on the assumption of a strict application of the formula-based fuel cost adjustment of electricity tariffs and lay out explicitly assumptions regarding the baseline fuel cost and tariff structure. The FIPs will include: (a) specific steps and targets toward a reduction of line losses, and improvement in the collection of bills from FATA; (b) the settlement of WAPDA's arrears vis-à-vis its main suppliers in FY 2003/04; and (c) a strong commitment to reduce receivables from the public sector. The FIPs will include quarterly financial targets, a detailed timetable regarding WAPDA's restructuring process, and contingency measures (such as cuts in administrative cost or tariff increase) to be enacted if needed to achieve the financial targets. The revised FIP for FY 2002/03 will aim at limiting WAPDA's cash deficit (after payment of all current obligations and postponement of some investments) to PRs 30 billion, limit government-guaranteed domestic borrowing to PRs 13 billion, and contain the stock of supplier arrears at the level at end-June 2002; the remaining cash shortfall will be absorbed by the budget. The FIP for FY 2003/04 will aim at a substantially reduced deficit, which would be entirely covered by budget subsidies. On the structural front, we will review, by end-March 2003, the electricity tariff brackets to better focus the subsidy on the most vulnerable, and thereby achieve additional revenue. The legal transfer of WAPDA's assets and liabilities to its corporate successors will be effected by end-June 2003. By end-April 2003, power purchase agreements between the regional distribution companies (DISCOs) and the recently licensed national transmission and dispatch company (NTDC) will be concluded, as well as between the various generation companies (GENCOs) and the NTDC. By end-June, the DISCOs, GENCOs, and NTDC would file with NEPRA for determination of tariffs, based on a policy decision taken in early 2002 that differentiated tariffs should reflect the cost structure of the various units. In 2003 we plan to privatize one GENCO and one DISCO (expressions of interest have already been invited for the latter).

Financial sector reforms

20. **We will pursue the implementation of the financial sector reform strategy, regrettably without any input from the Financial Sector Assessment Program mission that continues to be delayed**. The restructuring of the National Bank of Pakistan (NBP)will continue, with further gradual increases in the private sector share in equity. By June 2003, a decision will be taken on the strategy vis-à-vis disposal of the 49 percent government stake in Allied Bank. We will seek to privatize the Industrial Development Bank of Pakistan. The potential cost of the required balance sheet clean up will be included in the FY 2003/04 budget. The bank has been disallowed to take any new high-cost deposits or make new loans. The Agricultural Development Bank of Pakistan has been corporatized and is being restructured in the context of the Asian Development Bank (AsDB)-supported rural finance development project. Given the growing involvement of the private sector in wheat marketing, the stock of outstanding commodity operations (government-guaranteed bank credit extended to various public commodity boards) will be reduced to at most PRs 95 billion by June 2003 and PRs 85 billion by June 2004. In the context of an AsDB-supported reform project, by mid-2003 we will prepare a detailed action plan for transforming the NSS into a modern savings institution, with instruments tailored to the targeted market segments and returns closely aligned with market yield curves. Given the traditional importance of the NSS as

saving vehicle for government pensioners, with a strong social safety net element, we have established a new saving instrument exclusively for pensioners who can invest up to PRs 1 million under the scheme. This will allow to accelerate the elimination of subsidies under the other instruments. Effective from end-2002, we have adjusted rates in line with the existing formula, to reflect lower PIB yields, and we will complete computerization of one of the NSS districts, as a pilot for the whole country, by mid-2003. We will also more closely align the rate of return paid on the General Provident Fund with market rates, and prepare better targeting of access to this subsidized form of saving in the context of the next pay and pension reform. We plan to finalize a draft anti-money laundering law by mid-March 2003 for submission to parliament.

III. Other Issues

Program financing

21. **The program remains fully financed in FY 2002/03.** We will ensure that conditions attached to expected loan disbursements of the World Bank and AsDB are met. Most bilateral agreements with the Paris Club creditors have been signed, a few remaining ones are expected to be concluded in early 2003. Debt swaps for social expenditure and outright debt cancellation are being discussed with some creditors and we will ensure that implementation of any such swaps will be consistent with the financial program. A $100 million loan from the foreign branches of one of the nationalized banks has been restructured, as part of the planned private sector involvement.

Data issues

22. The remaining steps needed to participate in the General Data Dissemination Standard (GDDS) will be taken soon, with statistical metadata to be posted on the IMF's data dissemination board by June 2003. To improve data dissemination and move closer to subscribing to the Special Data Dissemination Standard (SDDS), we plan to meet by end-2003 the requirements of quarterly national accounts and of a regular survey on wage earning. We have now released the data (as per original sample) from the latest PIHS. Because we had strong reservations about the quality of these data, we have reviewed the data thoroughly, inconsistencies regarding data collection and presentation have been removed, and revised data published along with the original report. The proposal to create the Pakistan Bureau of Statistics (PBS) is under consideration, consolidating various existing agencies. PBS will be granted greater autonomy to enhance the quality and credibility of our statistics.

Program monitoring

23. Given the current level of uncertainty in the macroeconomic outlook, we propose to continue monitoring of the program through quarterly reviews. The fifth review will focus on preparation of the 2003/04 budget. The proposed additional structural performance criteria/benchmarks for January–June 2003 and the proposed end-June 2003 quantitative performance criteria and indicative targets are listed in Tables 1 and 2(b), respectively.

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

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

	Outstanding Stock End-Jun. 2002	Prog. End-Sep. 2002	Adj. Prog. End-Sep. 2002	Act. End-Sep. 2002	Prog. End-Dec. 2002	Prog. End-Mar. 2003	Proposed Prog. End-Jun. 2003
Net foreign assets of the SBP (floor in millions of U.S. dollars)*	2,321.0	320.0	121.4	2,203.0	497.0	809.0	4,327.0
			(In billions of Pakistani rupees)				
Net domestic assets of the SBP*	445.4	-0.2	4.8	-124.4	8.8	-13.2	-181.2
Overall budget balance (floor)*	...	-56.4	-64.4	-44.4	-98.7	-142.3	-178.4
Net government bank borrowing*	514.1	-4.4	15.5	-12.7	-15.9	-38.6	-29.2
CBR revenue (floor)*	...	90.0	...	90.4	199.5	309.0	458.9
Net banking sector claims on public sector enterprises*	82.0	7.0	...	-5.5	11.7	16.3	20.0
Social- and poverty-related spending ("I-PRSP budgetary expenditure")	...	35.4	...	29.3	70.8	114.3	161.0
			(In millions of U.S. dollars)				
Outstanding stock of short-term external debt owed or guaranteed by the government and the SBP*	209.0	500.0	...	194.3	500.0	500.0	500.0
Contracting or guaranteeing of nonconcessional medium-term and long-term debt by the government* 2/	...	600.0	...	88.8	600.0	600.0	650.0
Accumulation of external payments arrears (continuous performance criterion during the program period)*	...	0.0	...	0.0	0.0	0.0	0.0
SBP's forex reserves held with foreign branches of domestic banks (outstanding stock)	65.0	100.0	...	51.6	100.0	100.0	100.0
Of which: other than current account*	0.0	0.0	...	0.0	0.0	0.0	0.0
Stock of outstanding foreign currency swap and forward sales between SBP and residents*	280.0	400.0	...	50.0	400.0	400.0	400.0
Memorandum items:							
Net external program financing	...	447.5	...	235.3	597.4	689.1	663.5
Of which: privatization proceeds	...	50.0	...	10.0	100.0	150.0	234.0
External cash budget grants	...	36.4	...	50.0	106.6	193.0	238.5
Daily cash reserve requirements ratio (in percentage points)	4.0	4.0	...	4.0	4.0	4.0	4.0
Special cash reserve requirements ratio on foreign currency deposits (in percentage points)	20.0	20.0	...	15.0	20.0	15.0	15.0
Outstanding KESC borrowing 3/	0.0	...	...	0.0	...	...	0.0

Source: Pakistani authorities.

1/ The relevant variables are defined in the Technical Memorandum of Understanding (TMU) dated June 2002 (and as amended during the third review) and are subject to adjustors specified in the TMU. For variables marked "*" the end-September 2002, end-December 2002, end-March 2003, and end-June 2003 program flows represent ceilings (or floor, if indicated) that constitute performance criteria. All other targets are indicative.

2/ Excluding PRGF loans.

3/ Bonds issued and loans contracted by KESC in the course of 2002/03.

Table 2(a). Pakistan: Structural Performance Criteria and Benchmarks Under the PRGF Arrangement as set Under the Third Review 1/

Measures	Timing	Status as of January 31, 2003
I. Structural Performance Criteria		
No new (as per status of September 1, 2002) 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 commitment.	Continuous	Not met. Time-bound exemptions for sales tax and custom duties for imported equipment to convert cars/buses to CNG partially extended beyond the original expiration of November 1, 2002, and duty sales tax exemptions for CKD buses re-instated in December 2002.
Implement new organizational setup for CBR headquarters per approved CBR reform plan (as described in MEFP dated November 22, 2001, para. 21).	February 28, 2002	Done.
Apply standard GST penalty regime to retailers and eliminate GST exemptions for all fertilizer wholesale and retail trade.	March 31, 2002	Done.
Implementation of universal self-assessment effective for all income earned from July 1, 2002.	July 1, 2002	Done (as new income tax ordinance came into force).
Start operations of a Large Taxpayer Unit, integrating all domestic tax operations.	July 1, 2002	Done. Large Taxpayer Unit in Karachi started operations on 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 nonstandard 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	Done.
Bring KESC to point of sale (as detailed in MEFP dated November 22, 2001, para. 23).	July 31, 2002	Not met. Expressions of interest invited in March 2002. Two investors expressed interest and one investor provided statement of qualification, which was accepted in June 2002. Investor has not started due diligence. Complementary reforms (multiyear tariff framework, clarification of regulatory role of NEPRA and monopoly commission, and write down of government capital) implemented in September/October 2002.

Table 2(a). Pakistan: Structural Performance Criteria and Benchmarks Under the PRGF Arrangement as set Under the Third Review (continued) 1/

Measures	Timing	Status as of January 31, 2003
Issue circular allowing banks to purchase from August 1, 2002 foreign exchange from money changers at freely negotiated rates.	August 1, 2002	Done. Foreign Exchange Manual issued in January 2002 allows banks to purchase foreign exchange from money changers at freely negotiated rates.
Issue budget call for FY 2003/04 budget on the basis of the New Accounting Model (NAM) for federal government and any one province, for parallel run with existing system.	October 31, 2002	Done; budget call for NWFP and the federal government made on basis of NAM.
Publish quarterly progress reports on implementation of financial improvement plan of WAPDA/successors.	November 30, 2002 for the quarter July–September 2002; February 28, 2003 for the quarter October–December 2002, and May 31, 2003 for the quarter January–March 2003.	Done so far. First report on WAPDA (and other major public enterprises) published on the ministry of finance website in November 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 FY 2001/02–2003/04.	December 31, 2001	Done. List and annual targets included in the I-PRSP.
Quarterly published progress reports on implementation of Poverty Reduction Strategy, including "I-PRSP expenditure," as well as on progress in (a) establishing institutional framework for I-PRSP monitoring; (b) preparation of full PRSP; and (c) developing baseline data and monitoring framework for intermediate indicators.	To start end-December 2001 for 2001/02 Q1 data, and continued on the basis of the same quarterly schedule throughout FY 2001/02 and FY 2002/03.	Done so far. Fifth report published in December 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	Done. Draft rules published end-March 2002 to obtain public feedback. Final rules became effective July 1, 2002.
Prepare proposals for revised income and sales tax appeals and dispute resolution process with a view to implement them with the FY 2002/03 budget.	March 31, 2002	Done. New rules became effective July 1, 2002.

Table 2(a). Pakistan: Structural Performance Criteria and Benchmarks Under the PRGF Arrangement as set Under the Third Review (concluded) 1/

Measures	Timing	Status as of January 31, 2003
Bring United Bank Ltd. and PTCL to the point of sale through transparent and open public offer for sale.	May 31, 2002	Delayed. UBL was privatized only in September 2002; investors interested in PTCL do not yet meet qualification requirements.
Issuance of a streamlined foreign exchange manual to simplify and clarify rules regarding access to foreign exchange and current account transactions.	July 1, 2002	Done. 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	Delayed. Actuarial cell in the Ministry of Finance established only in late 2002.
Implement structural electricity tariff adjustment consistent with WAPDA financial improvement plan.	July 15, 2002	Delayed. Structural tariff increase of 9.2 percent on average became effective on August 13, 2002
Preparation of financial plans and quarterly performance targets for FY 2002/03 for PIA, Pakistan Railways, and Pakistan Steel Mills.	August 31, 2002	Partially delayed. Financial plans prepared by end-August 2002, but quarterly performance targets prepared only in September 2002.
Eliminate administrative restrictions on the setting of interest rates on foreign currency deposits.	September 30, 2002	Done (SBP Circular No. 17 issued on July 9, 2002).
Implement revised sales tax and customs refund rules and procedures to reduce the incidence of incorrect claims and payments.	September 30, 2002	Done.
Prepare customs administration reform plan.	September 30, 2002	Done. Plan was prepared by August 20, 2002.
Make model income tax office for small and medium taxpayers in Lahore fully operational.	October 31, 2002	Done.
Amend SBP Act to strengthen central bank autonomy, in particular in the area of reserve management, per Safeguard Assessment recommendations.	October 31, 2002	Partially met. Amendments published in Gazette of Pakistan on November 4, 2002 strengthen autonomy but less than recommended.

1/ Conditionality as of the Executive Board's conclusion of the third review under the PRGF arrangement (IMF Country Report No. 02/246).

Table 2(b). Pakistan: Structural Performance Criteria and Benchmarks Under the PRGF Arrangement as Proposed for the Fourth Review

Measures	Timing	Status as of January 31, 2002	Related to
I. Structural Performance Criteria			
No new (as per status of March 1, 2003) 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 commitment.	Continuous		
Preparation of revised WAPDA FIP for FY 2002/03 and FY 2003/04, aimed at containing WAPDA's deficit in FY 2002/03 and substantially reduce it in FY 2003/04, as detailed in the MEFP, para. 19.	April 15, 2003		6th disbursement
Submit to parliament a fiscal responsibility law, including (a) fiscal rules aimed at reducing consolidated government debt (federal and provincial) to below 60 percent of GDP within 10 years from the date of promulgation; and (b) the transparency and reporting requirements proposed in the draft published in July 2002.	June 1, 2003		7th disbursement
Privatize Habib Bank through effective transfer of majority ownership to private investors.	June 30, 2003		8th disbursement
Eliminate all exemptions from withholding tax on interest income.	June 30, 2003		8th disbursement
Establish formulaic link between rates of return on General Provident Fund and PIB yields.	June 30, 2003		8th disbursement
II. Structural Benchmarks			
Publish first report on intermediate social outcomes as detailed in para. 16 of the MEFP.	March 31, 2003		
Prepare strategy to reduce scope for abuse of practice of holding ownership under different names ("Benami").	March 31, 2003		
Prepare specific proposals for further tax policy reforms to be implemented with the 2003/04 budget, including a substantial list of remaining income tax exemptions from the CRITO list to be abolished.	March 31, 2003		
Complete legal transfer of assets and liabilities to the various WAPDA successor companies (GENCOs, NTDC, and DISCOs).	June 30, 2003		

Table 2(b). Pakistan: Structural Performance Criteria and Benchmarks Under the PRGF Arrangement as Proposed for the Fourth Review (concluded)

Measures	Timing	Status as of January 31, 2002	Related to
Make effective power purchase agreements between GENCOs and NTDC, and NTDC and DISCOs, in the context of the unbundling of WAPDA.	April 30, 2003		
III. Prior Actions			
Adjust return on NSS instruments to reflect PIB yields in July–December 2002, as per usual formula.		Done.	
Maintenance of average PDL rate at the levels of December 16, 2002 during subsequent petroleum product price adjustments.		Done so far.	
In the context of WAPDA reform, issue license to NTDC.		Done.	
Approve and initiate program for development of quick-evaluation annual core welfare indicator survey (representative at the district level), complementing the three-yearly PIHS survey, to enhance monitoring of intermediate social outcome indicators.			

Amendments to the Technical Memorandum of Understanding (TMU)

The TMU dated June 18, 2002 ("June TMU"), as amended during the third review on November 1, 2002, will remain valid for the remainder of FY 2002/03, with the revised baseline assumptions for net external program financing and external grants as indicated in Tables 1(a) and 1(b), and the following amendment to apply from April 1, 2003.

1. The following sentence will be added to para. 17 of the TMU: "The floor for end-June 2003 will be adjusted upward for any bank borrowing or bonds issued by KESC during FY 2003 and outstanding as of end-June 2003."

2. The first sentence in para. 8 will be replaced by: "**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, minus accelerated amortization of government external debt."

3. The following sentence will be added at the end of para. 14: "In case of accelerated amortization of government external debt, the floor on the NFA of the SBP and the ceiling on the NDA of the SBP for end-June 2003 will also be adjusted downward/upward to the extent of such accelerated amortization."

4. The following sentence will be added at the end of para. 15: "In case of accelerated amortization of government external debt, the ceiling on net bank borrowing by the government for end-June 2003 will adjusted upward to the extent of such accelerated amortization."

5. The following reporting requirement will be added to para. 19 of the TMU: "Quarterly data on KESC loans and debt outstanding, within one month."

6. The following reporting requirement will be added to para. 19 of the TMU: "Quarterly data on the number of government pensioners, the number of accounts, and the total amount invested in the new pensioners' benefit accounts, within two months."

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

(In millions of U.S. dollars)

	(Cumulative from July 1, 2002)				
	Prog.	Act.	Prog.		
	Sep. 2002	Sep. 2002	Dec. 2002	Mar. 2003	Jun. 2003
Program financing (a+b+c+d+e+f-g+h)	**447.5**	**235.3**	**597.4**	**689.1**	**365.5**
(a) World Bank	185.0	202.0	215.0	400.0	202.0
(b) AsDB loans	235.0	128.0	385.0	455.0	331.0
(c) Other multilaterals	0.0	0.0	0.0	0.0	0.0
(d) Bilateral loans	0.0	0.0	0.0	0.0	0.0
(e) Commercial bank borrowing	100.0	35.5	200.0	300.0	335.5
Of which: IDB	100.0	35.5	200.0	300.0	335.5
(f) Privatization receipts	50.0	10.0	100.0	150.0	284.0
(g) Amortization due	393.0	410.2	790.9	1,346.2	1,710.4
Multilateral creditors	130.7	134.7	270.6	400.6	531.6
Bilateral creditors	184.9	196.8	302.0	467.3	577.4
Commercial creditors	49.5	50.2	169.7	397.7	499.5
Other (Military)	27.9	28.5	48.6	80.6	101.9
(h) Debt service rescheduled/arrears	270.5	270.0	488.3	730.3	923.4
Multilateral creditors	0.0	0.0	0.0	0.0	0.0
Bilateral creditors	245.9	244.8	440.3	656.6	826.3
Commercial creditors	0.0	0.0	0.0	0.0	0.0
Other (Military)	24.6	25.2	48.0	73.7	97.1

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

(In millions of U.S. dollars)

	(Cumulative from July 1, 2002)				
	Prog.	Act.	Prog.		
	Sep. 2002	Sep. 2002	Dec. 2002	Mar. 2003	Jun. 2003
External cash budget grants	36.4	50.0	106.6	193.0	238.5
United States	0.0	0.0	0.0	0.0	0.0
European Union	13.1	0.0	21.9	21.9	0.0
Japan	19.0	0.0	19.0	64.0	64.0
United Kingdom	0.0	0.0	57.0	57.0	57.0
Other	4.3	50.0	8.7	50.1	117.5
Saudi oil facility	164.3	189.0	325.6	484.7	671.4
					0.0
Project grants	25.2	29.5	50.4	35.5	69.3
Capital Grants	0.0	0.0	0.0	0.0	0.0

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International Monetary Fund
Washington, D.C. 20431 USA

IMF Completes Fourth Review of Pakistan's PRGF-Supported Program, Approves US$118 Million Disbursement to Pakistan

The Executive Board of the International Monetary Fund (IMF) completed today the fourth review of Pakistan's performance under a three-year, SDR 1.03 billion (about US$1.41 billion) Poverty Reduction and Growth Facility (PRGF) arrangement. This decision entitles Pakistan to the release of a further SDR 86.14 million (about US$118 million), which will bring total disbursements under the program (see Press Release No. 01/51) to SDR 430.72 million (about US$591 million).

In approving the disbursement, the Executive Board granted a waiver of Pakistan's nonobservance of the continuous structural performance criterion regarding tax exemptions and regulatory import duties.

The Poverty Reduction and Growth Facility is the IMF's concessional facility for low-income countries. PRGF-supported programs are 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 5½ -year grace period on principal payments.

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

"The Fund commends the authorities for making further progress on stabilization, in a difficult economic and political environment. All quantitative performance criteria for end-September 2002 were met. Continued implementation of cautious fiscal and monetary policies under the Fund-supported program has paved the way for the recovery observed since last spring, which is gathering momentum while inflation remains low. Tax revenue during the first half of the fiscal year were in line with projections. High remittances and private capital inflows contributed to a strong increase in official reserves and strengthened the Pakistani rupee. Pro-poor expenditures, while lower than expected, rose significantly during the first half of fiscal year 2002/03 compared to the same period of 2001/02. A full Poverty Reduction Strategy Paper is being prepared and is expected to be finalized by mid-2003.

"Progress on the structural front was uneven. Though the performance of the large public enterprises through September was generally in line with their respective financial improvement plan targets, the financial situation of the Water and Power Development Authority (WAPDA) fell far short of the objectives, reflecting insufficient adjustment of tariffs to surging costs, difficulties in collecting bills in certain regions of Pakistan, and too little progress in reducing line losses. Also disappointing was the restoration of a few tax exemptions in recent months.

"Looking ahead, the authorities need to reinforce efforts to implement their poverty reduction strategy by consolidating macroeconomic stability and strengthening governance. On the fiscal side, achieving the programmed budget deficit targets will require a reduction of nonpriority expenditures and the implementation of measures aimed at containing WAPDA's losses and offsetting the lower-than-expected profit transfer from the State Bank of Pakistan (SBP) resulting from high sterilization costs. A slowdown in the pace of the SBP's foreign exchange purchases should contribute to containing money growth and reducing the need for costly sterilization.

"Implementation of a broad range of structural reforms will be essential to create a more investor-friendly environment and reduce poverty. The completion of the unbundling of WAPDA into smaller and privatizable corporate entities, along with other measures aimed at improving its operational performance, should contribute to reducing its need for government subsidies, thereby freeing resources for priority social and capital expenditures. The removal of a significant number of tax exemptions with the next budget should lead towards a tax system where the burden is more fairly distributed across income earners. Adoption of a draft fiscal responsibility law should enhance transparency in public finances. Finally, the planned privatization of Habib Bank and reform of the National Savings Schemes will allow the financial sector to better support investment and growth in Pakistan," Mr. Aninat stated.

Statement by the IMF Staff Representative
February 28, 2003

1. This statement summarizes the information that has become available since the staff report was circulated to the Executive Board on February 14, 2003. It does not change the thrust of the staff appraisal.

Prior actions

2. The information provided by the authorities indicates that all the prior actions listed in the February 8, 2003 Memorandum of Economic and Financial Policies have been taken.

3. Returns on National Savings Schemes instruments were lowered, as per the existing formula, effective January 1, 2003 to reflect lower yields on Pakistan Investment Bonds in July–December 2002. Returns on the various instruments were reduced between 1.4 to 2.0 percentage points.

4. In the face of the significant increase in international oil prices in the past weeks, the authorities have preserved the market-based fortnightly petroleum pricing mechanism and maintained the Petroleum Development Levy rates at their levels of December 16, 2002, resulting in sharp increases in consumer prices.

5. In the context of the Water and Power Development Authority's (WAPDA) unbundling and corporatization, the National Transmission and Dispatch Company (spun off WAPDA) was licensed by the power sector's regulator in late December 2002.

6. The authorities approved on February 24, 2003 a program for developing annual core welfare indicator surveys, and initiated work on its design. These surveys, representative at the district level, will complement the three-yearly household survey to enhance the monitoring of intermediate social outcome indicators.

Recent developments

7. Little additional information on macroeconomic developments has become available since the staff report was issued. Inflation remains subdued (3.4 percent in the year through January 2003). Exports and imports for the period July 2002–January 2003 in U.S. dollar terms grew by about 20 percent over the corresponding period of 2001/02, while remittances doubled to $2.5 billion. The State Bank of Pakistan slightly reduced its purchases of foreign exchange on the interbank market, building foreign exchange reserves to $8.4 billion as of February 26, 2003. The Pakistani rupee remained broadly stable against the U.S. dollar.

8. Available data indicate that the authorities likely met the end-December 2002 fiscal deficit target. The Central Board of Revenue (CBR) met its revenue target, reflecting a relatively buoyant economy, strong imports, and high oil prices, and probably some first effects of administrative reform. CBR revenue collection was also on target in January 2003.

9. According to preliminary data, social sector spending ("I-PRSP expenditure") rose by 45 percent to PRs 66.5 billion during July–December 2002 over the preceding year, but fell short of the target level by about 6 percent.

10. Available data indicate that the monetary targets for end-2002 were likely met too. Net foreign assets of the banking system continued to grow at a rapid pace in September–December 2002. Broad money growth eased somewhat to 17 percent in the year through December, and reserve money to 10 percent. The yield on 6-month treasury bills fell to 3.2 percent in recent auctions. The main Karachi Stock Exchange Index on February 27, 2002, was down 13 percent from end-2002 (and down 20 percent from its 2003 peak).

11. The World Bank concluded on February 26 that progress on the development of the full PRSP (Poverty Reduction Strategy Paper), as evidenced by the PRSP Preparation Status Report, is satisfactory and provides a sound basis for continued access to World Bank concessional financial assistance.

Statement by Abbas Mirakhor, Executive Director for Pakistan
February 28, 2003

My authorities thank staff for a well-written and candid report which describes progress under the PRGF and the challenges that lie ahead of Pakistan. They also express their deep appreciation for the continuing support of staff, management, and the Executive Board in pursuit of high sustainable growth and poverty reduction.

Recent economic performance in Pakistan has been encouraging. Since the last review, economic activity appears to be gathering strength, inflation remains quiescent, the fiscal deficit for end-September has been met thanks, in part, to rising tax collections by the Central Board of Revenue (CBR). I-PRSP expenditures have risen sharply, and the external sector has overperformed, reflecting higher-than expected private inflows and strong exports. The implementation of structural reforms has been broadly on track, except for continuing financial difficulties experienced by the Water and Power Development Authority (WAPDA). Privatization has made some headway, with faster progress being constrained by limited investor interest. In other structural areas, staff note with regret government's decision to restore some tax exemptions, amendments to the central bank act that were less strong than hoped for, and the risk of abuse from a new National Savings Scheme (NSS) instrument targeted at pensioners. The authorities assure the Board that the new exemptions are limited in nature and scope and bear virtually no fiscal impact. In one case, the exemption merely corrected an inadvertent error. The amendments to the central bank act do indeed strengthen the institution that was already widely regarded as being highly independent. In regards to the new NSS instruments targeted at pensioners, the authorities will put in place appropriate safeguards—including special documentation requirements and monitoring mechanisms—to ensure that there is no abuse.

The new civilian government, which took power following the October 2002 elections, has endorsed the main goals of the I-PRSP and supports the broad macroeconomic and structural contours of the PRGF. Staff express concern about the "dangerous view now gaining momentum" in Pakistan that a comfortable macrofinancial situation should permit some relaxation of fiscal discipline. While there may have been some risk of a drift towards macroeconomic populism in the initial days of the new government, there has since been a growing realization that adhering to the program is in Pakistan's best interest and offers the best chance of extricating the economy from its slow growth equilibrium. The regular increases in domestic petroleum prices provide one illustration of the authorities' commitment to the program.

The macroeconomic framework for the remainder of FY 2002/03 in terms of growth and inflation is largely unchanged. However, there are some indications that the GDP growth target of 4.5 percent may be exceeded. Revisions to the balance of payments projections arise from stronger-than-expected foreign exchange inflows. The staff report notes the two forces at work, namely, "a combination of a shift of inflows to official channels and a still ongoing portfolio reallocation." On the assumption that the portfolio reallocation is a one-time phenomenon, the balance of payments projections assume a tapering off in 2003.

The continued high level of private inflows has presented monetary policy with a dilemma which has been well-documented in previous staff reports. In light of the large fiscal costs associated with "massive" sterilization operations, the monetary/exchange rate policy mix will be slightly modified towards lesser intervention—thereby regaining better control over monetary aggregates—and greater exchange rate flexibility. At the same time, monetary policy will remain alert to the emergence of inflationary pressures in light of the rapid growth in broad money and evidence—albeit largely anecdotal—of sharp increases in asset prices, especially real estate. Staff recommendation to exercise caution in relaxing interest rate policy further is therefore well taken. On exchange rate policy, the authorities are cognizant of the risks that reduced intervention could lead to a real appreciation of the rupee and ultimately hurt the presently strong pace of export growth. They agree with staff that the best way to safeguard external competitiveness is to accelerate the pace of structural reforms.

The combination of sterilization costs, which have sharply reduced central bank profit transfers to the budget, and the financing needs of the two power utilities (WAPDA and KESC) have placed unexpected strains on the budget. Given the importance of fiscal consolidation to macroeconomic stability and debt reduction and Pakistan's good record of consistently meeting fiscal deficit targets, the authorities will make every effort to achieve the savings required to close the fiscal gap without affecting high-priority social and poverty-reducing expenditures.

In the structural area, tax policy and tax administration reform will continue to be given priority. The authorities are encouraged by the fact that reforms in the Central Board of Revenue (CBR) appear to be bearing fruit, as reflected in the much improved revenue performance. Further reforms will be implemented in light of the FAD report on tax and customs administration. The recently opened pilot tax offices have been well received, there is to be a sweeping reduction of income tax exemptions in the next budget, and the authorities intend to evolve a strategy to deal with the practice of "benami" accounts. Parliament is also expected to take up the draft fiscal responsibility law which, inter alia, defines a multi-year framework for reducing public debt, and it is the intention to work with the provincial governments to extend the relevant provisions of the law to provinces. Staff express concern at the involvement of members of parliament in the selection of local development projects, and fear it may lead to a setback in fiscal management. The authorities wish to reiterate that these development schemes will be subject to the same scrutiny and discipline as other projects in the development budget.

While the authorities remain strongly committed to privatization, their efforts have, in some cases, been frustrated by a lack of investor interest, forcing resort to a negotiated sale. In other cases, the privatization drive is proceeding, with Habib Bank and major public enterprises in the oil and gas sector expected to be privatized in the coming months. A privatization strategy for the national airline (PIA) is also expected to be in place by next year.

The authorities fully share staff's concerns regarding the poor operational and financial performance of WAPDA and the need to address its problems more forcefully. Box 1 of the staff report brings out WAPDA's problems succinctly. Timely and adequate adjustments in tariffs, redoubled efforts to reduce line losses, proceeding with the unbundling of WAPDA, and enforcing bill collection, especially in the Federally Administered Tribal Area (FATA), will be key to improving financial performance.

After a slow start, reflecting capacity constraints, I-PRSP expenditures have risen sharply, especially in regards to education, health, and rural development suggesting that a major expenditure shift towards the social sectors is taking place. Nevertheless, the authorities recognize that the task of capacity building of local elected governments is an on-going process requiring continued commitment. The Poverty Reduction Strategy Paper Preparation Status Report prepared by the Government of Pakistan and the Joint Staff Assessment chart a road map of development of the full-PRSP and describe the challenges ahead, especially in the area of independent monitoring of outcomes and intermediate indicators. However, as the papers note, good progress is being made in this important area.