November 2005
IMF Country Report No. 05/409

Pakistan: 2005 Article IV Consultation and Ex Post Assessment of Longer-Term Program Engagement—Staff Reports; Staff Supplement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Pakistan

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2005 Article IV consultation with Pakistan, the following documents have been released and are included in this package:

- the staff report for the 2005 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on August 26, 2005, 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 October 11, 2005. 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 supplement of November 1, 2005 updating information on recent developments.

- a staff report on ex post assessment of longer-term program engagement, which was completed on October 7, 2005.

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its November 2, 2005 discussion of the staff report that concluded the Article IV consultation.

- a statement by the Executive Director for Pakistan.

The document listed below has been or will be separately released.

Selected Issues and Statistical Appendix

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

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PAKISTAN

Staff Report for the 2005 Article IV Consultation

Prepared by the Staff Representatives for the 2005 Consultation with Pakistan

(In consultation with other departments)

Approved by Amor Tahari and Michael T. Hadjimichael

October 11, 2005

- Discussions for the 2005 Article IV consultations were held in Islamabad and Karachi during August 15–26, 2005. The staff team consisted of Messrs. Zavadjil (head), van Rooden, Schimmelpfennig (all MCD), Baig (FAD), Bhatia (MFD), and Leite (PDR). Messrs. Mirakhor (Executive Director), Khan (MCD), and Zaidi (Senior Advisor to the Executive Director) attended parts of the discussion. The mission was assisted by Mr. Lorie (Senior Resident Representative).
- The mission met with State Bank of Pakistan Governor Husain, Finance Advisor Shah, Finance Secretary Ahsan, and other government officials. The mission also met with representatives of banks, the private sector, and nongovernmental organizations.
- This report was finalized before Pakistan was struck by an earthquake on October 8, 2005. The impact of this tragic event and possible implications for economic policy will be discussed in an update to be issued before the Board meeting.
- Pakistan completed its PRGF arrangement in December 2004. As of August 31, 2005, total Fund credit and loans outstanding to Pakistan amounted to SDR 1.1 billion (105 percent of quota). The Executive Board completed the 2004 Article IV consultation and the ninth and final review under the PRGF on December 1, 2004 (IMF Country Report No. 04/411).
- Pakistan has accepted the obligations of Article VIII. It maintains a restriction subject to Fund approval in the form of a 50 percent limit on advance payments for some imports.
- The exchange rate is described as floating, but has recently followed the U.S. dollar very closely.
- The principal authors of this report are Milan Zavadjil, Ron van Rooden, and Axel Schimmelpfennig, with contributions from Taimur Baig, Ashok Bhatia, Carlos Leite, and Abhisek Banerjee.

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Executive Summary

Macroeconomic performance continues to be strong, but inflationary and external pressures are evident. Economic growth reached 8.4 percent in 2004/05 (July–June) and is expected to remain high. Inflation has accelerated and is likely to stay above the authorities' target over the coming year. Import growth has also been rapid, moving the current account into deficit during 2004/05, despite higher worker's remittances.

Indicators point to progress toward poverty reduction. High growth, including in agriculture, is estimated to have raised disposable incomes. A recent survey shows improvements in various health and education outcomes. Further increases in health and education spending are nonetheless needed to achieve the Millennium Development Goals.

Pakistan's medium-term outlook is favorable. The authorities' ambitious growth objectives require substantial increases in investment, including from the private sector. Public investment has been increased to ease bottlenecks in transportation, irrigation, and energy. Likewise, reforms to improve the investment climate are being undertaken, though weak governance in some public sector institutions remains a problem.

In the short-run, macroeconomic policies need to be tightened somewhat to counter inflationary and external pressures. The State Bank of Pakistan (SBP) has raised its policy rates substantially, but key interest rates remain slightly negative in real terms. Further increases in interest rates seem warranted as monetary growth is still high. A modest tightening of fiscal policies relative to the budget would alleviate demands on monetary policy. The government has already taken steps to offset pressures on the budget from rising oil prices, but for 2005/06, a small increase in the deficit is still projected. Some additional revenue effort and tight expenditure control could contain the deficit at last year's level.

Better revenue performance is needed to achieve medium-term fiscal objectives. The government is targeting higher social and development spending, while further reducing the debt-to-GDP ratio. Stronger tax efforts will be required to achieve these targets. Enhancing compliance of existing tax payers is a first step to improving collection, but a strategy to extend the tax net into the service and agriculture sectors needs to be developed quickly.

Vulnerabilities have been reduced. Debt dynamics are favorable, and international reserves are adequate. The real effective exchange rate has appreciated slightly in early 2005, but competitiveness is not a concern so far. The financial sector has strengthened further as reflected in financial soundness indicators and resilience in standard stress tests.

Structural reforms are progressing. The sale, together with management control, of 26 percent of the public telecommunication company was the largest transaction so far in Pakistan's privatization program. The sale of several other important companies is under way. However, energy sector reforms are taking longer than envisaged.

I. INTRODUCTION

1. **The key challenge facing Pakistan is to continue building on the impressive economic gains of the last half decade.** Persistent implementation of reforms has paid off: growth in 2004/05 was amongst the highest in the world; vulnerabilities have been reduced; and Pakistan has regained access to international capital markets. While the acceleration of inflation and the emergence of a current account deficit are to some extent the "price of success," they point to the need for careful macroeconomic management, including to deal with the oil price shock. But this should not detract from recent achievements. Moreover, Pakistan is better placed than at any time in the recent past to sustain growth over the medium term and achieve a lasting reduction in poverty.

2. **Cooperation with the Fund has been fruitful.** In contrast to earlier experience, the 2000 Stand-By Arrangement and the 2001–04 arrangement under the Poverty Reduction and Growth Facility were implemented steadfastly, as discussed in the Ex Post Assessment of Pakistan's Longer-Term Program Engagement (Box 1, refer to www.imf.org). Furthermore, many of the recommendations made during recent Article IV consultations have been implemented (Text Table 1).

3. **The political and security situation has been calmer in recent months.** Local elections in August gave support to the ruling coalition, although there was some scattered violence. With parliamentary elections scheduled for 2007, there is now a window to address remaining macroeconomic and structural problems. Pakistan and India continue working to enhance economic integration, including through the framework of the South Asian Free Trade Area.

Box 1. Ex Post Assessment of Pakistan's Longer-Term Program Engagement

The main findings of the ex post assessment (refer to www.imf.org) were:

- Pakistan's Fund-supported programs during 2000–04 were successful because of strong ownership, especially by the central government. International support helped the recovery from late 2001.

- Progress was slower in areas where broader institution building or cooperation from lower levels of government was needed. Tax collection remains disappointing and the energy sector continues to pose a large drain on the budget. This highlights the complexities in designing structural conditionality, which seems more effective in areas covered by the central government.

The authorities generally welcomed the report's findings. They emphasized that increased ownership was indeed the main factor behind the economic turnaround. As such, while some officials viewed conditionality under the 2000 Stand-By Arrangement as punitive, others said that most of the measures needed to be implemented regardless of the Fund. The authorities expressed frustration with the frequent need for waivers of structural performance criteria, even for minor deviations or brief delays. They urged the Fund to review its procedures for deciding whether a performance criterion has been met or not.

Text Table 1. Pakistan: Authorities' Response to Fund Policy Advice

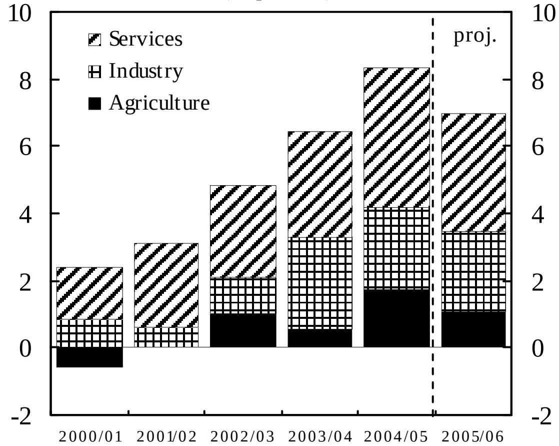
Key Recommendations	Implementation
Fiscal and Monetary Policies	
Reduce public and external debt burden.	Debt-to-GDP ratios have improved sharply.
Limit interest rate and exchange rate risk.	Domestic borrowing was mainly short term (less than 1 year). External borrowing was largely on concessional terms.
Strengthen revenue mobilization.	Tax-to-GDP ratio fell in 2004/05 and is projected to remain flat in 2005/06.
Raise social and development spending.	Substantial increases in real per capita terms over last 5 years.
Pass-though of international oil prices.	Substantial pass-through, though domestic prices for some products are below border prices.
Tighten monetary policy more forcefully.	Policy rates have been raised significantly since early 2005.
Structural Policies	
Continue financial sector reform strategy and follow up on FSSA recommendations.	Additional provisioning requirement for consumer credit introduced, Debt Office functional and debt policy being developed, AML/CFT law approved by Cabinet.
Divest remaining public sector banks.	Ongoing. Authorities see merit in retaining one large public sector bank.
Press ahead with privatization.	Telecommunication company successfully privatized. List of companies to be privatized expeditiously approved.
Complete energy sector reforms.	Some progress in unbundling of power utility. Regional tariff framework still outstanding.
Improve business and investment climate.	Streamlining of tax system, and many other measures.
Introduce medium-term budget framework.	Pilot has been rolled out to two line ministries.
Enhance statistics.	Intermediate outcome indicators survey results published, household survey about to be published. Quarterly national accounts still not complete. Fiscal data problems remain.

Source: Fund staff.

II. Recent Economic Developments

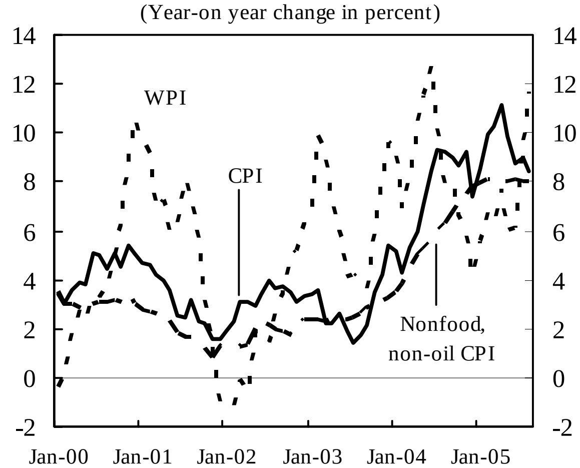
4. **Pakistan's macroeconomic performance continues to be favorable, but inflationary and external pressures are evident.** Growth is estimated to have reached 8.4 percent in 2004/05 with strong domestic consumption and investment demand offsetting the adverse impact from net exports (Text Figure 1, Text Table 2, and Table 1). Rapid growth continued in manufacturing, partly export driven. Timely rains contributed to bumper harvests. However, 12-month inflation reached 11 percent in April 2005, before easing to 8.4 percent in August (Text Figure 2), reflecting monetary tightening and government measures to increase food imports (including from India). Core inflation has remained at 8 percent in 2005. Asset prices (including real estate) had shot up, but have cooled since the stock market correction in March 2005. The correction did not have a significant impact on economic activity (Box 2).

Text Figure 1. Pakistan: Contributions to Growth, 2000/01–2005/06
(In percent)



Sources: Pakistani authorities, and Fund staff estimates.

Text Figure 2. Pakistan: Inflation, 2000:1–2005:8
(Year-on year change in percent)



Sources: Pakistani authorities, and Fund staff estimates.

Text Table 2. Pakistan: Key Economic Indicators, 2000/01–2005/06

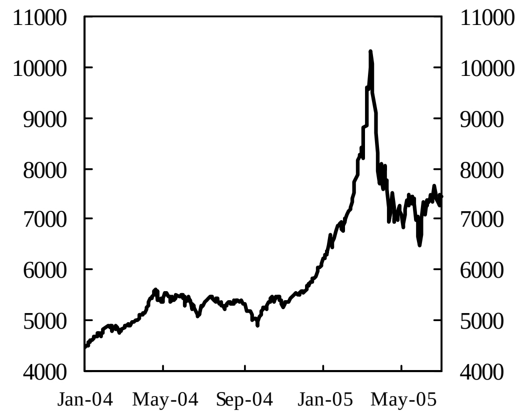
	2000/01	2001/02	2002/03	2003/04	2004/05 Est.	2005/06 Proj.
Output and prices			(Annual changes in percent)			
Real GDP at factor costs	1.8	3.1	4.8	6.4	8.4	7.0
Consumer prices (period average)	4.4	2.5	3.1	4.6	9.3	9.0
Public finances			(In percent of GDP)			
Revenues (including grants)	14.3	16.1	17.4	14.9	14.0	13.2
Tax revenues	10.6	10.9	11.5	11.1	10.0	9.9
Collected by Central Board of Revenues	9.4	9.2	9.5	9.4	9.0	9.1
Expenditures (including statistical discrepancy)	17.6	19.7	18.7	16.7	17.1	16.8
Budget balance (excluding grants)	-4.3	-5.5	-3.8	-2.3	-3.3	-3.8
External sector						
Current account excluding official transfers	-2.7	0.1	3.8	1.4	-1.6	-2.5
Gross reserves (in millions of U.S. dollars)	1,679	4,330	10,251	10,621	9,985	12,006
In months of next year imports of goods and services	1.7	3.7	6.4	5.2	4.1	4.5

Sources: Pakistani authorities; and Fund staff estimates.

Box 2. Stock Market Developments

Equity prices have risen substantially over the last 3½ years before suffering a correction in early 2005 (Text Figure 3). The performance through 2004 reflected largely the economic turnaround, while privatization prospects lifted share prices of partly floated public enterprises. However, the 65 percent increase during the first 2½ months of 2005 appears to have been speculative. An inquiry into the boom and subsequent correction found that some key players abused weaknesses in the system to profit from price manipulations. In particular, the *badla*[1/] facility to finance stock purchases was abused to influence market liquidity. Since the initial correction by 25–30 percent in March 2005, the market has stabilized and is still up substantially on the year (with P/E ratios of around 12). Regulatory actions have been taken to address shortcomings that contributed to the bubble: *Badla* financing has been replaced with a "continuous funding system," which requires more due diligence by the creditor; and group accounts, which were sometimes abused to circumvent margin requirements, have been prohibited.

Text Figure 3. Pakistan: Karachi Stock Exchange 100 Index, 2004:1–2005:8

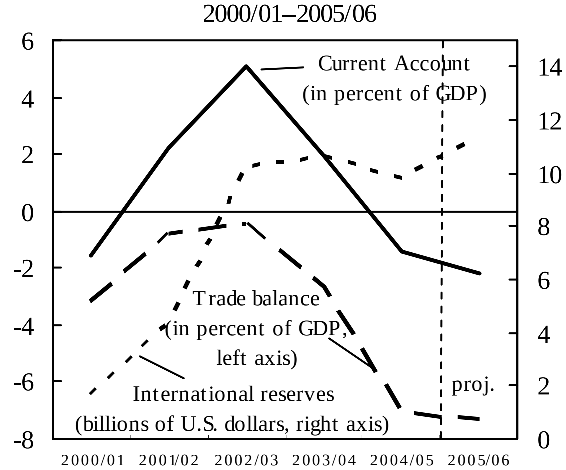


Sources: Pakistani authorities, and Fund staff estimates.

1/ A facility to finance stock purchases akin to a repo transaction that allowed the buyer to postpone settlement indefinitely.

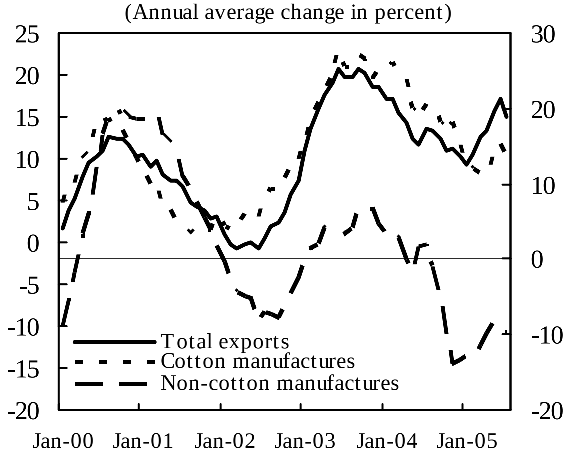
5. **Despite higher worker's remittances, the current account moved into deficit in 2004/05** (Text Figure 4 and Table 2). Exports and imports have grown rapidly (Text Figures 5 and 6). Following the end of the textile quota system, textile exports rose by 15 percent in the first six months of 2005 over the same period in 2004. Faster import growth reflected both higher oil prices and strong demand, including for machinery. Gross international reserves fell somewhat in 2004/05 to $10 billion (over four months of projected imports), notwithstanding a continued increase in non-debt-creating inflows and substantial concessional financing by the Asian Development Bank and the World Bank Group.

Text Figure 4. Pakistan: External Developments, 2000/01–2005/06



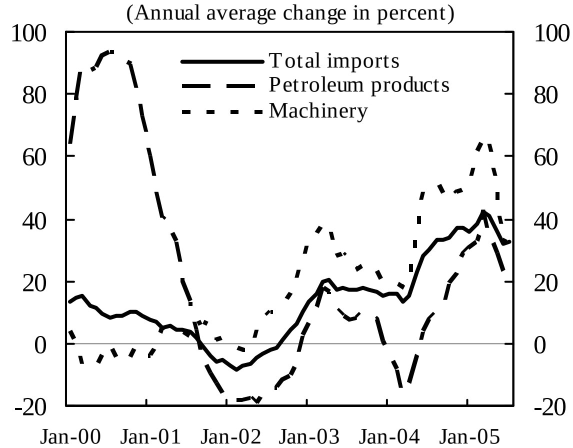
Sources: Pakistani authorities, and Fund staff calculations.

Text Figure 5. Pakistan: Export Performance, 2000:1–2005:7
(Annual average change in percent)



Sources: Pakistani authorities, and Fund staff estimates.

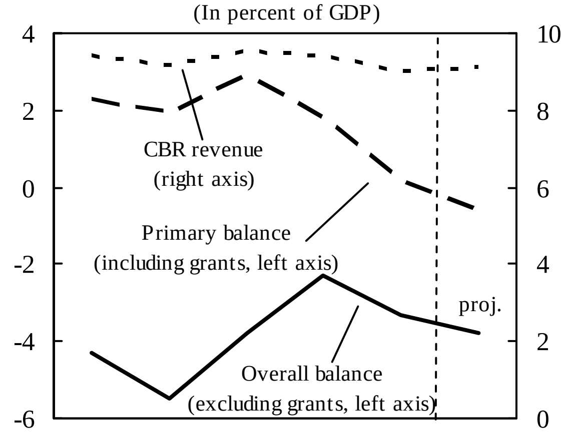
Text Figure 6. Pakistan: Import Performance, 2000:1–2005:7
(Annual average change in percent)



Sources: Pakistani authorities, and Fund staff estimates.

6. **Fiscal targets for 2004/05 were broadly met.** The overall deficit (excluding grants) was 3.3 percent of GDP, roughly in line with the budget, but up 1 percentage point over the 2003/04 outcome (Text Figure 7 and Table 3). Compared with the budget, the drop in the tax-to-GDP ratio and modestly higher-than-budgeted spending were largely offset by higher nontax revenues. While the Central Board of Revenues (CBR) met its nominal target, the tax ratio fell because of the elimination of excises on petroleum products (to offset rising international oil prices) and a number of tax relief measures. Higher expenditures occurred mostly on account of defense and provincial development outlays.[1] To a lesser extent, subsidies also increased, notably to the power utilities. The Water and Power Development Authority's (WAPDA) performance deteriorated again because of reduced availability of low-cost hydropower (Tables 4 and 5). On the positive side, government debt fell substantially to 61 percent of GDP.

Text Figure 7. Pakistan: Fiscal Developments, 2000/01–2005/06
(In percent of GDP)

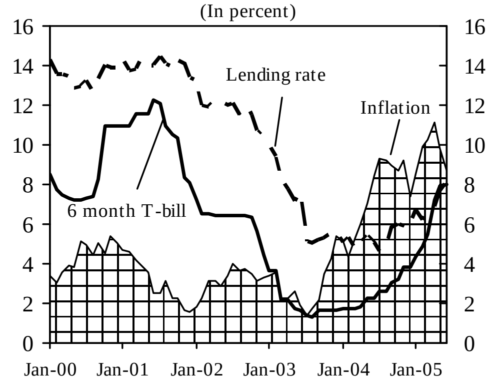


Sources: Pakistani authorities, and Fund staff estimates.

[1] Provincial development spending may be overstated as indicated by the statistical discrepancy.

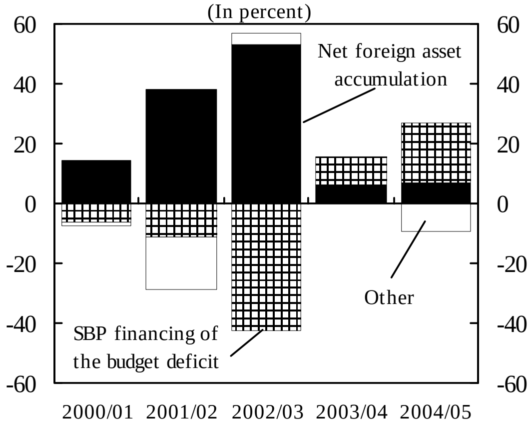
7. **The SBP has tightened monetary policy significantly.** In addition to inflation going into double digits, capacity utilization rates had reached 80–100 percent in some key industries (Text Table 3). Since the beginning of 2005, the SBP has raised the six-month treasury bill (T-bill) rate by more than 4 percentage points to 8 percent in May, but has since kept it broadly unchanged; key interest rates still remain slightly negative in real terms (Text Figure 8). Despite the tightening, reserve money growth has not yet slowed because the SBP provided substantial budget financing during 2004/05 as the government's gross financing needs could not be fully met from the market at prevailing rates (Text Figure 9). Consequently, monetary aggregates expanded rapidly (Text Figure 10, and Tables 6 and 7).

Text Figure 8. Pakistan: Interest Rates and Inflation, 2000:1–2005:6
(In percent)



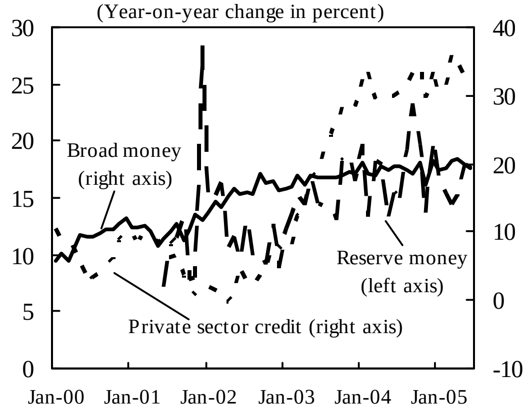
Sources: Pakistani authorities, and Fund staff estimates.

Text Figure 9. Pakistan: Contributions to Reserve Money Growth, 2000/01–2004/05
(In percent)



Sources: Pakistani authorities, and Fund staff estimates.

Text Figure 10. Pakistan: Monetary Growth, 2000:1–2005:6
(Year-on-year change in percent)



Sources: Pakistani authorities, and Fund staff estimates.

Text Table 3. Pakistan: Capacity Utilization, 2003/04–2004/05
(In percent)

	2003/04				2004/05			
	Sep.	Dec.	Mar.	Jun.	Sep.	Dec.	Mar.	Jun.
Edible oil & ghee	39.0	40.0	39.1	39.9	38.9	40.0	40.2	42.0
Automobiles	52.8	59.8	62.3	67.0	53.7	58.3	59.7	65.4
Electronics	35.7	40.8	50.2	59.8	19.9	22.0	27.3	31.4
Cement	72.3	71.2	73.3	75.9	83.4	81.7	79.9	84.0
Steel (Pak Steel)	92.0	99.0	90.0	93.6	98.0	95.0	91.0	72.0
Industrial chemicals	83.5	86.6	87.9	88.8	95.6	96.6	97.6	98.8
Paper & paper board	99.9	98.2	97.2	97.2	98.8	99.7	101.3	100.8

Sources: Pakistani authorities, and Fund staff calculations.

8. **Progress has been made in structural reforms, notably privatization.** In June, the largest privatization transaction in Pakistan's history took place, with the sale, together with management control, of 26 percent of the Pakistan Telecommunication Company Ltd. The winning bid amounted to $2.6 billion (2¼ percent of GDP). The sale of several other major companies is under way, including Pakistan Steel and Pakistan Petroleum. However, the sale of the Karachi Electric Supply Corporation has been delayed, as the auction winner did not meet the payment deadline. Negotiations are continuing with the other auction participant. Energy sector reforms have again taken longer than envisaged. While some progress has been made in unbundling WAPDA, the individual distribution companies still cannot operate independently because their tariffs have not been set.

III. Report on the Discussions

9. **The key challenges facing Pakistan are to sustain strong growth over the medium term and improve living standards, while tackling existing and emerging vulnerabilities.** Medium-term growth prospects depend importantly on addressing infrastructure bottlenecks and emerging skill shortages, while improving the investment climate. Progress on poverty reduction will require further increases in social spending, particularly on health and education. Concurrently, Pakistan should strive to further reduce its still relatively high public debt burden. Raising the revenue ratio will be essential to achieving these objectives simultaneously. Against this background, discussions focused on:

- sustaining growth over the medium term;
- the appropriate macroeconomic policy mix in 2005/06;
- identifying and addressing vulnerabilities;
- improving revenue performance; and
- assessing poverty reduction efforts.

A. Sustaining Strong Economic Growth

10. **The authorities are targeting growth in the 6–8 percent range over the medium term,** which they consider the minimum to achieve their development objectives and substantial poverty reduction.[2] They were confident that the institutional reforms of the past five years (including the Fiscal Responsibility Law,[3] more central bank independence, financial sector reforms, and privatization) had laid the basis for noninflationary growth. But

[2] Growth sustainability in Pakistan is analyzed in the accompanying Selected Issues paper (refer to www.imf.org).

[3] The Fiscal Responsibility Law, inter alia, requires that government debt is reduced by 2½ percentage points per year, places a ceiling on government guarantees, and calls for social and poverty-related expenditures of at least 4 percent of GDP. See also Selected Issues paper IMF Country Report No. 02/247.

substantial public infrastructure investments were still needed to remove key bottlenecks in the areas of transportation, irrigation, and energy. Moreover, reforms to improve the business and investment climate are in progress, including streamlining the tax and judicial systems, and overhauling regulations and procedures that slow private sector development. To address emerging skill shortages, the authorities are strengthening higher education and technical training.

11. **Public sector governance remains an irritant to some private investors.** A recent International Finance Corporation study lists land regulations, tax administration, business registration procedures, and labor regulations as significant investment barriers. Liberalization, updating legal frameworks (some dating back to colonial times), labor reform, automation and e-government solutions, as well as one-stop shops are proposed in the study to improve the investment climate. According to World Bank staff data, corruption is still a frequent phenomenon in interactions with the government. Nevertheless, according to the World Bank's 2005 Doing Business survey, Pakistan made progress in enhancing the business climate and compares well within the region. The authorities said they were putting priority on creating an environment conducive to investment. Governance in key macroeconomic institutions, including transparency, had already been improved, as attested to by the data, fiscal transparency, and various financial ROSCs.

12. **The authorities considered Pakistan well placed to benefit from regional and global opportunities.** Improved relations with India are setting the stage for bilateral trade to increase rapidly from its current depressed levels. Likewise, the reconstruction of Afghanistan is offering business opportunities. The opening of Gwadar port should make Pakistan a regional transport hub, serving central Asia and some parts of China. Staff stressed the need for export diversification to make the economy less vulnerable.

B. The Macroeconomic Policy Mix for 2005/06

13. **The growth outlook for 2005/06 is favorable.** The authorities and staff largely agreed on macroeconomic prospects for 2004/05. Growth is projected at 7 percent as the contribution of agriculture is expected to return to a more normal but positive level. However, there is still a weather-related risk that agricultural output will be lower than projected. High international oil prices and their impact on global demand pose another downside risk, but are unlikely to cause a major slowdown given the domestic demand momentum. Many indicators show that investment has been rising and new capacity will come on stream during 2005/06 (Text Table 4); however, national accounts data appear to understate private investment because of incomplete coverage of firms and underreporting. In addition, strong export growth should continue, assuming the textile industry continues to adjust successfully to new world market conditions. Inflation has settled in the 8–9 percent range, though the authorities see more signs of an immediate decline than the staff. The current account deficit is projected to widen, in part reflecting the oil price increases, but privatization inflows are expected to boost international reserves to $12 billion by end-2005/06.

Text Table 4. Pakistan: Investment Indicators, 2000/01–2004/05
(In percent of GDP)

	2000/01	2001/02	2002/03	2003/04	2004/05
Gross capital formation	17.2	16.8	16.9	17.3	16.8
Gross fixed capital formation	15.8	15.5	15.3	15.6	15.3
Government	2.2	2.9	2.7	2.9	3.5
Private	13.7	12.6	12.6	12.7	11.8
Change in inventories	1.4	1.3	1.7	1.7	1.6
Import of machinery	...	...	3.6	4.4	5.3
Foreign direct investment	0.5	0.5	0.7	0.8	1.1
Commercial credit	14.9	13.9	14.8	17.1	19.0

Sources: Pakistani authorities, and Fund staff calculations.

14. **The 2005/06 budget targets an increase in the overall deficit to 3.8 percent of GDP.** This reflects a drop in nontax revenues, which is only partly offset by expenditure restraint. However, nontax revenues are budgeted conservatively, as previously. CBR revenue is projected to remain almost flat in percent of GDP; again, a number of tax relief measures for exporters and manufacturing were introduced in the budget. Expenditures are envisaged to decline relative to GDP in several categories, including defense and subsidies, which may be ambitious, while development outlays remain unchanged. Even with the increase in the fiscal deficit, government debt would fall to 53 percent of GDP given a very favorable growth-interest differential and substantial privatization receipts.

15. **The government has taken steps to offset pressures on the budget from rising international oil prices and should be able to achieve the target.** The authorities agreed that high oil prices no longer appeared temporary and that the differential between international and domestic oil prices could undermine the budget (Box 3). As such, significant increases in petroleum retail prices were implemented in September and October. In addition, the government is now targeting modestly higher-than-budgeted CBR revenues, and has increased nontax revenue projections to more realistic levels. Expenditures will be tightly controlled, with priority given to achieving the development spending target.

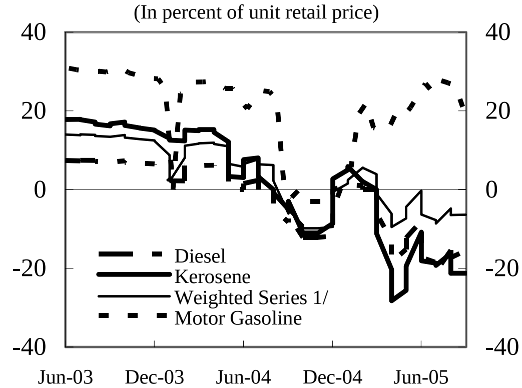
16. **Staff called for containing the deficit to last year's level to alleviate the demands on monetary policy.** With the economy operating close to potential and domestic demand growing rapidly, a fiscal impulse seems untimely. The concomitant financing needs are likely to require T-bill rate increases in excess of what may otherwise be needed to contain inflation and could crowd out the private sector. Absent such harsh tightening, the SBP might—as in 2004/05—again be forced to provide substantial budget financing, which would add to inflationary pressures. The authorities stressed the importance of meeting Pakistan's growing infrastructure needs. They could not commit to keeping the deficit below the budgeted 3.8 percent of GDP, but said they would seize any opportunity to minimize the increase in the deficit, including through further oil prices adjustments.

Box 3. The Impact of Global Oil Price Increases

Rising international oil prices have not yet had any visible adverse impact on growth. About 40 percent of Pakistan's energy consumption is petroleum-related, and virtually all petroleum products are imported. Nonetheless, the impact on growth has been negligible so far, partly because adjustment of domestic retail prices has been incomplete, but also because rising investment, consumer confidence, and favorable agricultural output have helped sustain growth. High oil prices resulted in a current account deterioration of 1 percent of GDP in 2004/05; a similar impact is projected for 2005/06.

The automatic oil price adjustment mechanism has been suspended. Previously, retail prices were adjusted fortnightly according to the import-parity price, adding freight, distribution costs, dealer margin, sales tax, and a levy, which generated up to 1 percent of GDP in revenues. As oil prices rose, the government smoothed the impact on domestic prices by lowering the levy (Text Figure 11), and raising consumer prices only occasionally. By May 2004, the average levy was zero, and the government had to provide an outright subsidy, in addition to some cross-subsidization between products.

Text Figure 11. Pakistan: Petroleum Levies (+) and Subsidies (-), 2003:6–2005:9
(In percent of unit retail price)



Sources: OCAC, and Fund staff estimates.
1/ The weighted series takes into account the relative quantity of each product sold.

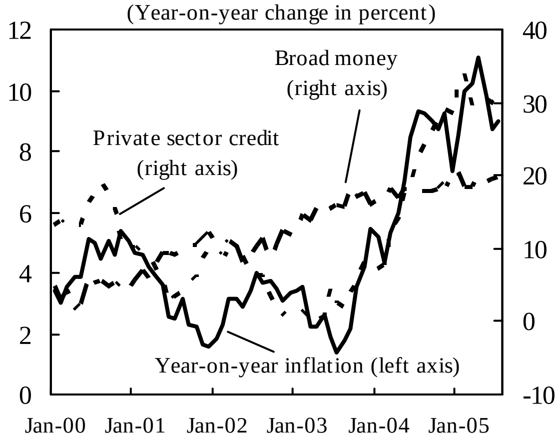
Incomplete adjustment of retail prices is exerting pressures on fiscal policy. In 2004/05, the fiscal deficit was about 1 percent of GDP higher due to lost revenues and increased subsidies. For 2005/06, the authorities have again budgeted negligible revenues and a subsidy. The recent rise in oil prices has been largely offset by the increases in retail prices in September and October. No significant additional pressures are expected if WEO oil price projections materialize.

17. **The authorities intend to rely on monetary policy to contain inflation, with fiscal policy laying the basis for medium-term growth.** They were confident that the recent tightening of monetary policy, combined with measures to increase domestic food supply, would be sufficient to achieve the 8 percent inflation target in 2005/06. Nevertheless, as stated in the July 2005 monetary policy statement, the SBP stood ready to raise T-bill rates further if necessary. The authorities agreed that external privatization receipts needed to be at least partly sterilized to prevent lower interest rates from undermining the SBP's anti-inflation stance.

18. **Staff cautioned that inflation may not decrease soon and that somewhat tighter monetary and fiscal policies were needed.** Given the authorities' policy mix, staff projects 12-month inflation at about 9 percent by June 2006, reflecting lags in monetary policy transmission (Text Figure 12), the fact that lending rates have yet to fully reflect rising T-bill rates (Text Figure 13), and the recent pass-through of petroleum price increases. While moderate inflation may have limited adverse effects in the short-run, staff believes there is a

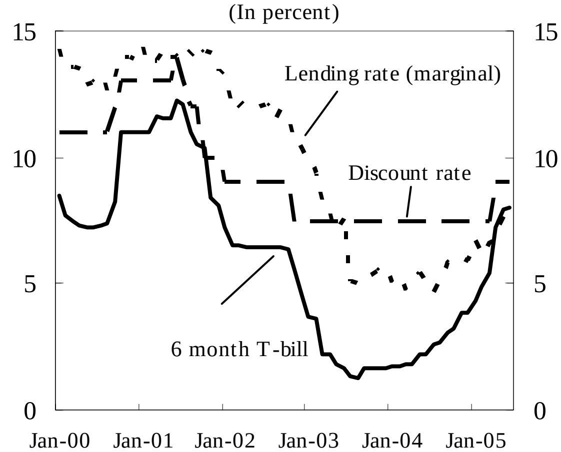
risk that inflationary expectations become ingrained around 10 percent. Perhaps more importantly, there is a risk that external imbalances could build, as indeed suggested by July–August 2005 trade data. Eventually, a much harsher tightening to restore macroeconomic stability could be required with adverse effects on growth. However, with a neutral fiscal stance and suitable monetary tightening, 12-month inflation could come down more quickly, and inflationary expectations would be re-aligned with the government's target range. The current very rapid import growth would also decelerate more sharply.

Text Figure 12. Pakistan: Monetary Growth Leads Inflation by 12 months, 2000:1–2005:7
(Year-on-year change in percent)



Sources: Pakistani authorities, and Fund staff estimates.

Text Figure 13. Pakistan: Policy Transmission to Interest Rates, 2000:1–2005:6
(In percent)

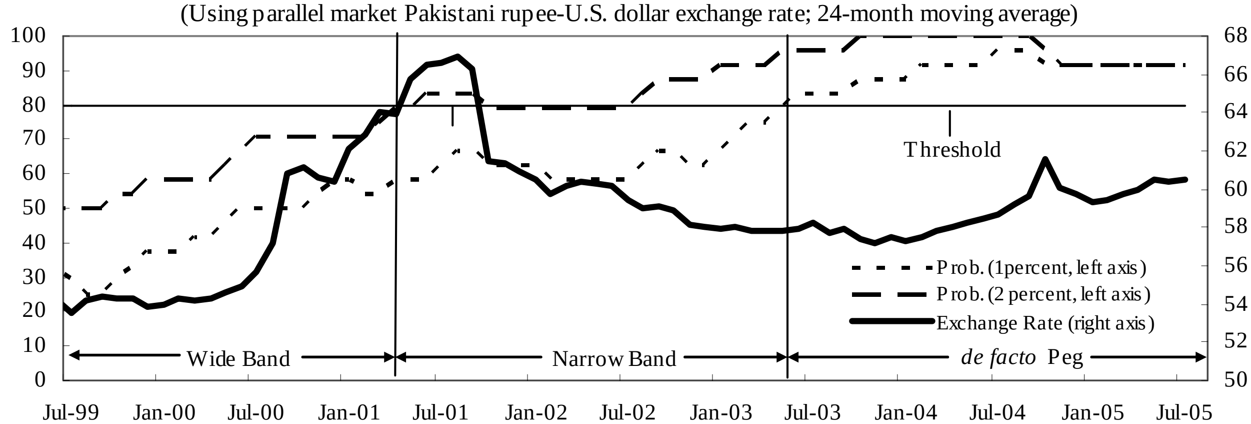


Sources: Pakistani authorities, and Fund staff estimates.

19. **The real exchange rate level is broadly appropriate.** Staff noted that, based on the Reinhart/Rogoff [4] approach, the Pakistani rupee appears to be de facto pegged to the U.S. dollar (Text Figure 14). This has led to a minor real appreciation, given relatively high domestic inflation (Text Figure 15). Nevertheless, the SBP sees the Pakistani rupee as appropriate or even slightly undervalued relative to Pakistan's trading partners and competitors. Staff agreed that the real exchange rate level was broadly appropriate, citing strong export growth, rising market share, the small variation of the real effective exchange rate, and a still limited current account deficit, partly driven by investment activities (Box 4).

[4] Reinhart, C. and K. Rogoff , "The Modern History of Exchange Rate Assessments: A Re-interpretation," NBER Working Paper 8963, 2002.

Text Figure 14. Pakistan: De facto Exchange Rate Arrangement, 1999:5–2005:7 1/
(Using parallel market Pakistani rupee-U.S. dollar exchange rate; 24-month moving average)

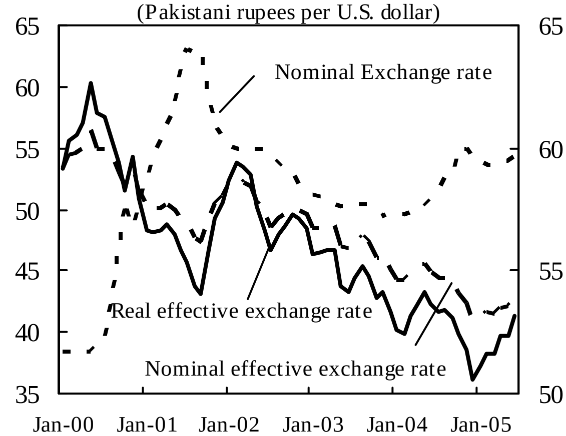


Sources: Pakistani authorities, and Fund staff estimates.

1/ De facto exchange rate classification according to Reinhart/Rogoff (2002): 'Prob.(1 percent)' depicts the occurrences of month-on-month exchange rate movements by less than +/- 1 over a 24-month moving window. If the probability is 80 percent or higher, the regime is classified as a de facto peg. 'Prob.(2 percent)' depicts the occurrences of month-on-month exchange rate movements by less than +/- 2 over a 24-month moving window. As long as this line stays above 80 percent, the regime is classified as de facto band.

20. **But staff cautioned that further real exchange rate appreciation would undermine competitiveness.** The deterioration in the terms of trade, rapid import growth, and the need for incentives for the textile sector suggested that nominal exchange rate flexibility could be needed quite soon to protect competitiveness, if the inflation differential is not reduced. The SBP reiterated its commitment to exchange rate flexibility, but would continue to intervene in the foreign exchange market to prevent excess volatility.

Text Figure 15. Pakistan: Exchange Rates, 2000:1–2005:6
(Pakistani rupees per U.S. dollar)



Sources: Pakistani authorities, and Fund staff calculations.

Box 4. Assessment of External Competitiveness

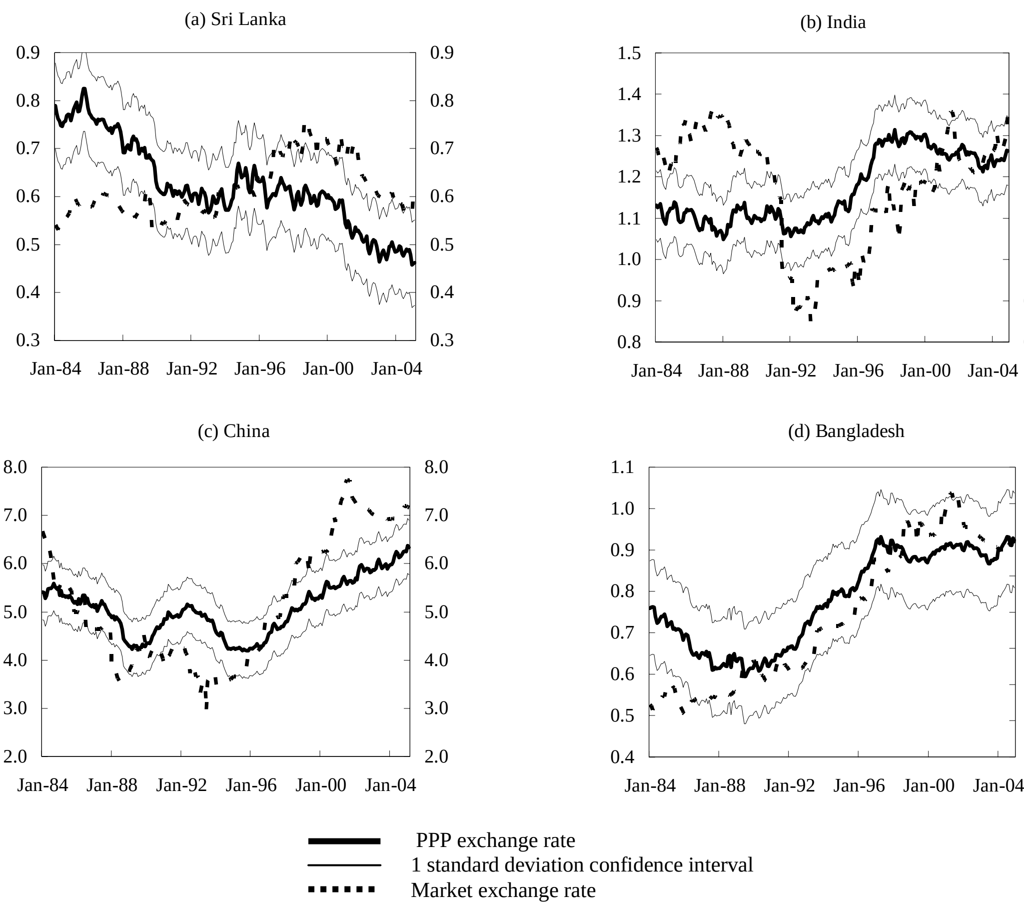
Pakistan's real effective exchange rate has been on a depreciating trend for the last five years. However, with the modest appreciation in the first half of 2005 and the shift of the current account into deficit, the issue of real exchange rate appropriateness has emerged again.

The strong performance of Pakistan's exports, including the shift toward manufactured exports and the increase in market share, is not a definitive indicator of competitiveness, given that Pakistan is opening up to trade and that imports have also increased rapidly. However, the widening trade deficit has been partly financed by a significant increase in private transfers, and the recent surge in imports has been fuelled in good part by imports of machinery, an indication that cyclical factors may explain these developments.

A cross-country comparison of price levels does not show evidence of misalignment of the Pakistani rupee. Looking at bilateral purchasing power parity (PPP), exchange rates for four important competitors suggest that market exchange rates are broadly in line with the predictions of relative PPP theory (Text Figure 16). Bilateral market exchange rates lie mostly within, or close to, the illustrated band of ±1 standard deviation of the PPP exchange rate—or the level consistent with a constant real exchange rate over the past two decades.[1/]

Text Figure 16. Pakistan: Bilateral Exchange Rates, 1984:1–2005:7

(Pakistani rupees per national currency)



Sources: Pakistani authorities, and Fund staff estimates.

1/ See also the analysis in the accompanying Ex Post Assessment (refer to www.imf.org).

C. Vulnerabilities Have Been Reduced

21. **Debt dynamics appear favorable over the medium term.** The authorities noted that the recently approved Fiscal Responsibility Law mandates continued debt reduction by at least 2½ percent of GDP per year. Staff projects domestic and external debt to continue on their downward path (Table 8), assuming that real growth steadies at 6 percent, external and domestic demand remain robust, and the fiscal deficit is restrained below 4 percent of GDP (Tables 9, 10 and Figures 1, 2). The trajectory of debt reduction, however, gradually flattens as the growth-interest rate differential narrows from the currently highly favorable gap.[5] Also, the debt-to-revenues and debt-to-exports ratios remain high, reflecting the relatively small values of Pakistan's government revenues and exports. However, rollover and interest rate risks are modest and exchange rate risk is comparable to other emerging markets. Debt sustainability bound tests indicate that the public debt path would remain on a downward trend with shocks to growth, or the primary fiscal balance. However, a large exchange rate depreciation would raise the debt-to-GDP ratio, though, subsequently, it would return to its downward trend.

22. **Under the authorities' scenario, the debt burden is reduced more rapidly.** This assumes growth rising to 8 percent in 2008/09, and the fiscal deficit gradually being reduced to 3.3 percent of GDP in 2009/10, as a result of stronger revenue mobilization. Staff strongly supported the intention to bring the deficit down to the 2004/05 level, and urged that this be done as soon as possible. Nonetheless, staff is somewhat more cautious on revenue projections given the recent track record.

23. **Under an alternative low-growth scenario, government debt to GDP would stabilize at the 2005/06 level as lower revenue and higher interest costs push up the deficit.** Such a scenario could be triggered by either a slowing world economy or domestic turbulence that limits investment. The projections abstract from policy responses, which would be required under the Fiscal Responsibility Law. On the external side, the current account deficit would be somewhat higher, calling for additional commercial borrowing by the government (Tables 11 and 12).

24. **The authorities considered the current international reserves level adequate.** They were not concerned about the modest fall in reserves during 2004/05, and argued that the current account deficit was largely covered by non-debt-creating flows. There were no sustained pressures on the exchange rate. A further increase in international reserves should be realized in 2005/06 on account of external privatization receipts. Staff welcomed the sharp increase in reserves since 2001, which has allowed Pakistan to catch up with levels maintained by similarly-placed countries (Text Figures 17a and 17b). Pakistan's reserves

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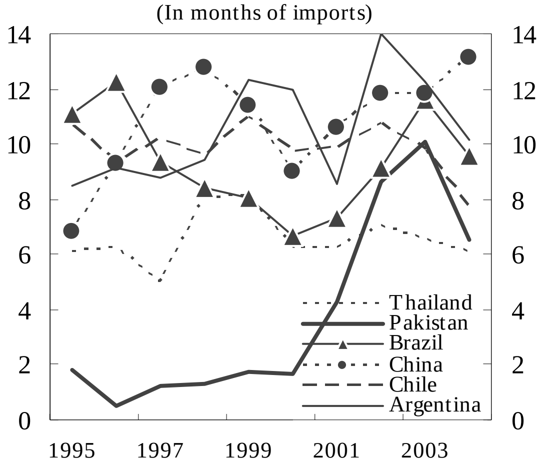
[5] External debt is largely on concessional terms, and the average domestic interest rate has come down as some instruments have been better aligned with market rates. However, with domestic rates on the rise, the differential is projected to narrow.

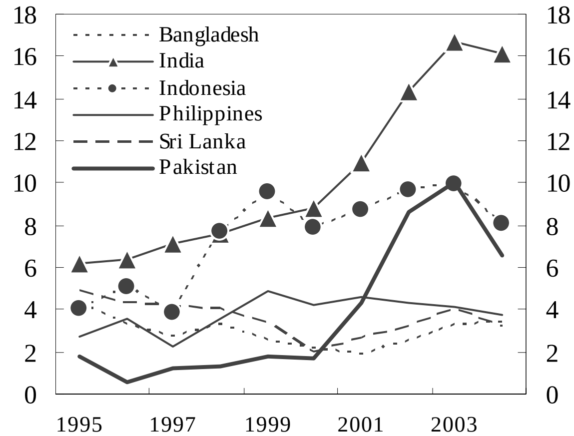
holdings appear in line with cross-country benchmarks, but are by no means excessive (Text Table 5). Staff also noted that it will be important to use privatization receipts in 2005/06 and beyond to build reserves, as Pakistan integrates into the world economy.

Text Figure 17a. Pakistan: International Reserves in Comparison with Emerging Markets, 1995–2004
(In months of imports)



Sources: Pakistani authorities, and Fund staff estimates.

Text Figure 17b. Pakistan: International Reserves in Regional Comparison, 1995–2004
(In months of imports)



Sources: Pakistani authorities, and Fund staff estimates.

Text Table 5. Pakistan: Benchmarks for Reserve Adequacy, 2003–04
(In millions of U.S. dollars)

Part A. Kim et al. (2004) 2/

	Imports (3 months; following year) (A)	Short-term external debt 1/ (B)	Foreigners' Portfolio Investment (C)	International Reserves Predicted (A)+(B)+(C*0.3)	International Reserves Actual
2003	4,041	5,329	1,400	9,790	10,941
2004	5,061	4,898	1,805	10,500	9,799

Part B. Wijnholds and Kapteyn (2001) 3/

	Short-term external debt 1/ (A)	Fraction of Broad Money: Lower range (10 percent) (B-lower)	Fraction of Broad Money: Upper range (20 percent) (B-upper)	Country risk Index (EIU) (C)	International Reserves Predicted: Lower range (A)+(B*C)	International Reserves Predicted: Upper range (A)+(B*C)	International Reserves Actual
2003	5,329	3,957	7,913	0.58	7,623	9,918	10,941
2004	4,898	4,676	9,353	0.54	7,423	9,949	9,799

Sources: Pakistani Authorities; and Fund staff calculations.

1/ Includes short-term debt (by initial maturity) and debt service on medium- and long-term scheduled for the following year.

2/ Kim, J., J. Li, R. Rajan, O. Sula, and T. Willett (2004) "Reserve Adequacy in Asia Revisited: New Benchmarks Based on the Size and Composition of Capital Flows". Paper presented at Claremont-KIEP Conference.

3/ Wijnholds, J. and A. Kapteyn (2001) "Reserve Adequacy in Emerging Market Economies", IMF Working Paper 01/143.

25. **To maintain market presence, the authorities intend to continue tapping international capital markets once per year.** Given the availability of concessional financing and privatization receipts, Pakistan does not need market financing. Nevertheless, maintaining market presence following successful recent issues is considered essential by the authorities. Staff cautioned that external bonds should be designed to minimize the build-up of rollover, exchange rate, and interest rate risks.

26. **The authorities pointed to further strengthening of the financial sector.** Banks' financial soundness indicators have improved, and the sector shows resilience in standard stress tests (Box 5 and Table 13). Staff questioned whether another increase in the absolute minimum capital requirement was necessary given the improving capital adequacy ratio. The authorities argued that some banks were too small and further consolidation was needed. Staff also cautioned that the high rate of credit growth may lead to compromised prudential standards. The rapid credit expansion had already resulted in a rebound in corporate indebtedness, though in general, corporate vulnerabilities were declining and in line with comparator countries.[6] The authorities were confident that banks had strengthened substantially their risk management. But they agreed that, given improving nonperforming loan ratios, this may be an opportune time to tighten specific provisioning requirements and better prepare banks for any future problems.

27. **The SBP noted that it has recently increased the frequency of open market operations and focused on stabilizing overnight rates.** This has reduced volatility in banks' funding costs. Going forward, staff recommended that the SBP consider to announce a target band for the overnight rate and gradually replace T-bill rates with the overnight rate as the key intermediate monetary policy target. The resumption of long-term government bonds auctions envisaged in the 2005/06 budget should revive the secondary market and extend the maturity of government debt.

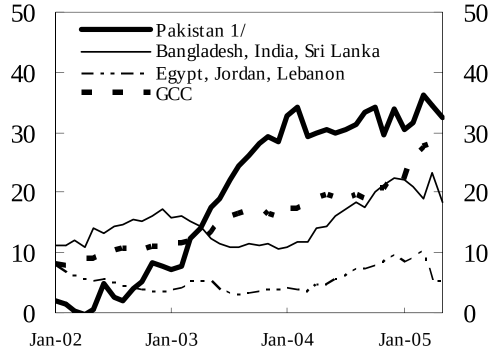
[6] See Selected Issues Paper (refer to www.imf.org).

Box 5. Banking System Update[1/]

Pakistan's banking system is expanding strongly and becoming more competitive. In 2004, total assets and customer deposits grew by 20 percent and 22 percent, respectively, while gross loans expanded by 38 percent—faster than in many comparator countries (Text Figure 18). Concentration declined, with the market share of the five largest banks slipping to 56 percent, from 62 percent in 1997, prior to reforms.

Loan growth, led by consumer financing, has boosted profitability. After-tax returns on assets reached 1.4 percent in the second quarter of 2005—a far cry from the chronic losses of 1997–2001. Consumer financing now accounts for over 10 percent of loans.

Text Figure 18. Pakistan: Private Sector Credit Growth, 2002:1–2005:5 1/
(Simple average annual percent change in local currency)



Sources: Pakistani authorities, and Fund staff estimates.
1/ Private sector credit for Pakistan, nongovernment sector otherwise.

As nonperforming loans fall, the banking system's capital cushion is expanding faster than risk-weighted assets (Text Table 6). Notwithstanding improving financial soundness indicators, periods of sustained rapid credit growth can mask a buildup of vulnerabilities. Thus, the SBP recently mandated special provisioning requirements for secured and unsecured consumer financing of 1.5 percent and 5 percent, respectively. The nonperforming loan ratio on consumer financing remains below 1 percent, compared with over 10 percent for all loans.

Stress test results underscore the need for continued supervisory vigilance. Staff updated some of the stress tests reported in the 2004 FSSA (IMF Country Report No. 04/215), Text Table 7).[2/] Resilience to a regulatory tightening has fallen marginally, but vulnerability to a (severe) credit shock is broadly unchanged. Vulnerability to an interest rate, exchange rate, or an equity price shock has increased somewhat. Resilience to a property price crash, conversely, has improved, as reliance on real estate collateral has wound down.

Text Table 6. Pakistan: Selected Banking System FSIs, 1997–2005
(In percent)

	1997	2004	2005 1/
Capital adequacy ratio (CAR)	4.5	10.5	10.9
Gross NPLs to gross loans	23.6	11.6	10.6
Net NPLs to capital	183.8	28.8	24.1
After tax return on average assets	-1.2	1.2	1.4
Noninterest expense to total gross income	85.2	51.6	48.2
Liquid assets to total assets	39.5	36.5	36.4

Source: State Bank of Pakistan.

1/ End June

1/ See also Selected Issues paper (refer to www.imf.org).
2/ End-September 2003 data may have portrayed the banking system's resilience somewhat favorably due to definitional changes.

Box 5. Banking System Update (concluded)

Text Table 7. Pakistan: Stress Test Results
for the 12 Largest Commercial Banks, 2003–04
(No. of undercapitalized banks; percent deposit share in parentheses) 1/

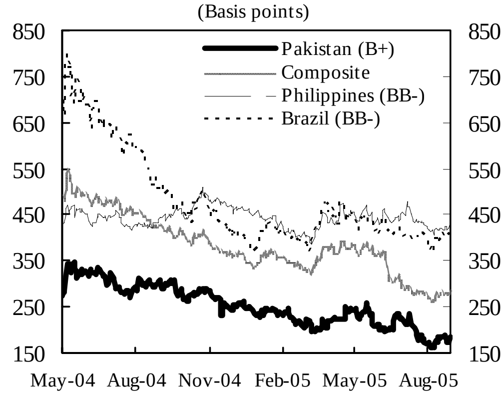
	2003 2/	2004
One-category reclassification of NPLs	1 (5.9)	2 (8.3)
35 percent increase in NPLs 3/	4 (37.2)	4 (35.1)
Yield curve steepening 4/	3 (10.9)	3 (25.0)
10 percent rupee depreciation 5/	1 (5.9)	3 (11.9)
30 percent stock market decline	1 (5.9)	2 (8.3)
50 percent real estate market decline	3 (27.5)	3 (25.0)

Sources: SBP; and Fund staff estimates.

1/ Undercapitalization defined as CAR < 8 percent. Results for 2003–04 not strictly comparable.
2/ End-September.
3/ Incremental NPLs provisioned at 50 percent.
4/ Rate increase by 100 b.p. for t ≤ 3 mo.; 300 b.p. for 3 mo. < t ≤ 1 yr.; and 500 b.p. for t > 1 yr.
5/ With 20 percent of foreign currency loans becoming NPLs, provisioned at 50 percent.

28. **The authorities agreed that sound macroeconomic policies and ongoing strengthening of key institutions were key to reducing vulnerabilities further.** They noted that the Debt Office was being expanded and has started to develop a debt management strategy. Moreover, the SBP has established a roadmap for implementation of Basel II, and steps have been taken to strengthen the regulatory framework of the stock market after the excessive speculation in early 2005. Pakistan's EMBI+ spread relative to its peers was evidence that the market has viewed these developments favorably (Text Figure 19).

Text Figure 19. Pakistan: EMBI + Bond Spreads, 2004:5–2005:8
(Basis points)



Source: Bloomberg.

D. Revenue Mobilization

29. **Staff noted that tax buoyancy has been disappointingly low despite ongoing CBR reforms.** CBR revenue declined in percent of GDP in 2004/05 and is expected to remain roughly flat in 2005/06. This has to some extent reversed the limited gains under the PRGF, and has curtailed the fiscal space available for social and development spending. The authorities responded that the decline reflected transition costs of streamlining the tax system

to improve the business climate. Staff agreed that streamlining was important, but regretted that tax relief measures had been granted in the last two budgets. Moreover, staff expressed concern that the exemption from sales tax of the textile value added chain might undermine the self-enforcing nature of the system. The authorities argued that this would increase CBR collection because they were previously unable to control fraudulent refund claims.

30. **The CBR is focusing on enhancing compliance of existing tax payers.** Despite high growth and profitability, two-thirds of corporate tax filers reported declining or unchanged income in 2004/05. Hence, the CBR saw scope for increasing collection from existing taxpayers. Staff agreed, but encouraged the renewal of efforts to extend the tax net into the agriculture and service sectors (including real estate and capital gains). This would create a more efficient and equitable tax system that could generate the resources needed for social and development expenditures while maintaining fiscal sustainability. The authorities agreed, but noted that the taxation of agriculture and services was a provincial prerogative, and past efforts in these areas had shown little result. Staff suggested that these issues be treated as part of the overall discussions on allocating tax revenues in the National Finance Commission.

E. Poverty Situation

31. **The authorities were confident that gains had been made in poverty reduction.** High growth, in particular in agriculture, is likely to have raised disposable income, including in rural areas. Indicators of wages and employment have recently risen significantly. Results from the Pakistan Social and Living Standards Measurement Survey show improvements in various health and education outcomes (Table 14). Pakistan also improved its ranking in the 2005 United Nation’s Human Development Index (135th place out of 177 countries in the 2005, up from 142nd in 2004). The authorities noted that results later this year from the Pakistan Integrated Household Survey will provide valuable additional information about progress in poverty reduction. Staff appreciated these developments, but cautioned that high inflation—if left unchecked—could erode many of these gains.

32. **Staff encouraged the authorities to further raise health and education spending.** Achieving the Millennium Development Goals remains challenging for Pakistan, and health and education expenditures are still relatively low in international comparison (Tables 15 and 16). While health and education spending has increased substantially in recent years (Table 17), they are budgeted to remain broadly unchanged in real per capita terms during 2005/06, partly because of local capacity constraints. The authorities agreed it was crucial to increase the quality and effectiveness of social spending, including through the implementation of a medium-term budget framework, and enhancing administrative and financial capacity at the district level. In this regard, staff looks forward to the revised Poverty Reduction Strategy Paper which the authorities intend to present in 2006.

F. Statistical Issues

33. **Staff believes that data are broadly adequate for effective surveillance** (see Appendix III). Notwithstanding this, fiscal data suffer from a large statistical discrepancy; government expenditure data based on economic classification are not available; and early publication of quarterly national accounts would facilitate within-year analysis of economic developments. Staff encourages the authorities to continue improving data on the basis of the recent ROSC recommendations and to take the remaining steps to subscribe to the Special Data Dissemination Standard.

IV. Staff Appraisal

34. **Pakistan's economy continues to gain momentum.** Reflecting strong domestic and external demand, growth is projected to exceed 6 percent for the third consecutive year in 2005/06. While the terms of trade have recently been unfavorable, Pakistan continues to benefit from rising private transfers, textile exports, and foreign investment, despite security and governance concerns. Some preliminary evidence that poorer segments of the population are benefiting from strong growth is becoming available. However, the growth acceleration has been accompanied by inflationary pressures, and, in 2004/05, the current account shifted into deficit. In all, macroeconomic performance has been remarkable given that 5–6 years ago the economy was in crisis.

35. **Ambitious growth objectives have been set.** Given the past experience in Pakistan, the targeted 6–8 percent growth is probably the minimum needed to substantially reduce poverty over the medium term. The authorities have rightly identified the lack of physical and human capital as key constraints to growth. The ongoing boost in public spending to rectify the shortage of transportation and irrigation infrastructure is therefore welcome. Curtailing the large energy subsidies and channeling additional resources into development and social spending, especially education and health, would further improve growth prospects.

36. **The medium-term fiscal framework is broadly appropriate.** Pakistan has taken advantage of the favorable international climate and stronger domestic economic performance to reduce vulnerabilities greatly in recent years. Key public and external debt indicators are projected to continue improving, though some remain very high by emerging market standards. In this context, staff welcomes the approval of the Fiscal Responsibility Law, which provides a framework for continued debt reduction while raising social expenditures.

37. **But medium-term fiscal objectives can only be met with a marked improvement in revenue performance.** Tax buoyancy has been a disappointment, partly caused by tax relief measures and subsequent erosion of the tax base. While streamlining the tax system to improve the investment climate is important, it needs to be accompanied by determined efforts to bring previously untaxed sectors into the tax net. The CBR's focus on enhancing compliance of existing taxpayers is probably appropriate in terms of generating revenue in

the short term. However, a strategy to extend the tax net into the service and agriculture sectors needs to be developed in cooperation with the provinces.

38. **For the strong medium-term potential to be realized, short-term macroeconomic risks need to be managed.** Inflation is still in the high single digits, with monetary growth yet to slow. Without a rapid increase in exports, continued import growth at the current pace could result in an unsustainably high current account deficit.

39. **A modest tightening of monetary and fiscal policies is therefore needed.** This would lessen the risk of an increase in the external imbalances and would reduce inflationary expectations without hurting growth too much, given that the economy is operating close to potential. It is appropriate that the SBP has now put achieving low inflation at the top of its agenda and has raised interest rates significantly. Rates should continue to be increased until lending and T-bill rates are firmly positive in real terms, and there is evidence that inflationary pressures are abating. On the fiscal side, the government has already taken welcome steps to protect their fiscal deficit target of 3.8 percent of GDP in the wake of recent international oil price hikes. Additional pass-through of oil price increases as required (including through reinstating the automatic fuel price adjustment mechanism), some limited further effort on the revenue side, and expenditure restraint could keep the deficit to last year's level of 3.3 percent of GDP and avoid too much of the burden falling on monetary policy.

40. **External competitiveness needs to be monitored closely.** Exchange rate policy has served Pakistan relatively well in recent years, contributing to strong export growth and reduced external vulnerabilities, accompanied by only a limited build-up of inflationary pressures. Despite some minor recent real appreciation, the level of the real exchange rate is still broadly appropriate. Nevertheless, there appears to be limited room for further real appreciation, and some nominal exchange rate flexibility could be needed quite soon to protect competitiveness, if the inflation differential is not reduced.

41. **The structural reforms agenda needs to be pursued forcefully.** While the overall business climate and governance in key macroeconomic institutions have clearly improved, problems in the energy sector, judiciary, and some other areas make Pakistan a challenging environment for many investors. Improving governance in all public institutions should therefore be a government priority. The sharp acceleration in the privatization program is welcome and should result in better service delivery and cheaper inputs in some key sectors. But it is also important to finally complete the reforms of the regulatory and tariff framework for the power sector. This would allow privatization in this sector to start in earnest and would help ensure competitive and reliable power supply. Reforms of fiscal reporting and expenditure management should be accelerated, and the efficiency of expenditures monitored closely.

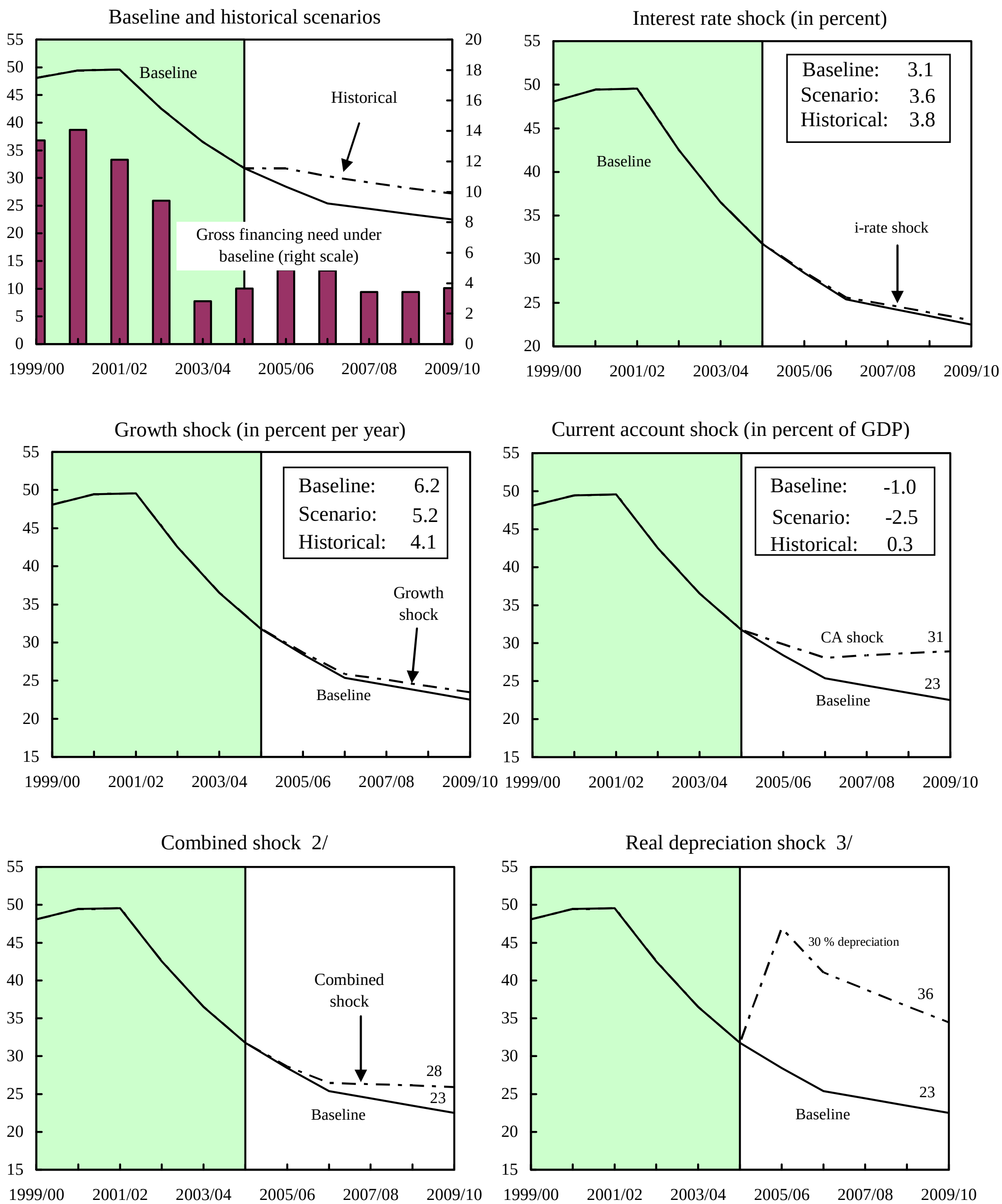
42. **Impressive financial sector reforms have resulted in a healthier and more competitive banking system.** However, rapid private sector credit growth could be a source of vulnerability in the future. Given the current position of strength, this is an opportune time to tighten provisioning requirements. Steps to stabilize short-term interest rates and make them the key intermediate monetary policy target are welcome and should be pursued aggressively.

43. **Some gains appear to have been made, but poverty reduction needs to be at the top of the policy agenda.** Some reduction in poverty, and improvement in social indicators, appears to have taken place. Looking ahead, larger increases in health and education spending than budgeted for 2005/06 and better service delivery at the local level are needed if substantial progress toward the Millennium Development Goals is to be made.

44. **Pakistan maintains an exchange restriction on payments for current international transactions that should be lifted.** Under this restriction, advance payments for certain imports are limited to 50 percent (see Appendix I). Staff is not proposing approval given the lack of a timetable for lifting the restriction, even though the authorities are working to ease the restriction.

45. **It is expected that the next Article IV consultation take place within the standard 12 month cycle.**

Figure 1. Pakistan: External Debt Sustainability: Bound Tests, 1999/2000–2009/10 1/
(External debt in percent of GDP)



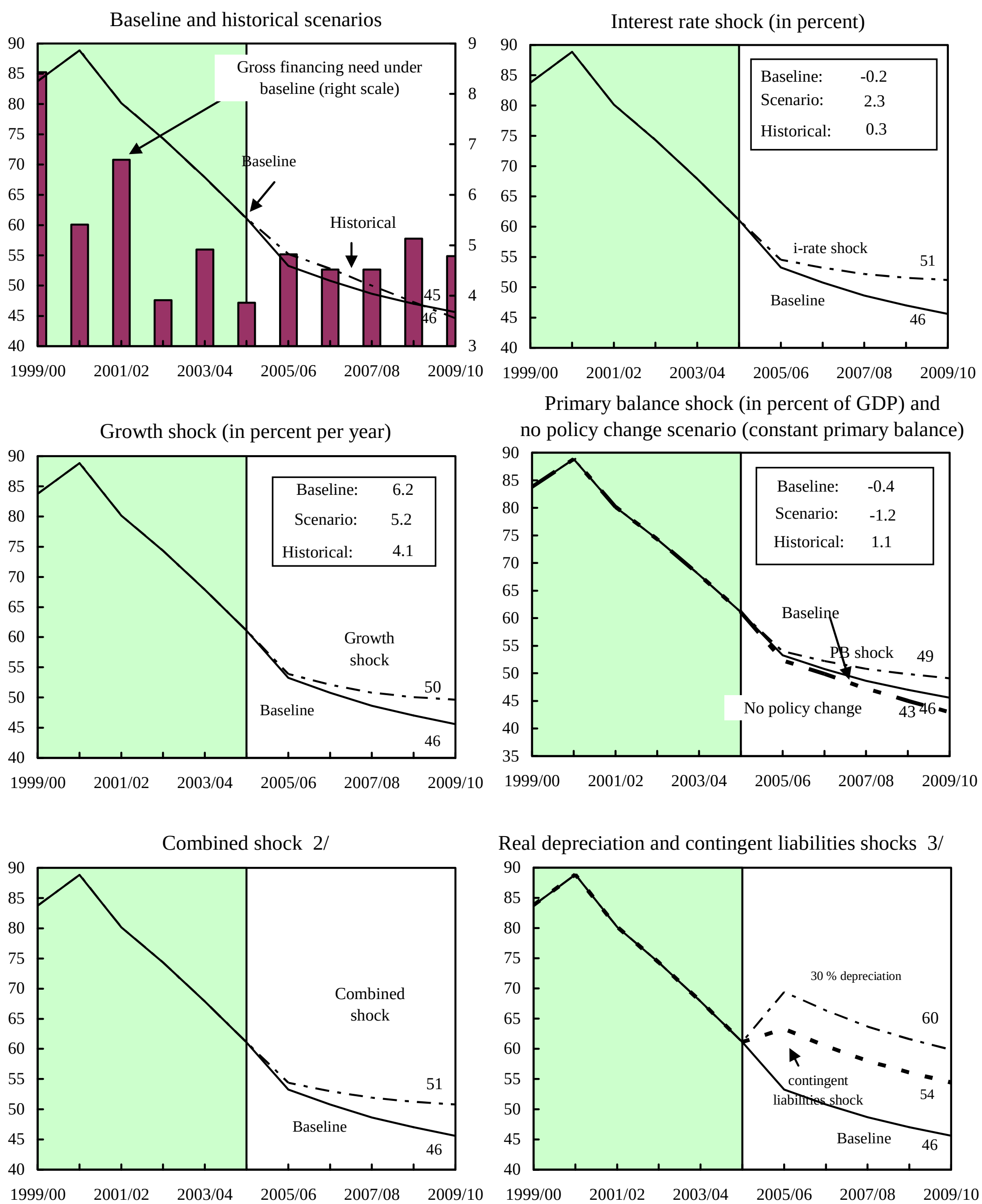
Sources: International Monetary Fund, Country desk data, and staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.

3/ One-time real depreciation of 30 percent occurs in 2005/06.

Figure 2. Pakistan: Public Debt Sustainability: Bound Tests, 1999/2000–2009/10 1/
(Public debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.

1/ Shaded areas represent actual data.Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.

3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2005/06, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Table 1. Pakistan: Selected Economic Indicators, 2000/01–2005/06
(Poverty rate: 32.1 percent (2000/01))
(Unemployment rate: 7.7 percent (2004/05))
(Main Exports: Cotton manufactures)

	2000/01	2001/02	2002/03	2003/04	2004/05		2005/06
					CR 04/411	Est.	Proj.
Output and prices			(Annual changes in percent)				
Real GDP at factor costs	1.8	3.1	4.8	6.4	6.5	8.4	7.0
Partner country demand (WEO definition)	3.6	2.4	3.3	4.1	3.8	4.1	3.7
Consumer prices (period average)	4.4	2.5	3.1	4.6	7.0	9.3	9.0
Consumer prices (end of period)	2.5	3.4	1.9	8.5	4.4	8.7	9.1
Pakistani rupees per U.S. dollar (period average)	12.8	5.2	-4.7	-1.5	...	3.1	...
Savings and investment			(In percent of GDP)				
Gross national savings	15.6	19.0	22.0	19.3	19.2	15.6	15.5
Government	-1.3	0.2	0.7	0.9	0.7	0.5	0.0
Nongovernment (including public sector enterprises)	16.9	18.8	21.3	18.4	18.5	15.1	15.5
Gross capital formation 1/	17.2	16.8	16.9	17.3	19.9	16.8	17.7
Government	2.2	2.9	2.7	2.9	3.0	3.5	3.6
Nongovernment (including public sector enterprises)	15.0	13.9	14.2	14.4	16.8	13.4	14.1
Public finances			(In percent of GDP)				
Revenue (including grants)	14.3	16.1	17.4	14.9	14.7	14.0	13.2
Expenditure (including statistical discrepancy)	17.6	19.7	18.7	16.7	17.0	17.1	16.8
Budget balance (excluding grants)	-4.3	-5.5	-3.8	-2.3	-3.2	-3.3	-3.8
Budget balance (including grants)	-3.3	-3.6	-1.4	-1.8	-2.3	-3.0	-3.6
Primary balance (including grants)	2.3	2.0	2.9	1.8	1.1	0.2	-0.6
Total government debt	88.8	80.2	74.3	67.8	63.6	61.1	53.3
External government debt	45.5	39.8	35.0	31.5	29.8	28.2	25.2
Domestic government debt	43.3	40.4	39.3	36.3	33.8	32.9	28.0
Implicit interest rate on government debt (in percent) 2/	7.4	6.6	5.9	5.5	...	5.6	...
Monetary sector			(Annual changes in percent of initial stock of broad money)				
Net foreign assets	5.1	13.4	18.9	2.1	1.2	2.2	5.4
Net domestic assets	3.9	2.0	-0.4	17.5	12.1	17.1	13.9
Of which: credit to the private sector	3.5	2.5	9.1	14.3	8.4	17.0	12.6
Of which: net claims on the government	-3.3	1.5	-1.4	2.8	3.0	3.7	1.0
Broad money	9.0	15.4	18.3	19.6	13.3	19.3	19.3
Six-month treasury bill rate (period average, in percent)	10.4	8.1	4.1	1.7	...	4.7	...
External sector			(In percent of GDP)				
Merchandise exports	12.5	12.7	13.2	12.9	13.1	13.0	13.1
Merchandise imports	14.3	13.1	13.7	14.1	15.9	17.0	17.0
Current account excluding official transfers	-2.7	0.1	3.8	1.4	-1.1	-1.6	-2.5
Current account including official transfers	-1.6	2.2	5.1	2.0	-0.7	-1.3	-2.2
Foreign direct investment	0.5	0.5	0.7	0.8	...	1.1	0.9
			(In percent of exports of goods and nonfactor services)				
External public and publicly guaranteed debt	309.4	295.8	238.0	218.2	209.8	191.8	177.3
Debt service	27.8	33.8	26.3	29.8	20.1	15.3	14.2
Implicit interest rate (in percent) 2/	4.3	4.2	3.4	2.8	3.0	3.0	...
Gross reserves (in millions of U.S. dollars) 3/	1,679	4,330	10,251	10,621	10,789	9,985	12,006
In months of next year imports of goods and services	1.7	3.7	6.9	5.0	5.9	4.1	4.5
In percent of short-term external debt (on remaining maturity basis)	26.1	73.1	210.5	169.2	258.0	197.3	306.5
Memorandum items:							
Real effective exchange rate (annual average, percentage change)	-2.5	-1.1	-1.5	-3.4	...	-0.1	…
Terms of trade (percentage change)	-1.6	-0.5	-0.9	0.9	-4.7	-3.6	-2.6
Real per-capita GDP (percentage change)	-0.2	1.1	2.3	4.4	4.6	6.3	5.0
GDP at market prices (in billions of Pakistani rupees)	4,163	4,402	4,823	5,533	6,164	6,548	7,659
GDP at market prices (in billions of U.S. dollars)	71.5	71.9	82.6	96.2	...	110.4	...
Per capita GDP (in U.S. dollars)	509	502	563	643	...	724	...
Population (millions)	140.4	143.2	146.8	149.7	...	152.5	...

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

1/ Including changes in inventories. Investment data recorded by the Federal Bureau of Statistics are believed to underreport true activity. Investment data also revised downwards by the FBS since IMF Country Report No. 04/411.
2/ Calculated as interest payments in percent of the end-of-period debt stock of the previous year.
3/ Excluding gold, foreign deposits held with the SBP, and net of outstanding short-term foreign currency swap and forward contracts.

Table 2. Pakistan: Medium-Term Balance of Payments, 2000/01–2009/10

	2000/01	2001/02	2002/03	2003/04	2004/05 CR 04/411	2004/05 Est.	2005/06 Proj.	2006/07 Proj.	2007/08 Proj.	2008/09 Proj.	2009/10 Proj.
	(In millions of U.S. dollars)										
Current account (excluding official transfers)	-1,951	96	3,166	1,312	-1,127	-1,776	-3,157	-3,811	-4,030	-4,414	-4,771
Current account (including official transfers)	-1,112	1,591	4,204	1,886	-717	-1,397	-2,788	-3,297	-3,570	-3,957	-4,368
Trade balance	-1,268	-292	-444	-1,212	-2,974	-4,353	-5,035	-5,332	-5,409	-5,639	-6,055
Exports f.o.b.	8,934	9,140	10,889	12,395	13,635	14,371	16,727	18,734	20,982	23,330	25,780
Imports f.o.b.	-10,202	-9,432	-11,333	-13,607	-16,609	-18,724	-21,762	-24,067	-26,391	-28,970	-31,835
Services (net)	-3,143	-2,617	-2,127	-3,586	-4,393	-5,873	-6,677	-7,333	-7,787	-8,266	-8,500
Of which: interest payments	-1,657	-1,579	-1,276	-1,050	-1,079	-936	-940	-1,223	-1,236	-1,309	-1,235
Private transfers (net)	2,460	3,005	5,737	6,110	6,240	8,450	8,555	8,854	9,166	9,492	9,784
Of which: workers' remittances	1,086	2,390	4,237	3,871	...	4,168	4,300	4,515	4,741	4,978	5,301
Official transfers (net)	839	1,495	1,038	574	410	379	369	514	460	457	404
Capital account	-623	-2,322	-1,709	-3,089	-1,531	-1,211	88	739	759	931	475
Public medium- and long-term capital	-652	-1,613	-1,656	-2,092	-531	-340	-89	-173	-385	-389	-1,017
Of which: project and nonproject loans	-332	-983	-1,840	-1,986	-521	-850	-42	-285	-535	-540	-572
Disbursements	1,463	531	581	434	903	583	1,000	800	600	600	500
Amortization 1/	-1,795	-1,514	-2,421	-2,420	-1,424	-1,433	-1,042	-1,085	-1,135	-1,140	-1,072
Public sector short-term (net)	-59	-1,064	-268	-856	-569	-353	-358	-150	-150	-300	-300
Private medium- and long-term	343	-80	164	493	264	852	1,275	1,535	1,758	2,084	2,256
Of which: FDI	322	368	612	752	550	1,162	1,200	1,380	1,587	1,777	1,937
Private short-term (including errors & omissions)	-256	435	51	-634	-695	-1,370	-740	-473	-465	-464	-464
Overall balance (before debt relief)	-1,735	-731	2,495	-1,203	-2,248	-2,608	-2,700	-2,557	-2,811	-3,026	-3,893
Financing	1,735	731	-2,495	1,203	2,248	2,608	2,700	2,557	2,811	3,026	3,893
Reserve assets (increase -)	-1,088	-3,082	-5,261	-404	-398	-213	-2,471	-866	-302	-239	21
State Bank of Pakistan (including FE-25s)	-729	-2,717	-5,911	-427	-233	507	-2,141	-699	-128	-57	76
Deposit money banks	-359	-365	650	23	-165	-720	-330	-167	-174	-182	-55
Fund repurchases	-194	-194	-418	-673	-380	-399	-150	-167	-197	-215	-188
Net exceptional financing	3,017	4,007	3,185	2,280	3,026	3,220	5,321	3,590	3,310	3,480	4,060
Of which: rollover of foreign deposits with banking system	1,676	1,314	900	1,200	1,200	1,200	1,200	1,200	1,200	1,200	1,200
Of which: program financing from IFIs	279	1,367	1,090	781	1,630	1,557	1,021	1,290	1,510	1,580	2,160
World Bank	0	698	213	192	640	725	600	730	860	960	1,300
AsDB	0	185	408	344	735	577	421	560	650	620	860
IMF	279	484	469	245	255	255	0	0	0	0	0
Of which: privatization receipts	0	117	186	199	96	363	3,000	1,000	500	600	700
	(In annual percentage change; unless otherwise indicated)										
Memorandum items:											
Current account (excl. official transfers, percent of GDP)	-2.7	0.1	3.8	1.4	-1.1	-1.6	-2.5	-2.8	-2.7	-2.7	-2.7
Current account (incl. official transfers, percent of GDP)	-1.6	2.2	5.1	2.0	-0.7	-1.3	-2.2	-2.4	-2.4	-2.4	-2.5
Exports f.o.b. (growth rate, percent)	9.1	2.3	19.1	13.8	10.0	15.9	16.4	12.0	12.0	11.2	10.5
Imports f.o.b. (growth rate, percent)	6.2	-7.5	20.2	20.1	22.1	37.6	16.2	10.6	9.7	9.8	9.9
Export unit value	-2.5	-3.1	10.2	10.9	...	7.4	4.4	2.4	1.7	1.6	1.7
Import unit value	-1.0	-2.6	11.2	9.9	...	11.4	7.2	0.8	0.3	0.4	0.7
Export volume	11.9	5.6	8.1	2.7	...	8.0	11.5	9.4	10.2	9.4	8.6
Import volume	7.3	-5.1	8.0	9.3	...	23.6	8.4	9.8	9.4	9.3	9.2
Terms of trade	-1.6	-0.5	-0.9	0.9	-4.7	-3.6	-2.6	1.6	1.4	1.2	1.1
End-period gross official reserves (in millions of U.S. dollars) 2/	1,679	4,330	10,251	10,621	10,789	9,985	12,006	12,652	12,685	12,615	12,409
(In months of next year imports of goods and nonfactor services)	1.7	3.7	6.9	5.0	5.9	4.1	4.5	4.4	4.0	3.7	3.4

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

1/ Includes accelerated repayments: (i) in 2002/03, $1 billion to the U.S.; and (ii) in 2003/04, $1.1 billion to AsDB.

2/ Excluding gold, foreign currency deposits held with the SBP, cash reserve requirement, and net of and outstanding short-term swap and forward contracts. Including sinking fund.

Table 3a. Pakistan: Consolidated Government Budget, 2000/01–2005/06

(In billions of Pakistani rupees)

	2000/01 FY	2001/02 FY	2002/03 FY	2003/04 FY	2004/05 FY		2005/06 FY	
					CR 04/411	Est.	Budget	Proj.
Revenue and grants	593.5	707.2	838.2	824.7	906.0	919.4	992.8	1,008.8
Revenue	553.0	624.1	719.3	794.1	851.1	900.0	970.8	989.0
Tax revenue	441.5	478.1	554.2	611.5	662.6	651.7	759.1	757.1
Federal	422.5	459.3	532.3	583.4	630.0	617.2	726.1	716.8
CBR revenue	392.1	403.9	460.0	521.9	590.0	588.4	690.0	695.0
Direct tax	124.6	142.6	152.0	164.5	185.1	176.9	215.4	215.2
Federal excise duty	49.0	46.9	44.0	45.8	46.5	58.7	59.4	58.1
Sales tax	153.5	166.3	195.1	220.6	252.9	235.5	294.0	281.1
Customs duties	65.0	48.1	68.8	90.9	105.5	117.2	121.2	140.6
Petroleum surcharge	17.9	36.6	46.9	44.6	18.0	10.6	15.9	1.0
Gas surcharge	12.3	17.7	21.3	16.8	17.8	16.2	16.7	17.2
Other	0.2	1.1	4.1	0.1	4.2	2.1	3.5	3.5
Provincial	19.0	18.8	21.9	28.1	32.6	34.5	33.0	40.3
Nontax revenue	111.4	146.0	165.1	182.7	188.5	248.4	211.7	231.9
Federal	91.5	124.7	139.7	160.6	149.6	225.8	178.7	202.5
Provincial	19.9	21.3	25.4	22.0	38.9	22.5	33.0	29.4
Grants	40.5	83.1	118.9	30.5	54.8	19.4	22.0	19.9
Expenditure	717.9	826.2	890.9	955.9	1,050.4	1,195.5	1,255.8	1,282.9
Current expenditure	645.7	700.2	802.4	774.9	866.0	942.7	999.9	1,007.9
Federal	479.0	524.6	608.0	556.5	623.3	688.6	719.8	727.8
Interest payments	234.5	245.3	207.2	196.3	214.0	210.2	236.0	230.0
Domestic	183.5	184.6	166.9	154.8	170.4	170.5	190.2	184.2
Foreign 1/	51.0	60.6	40.2	41.4	43.6	39.7	45.8	45.8
Defense	104.7	149.0	159.9	180.4	194.0	211.7	223.5	223.5
Running of the civil government	70.7	56.3	67.4	75.5	81.5	81.4	103.1	103.1
Pensions for defense and civil government	30.9	27.2	40.6	32.5	48.9	32.3	46.5	46.5
Subsidies 2/	19.9	23.7	51.5	37.0	53.0	57.8	72.3	86.3
Grants	18.1	22.8	23.5	34.3	29.5	94.7	38.4	38.4
Other	0.3	0.3	57.9	0.6	2.4	0.5	0.0	0.0
Provincial	166.7	175.6	194.4	218.4	242.7	254.1	280.1	280.1
Development expenditure and net lending	72.2	125.9	88.5	181.0	184.4	252.8	255.9	275.0
Public Sector Development Program	89.8	126.2	130.0	160.5	188.0	228.0	262.0	272.0
Federal	66.9	98.4	90.8	102.3	134.0	135.3	194.0	204.0
Provincial	22.9	27.8	39.2	58.2	54.0	92.8	68.0	68.0
Net lending	-17.6	-0.2	-41.5	20.4	-3.6	24.8	-6.2	3.0
Statistical discrepancy (“+” = additional expenditure)	14.8	-11.7	13.0	-32.4	...	-78.5	...	...
Federal government	29.8	15.3	5.8	9.3	...	-24.3	...	...
Provinces	-15.0	-26.9	7.2	-41.6	...	-54.2	...	...
Underlying budget balance (excluding grants)	-179.7	-190.5	-184.6	-129.4	-199.2	-217.0	-285.0	-294.0
Underlying budget balance (including grants)	-139.2	-107.3	-65.7	-98.9	-144.4	-197.6	-263.0	-274.1
One-off expenditure items 3/	...	52.0	...	...	...	...		...
Budget balance (excluding grants)	-179.7	-242.5	-184.6	-129.4	-199.2	-217.0	-285.0	-294.0
Budget balance (including grants)	-139.2	-159.3	-65.7	-98.9	-144.4	-197.6	-263.0	-274.1
Financing	139.2	159.3	65.7	98.9	144.4	197.6	262.9	274.1
External	80.2	51.7	-23.8	-37.1	38.7	113.1	99.6	271.6
Of which: privatization receipts	...	...	7.6	0.0	0.0	12.0	0.0	179.5
Domestic	59.0	107.6	89.4	136.0	105.7	84.6	163.3	2.5
Bank	-33.0	14.3	-55.9	63.7	60.0	60.2	98.0	-27.5
Nonbank	92.0	85.0	141.6	61.0	30.7	8.1	45.3	20.0
Privatization receipts	0.0	8.4	3.7	11.2	15.0	16.3	20.0	10.0
Memorandum items:								
Expenditure incl. statistical discrepancy and one-off	732.7	866.5	903.9	923.6	1,050.4	1,117.0	1,255.8	1,282.9
Primary balance (excluding grants and one-offs)	54.8	2.8	22.6	66.8	14.8	-6.8	-48.9	-64.0
Primary balance (including grants and one-offs)	95.3	86.0	141.5	97.4	69.6	12.5	-27.0	-44.1
Social and poverty-related expenditure 4/	122.3	133.5	169.7	208.7	278.0	300.4	324.0	324.0
Total government debt	3,698	3,528	3,584	3,755	3,923	4,000	...	4,079
Domestic debt	1,802	1,777	1,896	2,012	2,084	2,155	...	2,147
External debt	1,896	1,751	1,687	1,743	1,838	1,845	...	1,932
Nominal GDP at market prices	4,163	4,402	4,823	5,533	6,164	6,548	7,565	7,659

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

1/ Accrued payments. Excludes interest expenditure by the military which is included in the defense allocation.
2/ In 2002/03, subsidies include arrears settlement on behalf of KESC amouting to PRs 11 billion in the initial program and PRs 8 billion in the revised projections.
3/ 2001/02: KESC recapitalization (PRs 32 billion) and CBR bonds (PRs 20 billion).
4/ Social- and poverty-related expenditures as defined in the government's Poverty Reduction Strategy Paper

Table 3b. Pakistan: Consolidated Government Budget, 2000/01–2005/06

(In percent of GDP; unless otherwise indicated)

	2000/01 FY	2001/02 FY	2002/03 FY	2003/04 FY	2004/05 FY		2005/06 FY	
					CR 04/411	Est.	Budget	Proj.
Revenue and grants	14.3	16.1	17.4	14.9	14.7	14.0	13.1	13.2
Revenue	13.3	14.2	14.9	14.4	13.8	13.7	12.8	12.9
Tax revenue	10.6	10.9	11.5	11.1	10.7	10.0	10.0	9.9
Federal	10.2	10.4	11.0	10.5	10.2	9.4	9.6	9.4
CBR revenue	9.4	9.2	9.5	9.4	9.6	9.0	9.1	9.1
Direct tax	3.0	3.2	3.2	3.0	3.0	2.7	2.8	2.8
Federal excise duty	1.2	1.1	0.9	0.8	0.8	0.9	0.8	0.8
Sales tax	3.7	3.8	4.0	4.0	4.1	3.6	3.9	3.7
Customs duties	1.6	1.1	1.4	1.6	1.7	1.8	1.6	1.8
Petroleum surcharge	0.4	0.8	1.0	0.8	0.3	0.2	0.2	0.0
Gas surcharge	0.3	0.4	0.4	0.3	0.3	0.2	0.2	0.2
Other	0.0	0.0	0.1	0.0	0.1	0.0	0.0	0.0
Provincial	0.5	0.4	0.5	0.5	0.5	0.5	0.4	0.5
Nontax revenue	2.7	3.3	3.4	3.3	3.1	3.8	2.8	3.0
Federal	2.2	2.8	2.9	2.9	2.4	3.4	2.4	2.6
Provincial	0.5	0.5	0.5	0.4	0.6	0.3	0.4	0.4
Grants	1.0	1.9	2.5	0.6	0.9	0.3	0.3	0.3
Expenditure	17.2	18.8	18.5	17.3	17.0	18.3	16.6	16.8
Current expenditure	15.5	15.9	16.6	14.0	14.0	14.4	13.2	13.2
Federal	11.5	11.9	12.6	10.1	10.1	10.5	9.5	9.5
Interest payments	5.6	5.6	4.3	3.5	3.5	3.2	3.1	3.0
Domestic	4.4	4.2	3.5	2.8	2.8	2.6	2.5	2.4
Foreign 1/	1.2	1.4	0.8	0.7	0.7	0.6	0.6	0.6
Defense	2.5	3.4	3.3	3.3	3.1	3.2	3.0	2.9
Running of the civil government	1.7	1.3	1.4	1.4	1.3	1.2	1.4	1.3
Pensions for defense and civil government	0.7	0.6	0.8	0.6	0.8	0.5	0.6	0.6
Subsidies 2/	0.5	0.5	1.1	0.7	0.9	0.9	1.0	1.1
Grants	0.4	0.5	0.5	0.6	0.5	1.4	0.5	0.5
Other	0.0	0.0	1.2	0.0	0.0	0.0	0.0	0.0
Provincial	4.0	4.0	4.0	3.9	3.9	3.9	3.7	3.7
Development expenditure and net lending	1.7	2.9	1.8	3.3	3.0	3.9	3.4	3.6
Public Sector Development Program	2.2	2.9	2.7	2.9	3.1	3.5	3.5	3.6
Federal	1.6	2.2	1.9	1.8	2.2	2.1	2.6	2.7
Provincial	0.6	0.6	0.8	1.1	0.9	1.4	0.9	0.9
Net lending	-0.4	0.0	-0.9	0.4	-0.1	0.4	-0.1	0.0
Statistical discrepancy (“+” = additional expenditure)	0.4	-0.3	0.3	-0.6	...	-1.2	...	...
Federal government	0.7	0.3	0.1	0.2	...	-0.4	...	...
Provinces	-0.4	-0.6	0.1	-0.8	...	-0.8	...	...
Underlying budget balance (excluding grants)	-4.3	-4.3	-3.8	-2.3	-3.2	-3.3	-3.8	-3.8
One-off expenditure items 3/	...	1.2	...	...	...	...	...	...
Budget balance (excluding grants)	-4.3	-5.5	-3.8	-2.3	-3.2	-3.3	-3.8	-3.8
Budget balance (including grants)	-3.3	-3.6	-1.4	-1.8	-2.3	-3.0	-3.5	-3.6
Financing	3.3	3.6	1.4	1.8	2.3	3.0	3.5	3.6
External	1.9	1.2	-0.5	-0.7	0.6	1.7	1.3	3.5
Of which: privatization receipts	...	...	0.2	0.0	0.0	0.2	0.0	2.3
Domestic	1.4	2.4	1.9	2.5	1.7	1.3	2.2	0.0
Bank	-0.8	0.3	-1.2	1.2	1.0	0.9	1.3	-0.4
Nonbank	2.2	1.9	2.9	1.1	0.5	0.1	0.6	0.3
Privatization receipts	0.0	0.2	0.1	0.2	0.2	0.2	0.3	0.1
Memorandum items:								
Expenditure incl. statistical discrepancy and one-off	17.6	19.7	18.7	16.7	17.0	17.1	16.6	16.8
Primary balance (excluding grants and one-offs)	1.3	0.1	0.5	1.2	0.2	-0.1	-0.6	-0.8
Primary balance (including grants and one-offs)	2.3	2.0	2.9	1.8	1.1	0.2	-0.4	-0.6
Social and poverty-related expenditure 4/	2.9	3.0	3.5	3.8	4.5	4.6	4.3	4.2
Total government debt	88.8	80.2	74.3	67.9	63.6	61.1	...	53.3
Domestic debt	43.3	40.4	39.3	36.4	33.8	32.9	...	28.0
External debt	45.6	39.8	35.0	31.5	29.8	28.2	...	25.2
Nominal GDP (market prices, billions of Pakistani rupees)	4,163	4,402	4,823	5,533	6,164	6,548	7,565	7,659

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

1/ Accrued payments. Excludes interest expenditure by the military which is included in the defense allocation.
2/ In 2002/03, subsidies include arrears settlement on behalf of KESC amouting to PRs 11 billion in the initial program and PRs 8 billion in the revised projections.
3/ 2001/02: KESC recapitalization (PRs 32 billion) and CBR bonds (PRs 20 billion).
4/ Social- and poverty-related expenditures as defined in the government's Poverty Reduction Strategy Paper

Table 4. Pakistan: Financial and Operational Targets for WAPDA and Successor Companies, 2001/02–2004/05

(In millions of Pakistani rupees, unless otherwise indicated)

	2001/02	2002/03	2003/04		2004/05
	Act.	Act.	FIP	Act.	Est.
Main assumptions					
Average revenue (PRs/kWh) 1/	3.93	4.40	4.35	4.33	4.27
Units generated and purchased (in GWh)	60,849	64,038	65,574	69,091	73,515
Of which: thermal units (in percent of units generated)	68.7	65.1	67.3	58.9	65.1
purchased units (in GWh)	23,242	22,106	24,685	20,668	25,637
Main operational and financial targets					
Technical and nontechnical losses 2/	25.8	25.9	24.0	25.5	24.7
Total receivables	50,969	58,842	68,591	69,330	84,675
Of which: public sector and FATA receivables	29,182	33,986	47,089	41,684	52,858
Stock of payables to fuel suppliers and IPPs	25,565	6,406	4,618	4,481	3,551
Summary cash flow statement					
Total cash receipts (excluding GST, ED, & W/Tax)	177,409	201,016	204,884	212,450	221,267
Total cash outflows	178,649	207,879	213,918	182,305	209,596
Purchase of power from IPPs	109,101	116,133	106,049	94,895	109,700
Cost of fuel	37,365	47,978	40,692	40,009	52,157
Debt service to GOP (interest and amortization)	3,423	46	22,902	0	0
Debt service other than to GOP (interest and amortization)	11,684	15,944	12,269	16,142	8,255
Hydel profit payment	6,000	6,000	6,000	6,237	6,605
Operations and maintenance	17,261	19,411	21,366	21,566	26,949
Other cash outflows 3/	-6,185	2,367	4,640	3,456	5,930
Net cash available before investment program	-1,240	-6,863	-9,034	30,145	11,671
Investment expenditure	20,618	11,630	30,928	12,631	12,674
Foreign-financed component	13,034	0	18,928	1,482	0
Locally-financed component	7,584	11,630	12,000	11,149	12,674
Cash surplus (+)/deficit(-)	-21,858	-18,493	-39,962	17,514	-1,003
External financing	...	0	18,928	1,482	0
Memorandum items:					
Net change in payment arrears 4/	...	1,523	-1,788	20,740	20,077
Of which: arrears to the government	...	20,682	0	22,665	21,007
Of which: arrears to IPPs and suppliers	...	-19,159	-1,788	-1,925	-930
Accrual balance 5/	...	-20,016	-19,246	-1,744	-21,080

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

1/ Defined as the billing (equal to total cash receipts plus increase in receivables) divided by the number of units sold.
2/ Defined as units generated and purchased minus units sold, as a percentage of units generated and purchased.
3/ Negative “other cash outflows” in 2001/02 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.
4/ Change in the stock of arrears vis-à-vis IPPs, fuel suppliers and the government (including debt service).
5/ Cash balance minus any net change in the stock of arrears to suppliers and to the government plus foreign-financed investment.

Table 5. Pakistan: Financial and Operational Targets for KESC, 2001/02–2004/05

(In millions of Pakistani rupees, unless otherwise indicated)

	2001/02	2002/03	2003/04		2004/05	
	Act.	Act.	FIP	Act.	FIP	Est.
Main assumptions						
Average tariff (PRs per kWh)	4.5	4.6	4.6	4.7	4.6	4.6
Units generated and purchased (in GWh)	11,548	12,036	12,219	12,727	13,098	12,932
Of which: purchased units (in GWh)	3,406	3,809	3,261	3,664	4,096	4,289
Main operational and financial targets						
Technical and nontechnical losses 1/	41.1	40.8	38.0	37.9	34.0	34.2
Total receivables	21,130	19,842	20,334	21,842	...	22,120
Of which: public sector receivables	2,366	1,913	2,316	2,854	...	2,440
Stock of payables to fuel suppliers and IPPs	11,198	928	923	0	0	698
Summary cash flow statement						
Receipts	34,649	38,848	40,846	42,611	46,209	47,065
Collection of dues	32,452	36,183	38,439	39,954	43,438	43,105
GST	1,436	1,656	1,927	2,000	2,291	2,199
Other receipts	761	1,008	480	657	480	1,761
Payments	49,807	60,536	50,304	50,572	49,700	51,921
Purchase of power	14,147	25,293	14,864	16,675	18,855	18,628
Cost of fuel	21,721	23,930	23,100	23,355	24,233	26,840
Debt service (interest and amortization)	9,587	6,883	7,008	5,276	758	316
Taxes	837	987	1,587	1,288	1,509	1,303
Operations and maintenance	3,515	3,443	3,744	3,978	4,345	4,834
Net cash available before investment program	-15,158	-21,689	-9,458	-7,961	-3,491	-4,856
Investment program	1,560	1,881	5,884	2,133	8,309	2,988
Regular component	1,560	1,614	2,212	1,286	2,990	1,676
Additional component 2/	0	267	3,672	847	5,319	1,312
Cash surplus (+)/deficit(-)	-16,718	-23,570	-15,342	-10,094	-11,800	-7,844
Memorandum items:						
Net change in payment arrears 3/	...	-10,270	0	-928	0	698
Accrual balance 4/	...	-13,300	-15,342	-9,166	-11,800	-8,542

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

1/ Defined as units generated minus units sold, as a percentage of units generated.
2/ The additional component of the investment program was introduced in KESC's FIP. It is financed by the government and aims at improving KESC's financial situation through technical and administrative improvements.
3/ Change in the stock of arrears vis-à-vis IPPs, WAPDA, fuel suppliers and the government (including debt service).
4/ Cash balance minus any net change in the stock of arrears to suppliers and to the government plus foreign-financed investment.

Table 6. Pakistan: Monetary Survey, 2000/01–2005/06

	2000/01 FY	2001/02 FY	2002/03 FY	2003/04 FY	2004/05 FY		2005/06 FY
					CR 04/411	Est.	Proj.
	(End-of-period stocks; in billions of Pakistani rupees)						
Net foreign assets	26.3	230.8	539.6	583.1	621.2	636.9	797.6
Net domestic assets	1,499.7	1,530.5	1,539.1	1,903.4	2,196.9	2,328.7	2,740.7
Net claims on government	564.2	639.4	561.0	619.1	699.8	711.1	739.6
Of which:							
Net bank borrowing	499.9	567.2	511.2	574.9	634.9	642.9	649.3
Commodity operations	95.3	100.6	74.0	65.9	80.9	87.8	109.8
Claims on nongovernment	902.4	921.6	1,069.0	1,364.2	1,590.0	1,773.3	2,156.8
Private sector	802.1	840.9	999.9	1,298.0	1,505.8	1,719.8	2,092.3
Public sector enterprises	100.2	80.7	69.1	66.2	84.2	53.5	64.5
Privatization account	-2.9	-2.9	-2.9	-2.9	-2.9	-2.9	-2.9
Other items, net	36.1	-27.5	-88.0	-77.0	-90.0	-152.8	-152.8
Total liquidity (broad money)	1,526.0	1,761.4	2,078.7	2,486.6	2,818.1	2,965.6	3,538.3
Of which:							
Pakistani rupee liquidity	1,371.9	1,603.9	1,952.6	2,340.9	2,651.6	2,785.3	3,296.5
	(Changes in percent of stock of broad money at the beginning of the fiscal year)						
Net foreign assets	5.1	13.4	17.5	2.1	1.2	2.2	5.4
Net domestic assets	3.9	2.0	0.5	17.5	12.1	17.1	13.9
Of which:							
Net claims on the government	-3.3	4.9	-4.5	2.8	3.0	3.7	1.0
Net claims on private sector	3.5	2.5	9.0	14.3	8.4	17.0	12.6
	(Changes over 12 months; in percent)						
Broad money	9.0	15.4	18.0	19.6	13.3	19.3	19.3
Net claims on private sector	6.5	4.8	18.9	29.8	16.0	32.5	21.7
Memorandum items:							
Velocity	2.7	2.5	2.3	2.2	2.2	2.2	2.2
Money multiplier	2.9	3.0	3.1	3.2	3.3	3.3	3.4

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

Table 7. Pakistan: Accounts of the State Bank of Pakistan, 2000/01–2005/06

	2000/01 FY	2001/02 FY	2002/03 FY	2003/04 FY	2004/05 FY CR 04/411	2004/05 FY Est.	2005/06 FY Proj.
	(End-of-period stocks; in billions of Pakistani rupees)						
Net foreign assets	-19.1	133.5	461.6	512.2	540.2	503.7	643.8
Net domestic assets	552.3	451.1	207.9	260.7	306.7	405.4	393.8
Net claims on government	330.1	273.7	28.7	91.2	124.9	248.8	217.7
Of which:							
Budgetary support	361.1	302.6	52.9	112.9	140.9	268.5	231.8
Claims on nongovernment	40.1	22.7	11.5	1.3	1.8	-6.8	-6.8
Claims on scheduled banks	198.0	195.8	180.6	196.0	220.6	210.4	235.4
Privatization account	-2.9	-2.9	-2.9	-2.9	-2.9	-2.9	-2.9
Other items, net	-12.9	-38.2	-9.9	-24.9	-37.7	-44.1	-49.6
Reserve money 1/	533.2	584.6	669.5	772.9	846.9	909.0	1,037.6
Of which:							
Banks' reserves	127.3	110.5	141.0	156.2	160.2	196.3	218.6
Currency	394.6	460.2	525.0	614.5	684.6	709.4	815.7
	(Changes in percent of stock of reserve money at the beginning of the fiscal year)						
Net foreign assets	7.3	28.6	56.1	7.5	2.7	-1.1	15.4
Net domestic assets	-0.2	-19.0	-41.6	7.9	6.9	18.7	-1.3
Of which:							
Budgetary support	-6.7	-10.6	-41.9	9.0	3.6	20.1	-4.0
	(Changes over 12 months; in percent)						
Reserve money	7.1	9.6	14.5	15.4	9.6	17.6	14.1
Currency	5.2	16.6	14.1	17.1	11.4	15.4	15.0

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

1/ Reserve money includes special reserves on foreign currency deposits.

Table 8. Pakistan: Medium-Term Fiscal Framework, 2002/03–2009/10

(In percent of GDP, unless otherwise indicated)

	2002/03 Est.	2003/04 Est.	2004/05 Est.	2005/06 Proj.	2006/07 Proj.	2007/08 Proj.	2008/09 Proj.	2009/10 Proj.
Revenue and grants	17.4	14.9	14.0	13.2	13.4	13.4	13.5	13.6
Tax revenue	11.5	11.1	10.0	9.9	10.0	10.1	10.2	10.3
of which: CBR	9.5	9.4	9.0	9.1	9.2	9.3	9.4	9.4
Nontax revenue	3.4	3.3	3.8	3.0	3.0	3.0	3.0	3.0
Grants	2.5	0.6	0.3	0.3	0.4	0.3	0.3	0.2
Expenditure	18.5	17.3	18.3	16.8	16.9	16.9	17.1	17.2
Current expenditure	16.6	14.0	14.4	13.2	13.1	13.1	13.2	13.3
Interest payments	4.3	3.5	3.2	3.0	3.2	3.1	3.1	3.1
Provincial	4.0	3.9	3.9	3.7	3.7	3.8	4.0	4.1
PSDP	2.7	2.9	3.5	3.6	3.8	3.8	3.8	3.9
Net-lending	-0.9	0.4	0.4	0.0	0.0	0.0	0.0	0.0
Statistical discrepancy	0.3	-0.6	-1.2	0.0	0.0	0.0	0.0	0.0
Overall balance								
Excluding grants	-3.8	-2.3	-3.3	-3.8	-3.8	-3.8	-3.8	-3.8
Including grants	-1.4	-1.8	-3.0	-3.6	-3.4	-3.5	-3.6	-3.6
Financing	1.4	1.8	3.0	3.6	3.4	3.5	3.6	3.6
External	-0.5	-0.7	1.7	3.5	2.1	1.6	1.5	1.4
Domestic	1.8	2.5	1.3	0.0	1.3	1.9	2.1	2.2
Memorandum items:								
Primary balance								
Excluding grants	0.5	1.2	-0.1	-0.8	-0.6	-0.7	-0.7	-0.7
Including grants	2.9	1.8	0.2	-0.6	-0.2	-0.4	-0.4	-0.5
Interest Payments/Revenue (ratio)	28.8	24.7	23.4	23.3	24.6	23.9	23.7	23.5
PRSP expenditure	3.5	3.8	4.6	4.2	4.4	4.5	4.6	4.7
Total government debt	74.3	67.9	61.1	53.3	50.8	48.7	47.0	45.6
Domestic	39.3	36.4	32.9	28.0	25.7	24.4	23.6	23.1
External	35.0	31.5	28.2	25.2	25.1	24.2	23.4	22.5
Implicit interest rate (in percent) 1/	5.9	5.4	5.4	5.7	6.6	6.7	6.9	7.2
Domestic	9.1	8.2	7.9	9.0	9.6	9.8	10.1	10.4
External	2.5	2.1	2.2	2.4	2.9	3.2	3.4	3.6
Nominal GDP (billions of PRs)	4,823	5,533	6,548	7,659	8,715	9,840	11,058	12,426

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

1/ Calculated by dividing interest expenditure by the outstanding debt stock at the end of the previous period.

Table 9. Pakistan: External Debt Sustainability Framework, 1999/2000–2009/10

(In percent of GDP, unless otherwise indicated)

	Actual								Projections					
	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05			2005/06	2006/07	2007/08	2008/09	2009/10	
									I. Baseline Projections					**Debt-stabilizing non-interest current account 5/**
1 **External debt**	48.1	49.4	49.6	42.5	36.5	31.8			**28.4**	**25.4**	**24.4**	**23.5**	**22.5**	**-2.3**
2 Change in external debt	-0.1	1.4	0.1	-7.0	-6.0	-4.8			-3.3	-3.0	-1.0	-1.0	-1.0	
3 Identified external debt-creating flows (4+8+9)	5.4	0.6	1.7	-3.9	-11.1	-8.3			-4.1	-3.1	-1.2	-1.2	-1.3	
4 Current account deficit, excluding interest payments	1.2	-0.2	-0.3	-3.5	-5.5	-2.5			0.5	1.3	1.1	1.1	1.0	
5 Balance of goods and services	-29.1	-31.9	-31.6	-33.6	-34.1	-39.2			-38.2	-36.1	-36.6	-37.0	-37.4	
6 Exports	13.0	14.4	15.4	16.6	15.7	16.1			15.4	14.7	15.1	15.4	15.6	
7 Imports	-16.0	-17.5	-16.2	-17.0	-18.4	-23.1			-22.8	-21.4	-21.5	-21.6	-21.8	
8 Net non-debt creating capital inflows (negative)	-0.7	-0.3	-0.5	-0.8	-0.8	-1.3			-1.0	-1.1	-1.2	-1.2	-1.2	
9 Automatic debt dynamics 1/	4.9	1.0	2.5	0.3	-4.9	-4.5			-3.6	-3.2	-1.1	-1.1	-1.1	
10 Contribution from nominal interest rate	2.0	1.8	1.8	1.4	1.0	0.8			0.7	0.8	0.8	0.8	0.7	
11 Contribution from real GDP growth	-2.2	-0.9	-1.6	-2.4	-2.3	-2.4			-1.9	-1.5	-1.4	-1.4	-1.3	
12 Contribution from price and exchange rate changes 2/	5.1	0.1	2.3	1.3	-3.6	-2.8			-2.4	-2.6	-0.5	-0.5	-0.5	
13 Residual, incl. change in gross foreign assets (2-3)	-5.5	0.8	-1.6	-3.1	5.1	3.5			0.7	0.0	0.3	0.3	0.4	
External debt-to-exports ratio (in percent)	368.8	343.6	322.1	256.6	232.4	197.8			183.9	172.7	162.0	152.6	144.1	
Gross external financing need (in billions of US dollars) 3/	9.8	10.1	8.7	7.8	2.7	4.0			6.2	7.2	5.5	6.0	6.9	
in percent of GDP	13.4	14.1	12.1	9.4	2.8	3.6			4.9	4.8	3.4	3.4	3.7	
Key Macroeconomic Assumptions							10-Year Historical Average	10-Year Standard Deviation						Projected Average
Real GDP growth (in percent)	4.3	1.9	3.2	5.0	6.4	7.8	4.1	2.1	7.0	6.0	6.0	6.0	6.0	6.2
Exchange rate appreciation (US dollar value of local currency, change in percent)	-14.5	-2.9	-11.3	-4.9	4.9	1.6	-6.1	6.5	-3.0	-0.9	-5.6	-3.8	-3.8	-3.4
GDP deflator in US dollars (change in percent)	-9.5	-0.3	-4.5	-2.6	9.3	8.4	0.7	6.8	8.1	10.0	2.0	2.0	2.0	4.8
Nominal external interest rate (in percent)	4.0	3.7	3.6	3.0	2.8	2.5	3.8	0.9	2.6	3.4	3.3	3.3	3.0	3.1
Growth of exports (US dollar terms, in percent)	8.3	7.4	7.5	23.8	10.5	17.2	6.7	9.8	11.2	11.0	10.9	10.3	9.7	10.6
Growth of imports (US dollar terms, in percent)	0.2	6.6	-7.1	20.6	26.1	44.3	8.3	18.2	13.6	9.5	8.9	8.8	8.6	9.9
Current account balance, excluding interest payments	-1.2	0.2	0.3	3.5	5.5	2.5	0.3	2.8	-0.5	-1.3	-1.1	-1.1	-1.0	-1.0
Net non-debt creating capital inflows	0.7	0.3	0.5	0.8	0.8	1.3	0.9	0.4	1.0	1.1	1.2	1.2	1.2	1.2
									II. Stress Tests for External Debt Ratio					**Debt-stabilizing non-interest current account 5/**
A. Alternative Scenarios														
A1. Key variables are at their historical averages in 2006-10 4/									**31.7**	**30.3**	**29.2**	**28.1**	**27.2**	**-1.1**
B. Bound Tests														
B1. Nominal interest rate is at baseline plus one-half standard deviation									**28.5**	**25.6**	**24.8**	**23.9**	**23.0**	**-2.2**
B2. Real GDP growth is at baseline minus one-half standard deviations									**28.7**	**25.9**	**25.1**	**24.3**	**23.5**	**-2.2**
B3. Non-interest current account is at baseline minus one-half standard deviations									**29.8**	**28.1**	**28.4**	**28.7**	**28.9**	**-2.6**
B4. Combination of B1-B3 using 1/4 standard deviation shocks									**28.6**	**26.4**	**26.3**	**26.1**	**25.9**	**-2.3**
B5. One time 30 percent real depreciation in 2006									**46.9**	**41.1**	**38.8**	**36.6**	**34.4**	**-3.7**

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

1/ Derived as $[r - g - \rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as $[-\rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock. ρ increases with an appreciating domestic currency ($\varepsilon > 0$) and rising inflation (based on GDP deflator).

3/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

4/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

5/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Table 10. Pakistan: Public Sector Debt Sustainability Framework, 1999/2000–2009/10

(In percent of GDP, unless otherwise indicated)

		Actual 1999/00	2000/01	2001/02	2002/03	2003/04	2004/05			2005/06	2006/07	2007/08	2008/09	2009/10	
										I. Baseline Projections					Debt-stabilizing primary balance
1	**Public sector debt 1/**	83.8	88.8	80.2	74.3	67.9	61.1			**53.3**	**50.8**	**48.7**	**47.0**	**45.6**	**-1.7**
	o/w foreign-currency denominated	42.1	47.3	41.1	35.9	32.2	28.7			25.6	25.4	24.5	23.6	22.5	
2	Change in public sector debt	2.0	5.1	-8.7	-5.9	-6.4	-6.8			-7.8	-2.5	-2.1	-1.6	-1.4	
3	Identified debt-creating flows (4+7+12)	0.4	1.0	1.0	-7.5	-8.4	-7.0			-7.6	-2.6	-1.9	-1.5	-1.3	
4	Primary deficit	-1.9	-2.3	-2.0	-2.9	-1.8	-0.19			0.6	0.2	0.4	0.4	0.5	
5	Revenue and grants	14.4	14.3	16.1	17.4	14.9	14.0			13.2	13.4	13.4	13.5	13.6	
6	Primary (noninterest) expenditure	12.5	12.0	14.1	14.4	13.1	13.8			13.7	13.6	13.8	13.9	14.1	
7	Automatic debt dynamics 2/	2.3	3.3	3.1	-4.5	-6.5	-6.4			-5.7	-1.9	-1.8	-1.3	-1.2	
8	Contribution from interest rate/growth differential 3/	1.0	-1.8	0.7	-2.7	-6.0	-7.3			-5.9	-3.2	-2.7	-2.2	-2.0	
9	Of which contribution from real interest rate	4.3	-0.4	3.5	0.9	-1.9	-2.8			-2.2	-0.4	0.0	0.4	0.5	
10	Of which contribution from real GDP growth	-3.3	-1.4	-2.7	-3.6	-4.1	-4.5			-3.6	-2.8	-2.7	-2.6	-2.5	
11	Contribution from exchange rate depreciation 4/	1.2	5.1	2.4	-1.8	-0.5	0.9			0.2	1.4	0.9	0.9	0.9	
12	Other identified debt-creating flows	0.0	0.0	-0.2	-0.1	-0.2	-0.4			-2.5	-1.0	-0.5	-0.6	-0.6	
13	Privatization receipts (negative)	0.0	0.0	-0.2	-0.1	-0.2	-0.4			-2.5	-1.0	-0.5	-0.6	-0.6	
14	Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	
15	Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	
16	Residual, including asset changes (2-3)	1.7	4.1	-9.7	1.7	2.0	0.3			-0.3	0.1	-0.2	-0.2	-0.1	
	Public sector debt-to-revenue ratio 1/	581.9	623.1	498.9	427.5	455.3	435.1			404.4	378.3	362.5	347.7	335.8	
	Gross financing need 5/	8.4	5.4	6.7	3.9	4.9	3.9			4.8	4.5	4.5	5.1	4.8	
	in billions of U.S. dollars	6.1	3.5	4.9	3.3	4.7	4.2			6.2	6.1	6.6	8.1	8.2	
	Key Macroeconomic and Fiscal Assumptions							10-Year Historical Average	10-Year Standard Deviation						Projected Average
	Real GDP growth (in percent)	4.3	1.9	3.2	5.0	6.4	7.8	4.1	2.0	7.0	6.0	6.0	6.0	6.0	6.2
	Average nominal interest rate on public debt (in percent) 6/	8.5	7.4	6.6	5.9	5.5	5.6	7.3	1.3	5.7	6.9	7.0	7.2	7.5	6.9
	Average real interest rate (nominal rate minus change in GDP deflator, in percent)	5.7	-0.3	4.2	1.5	-2.4	-4.2	0.3	4.1	-3.6	-0.4	0.5	1.2	1.5	-0.2
	Nominal appreciation (increase in US dollar value of local currency, in percent)	-2.9	-11.3	-4.9	4.9	1.6	-3.1	-6.2	6.2	-0.8	-5.6	-3.8	-3.8	-3.8	-3.6
	Inflation rate (GDP deflator, in percent)	2.7	7.7	2.4	4.4	7.8	9.8	7.0	3.8	9.3	7.3	6.5	6.0	6.0	7.0
	Growth of real primary spending (deflated by GDP deflator, in percent)	5.3	-2.4	21.7	7.4	-3.2	13.6	3.7	9.7	6.2	5.2	7.3	7.1	6.9	6.5
	Primary deficit	-1.9	-2.3	-2.0	-2.9	-1.8	-0.2	-1.1	1.5	0.6	0.2	0.4	0.4	0.5	0.4
										II. Stress Tests for Public Debt Ratio					Debt-stabilizing primary balance
	A. Alternative Scenarios														
	A1. Key variables are at their historical averages in 2004/05-09/10 7/									**55.2**	**52.8**	**50.0**	**47.2**	**44.6**	**-1.4**
	A2. No policy change (constant primary balance) in 2004/05-09/10									**52.3**	**49.9**	**47.2**	**45.0**	**43.0**	**-1.7**
	B. Bound Tests														
	B1. Real interest rate is at baseline plus one half standard deviations									**54.5**	**53.2**	**52.2**	**51.6**	**51.2**	**-0.7**
	B2. Real GDP growth is at historical average minus one half standard deviations in 2005/06 and 2006/07									**53.9**	**52.1**	**50.8**	**50.0**	**49.6**	**-1.4**
	B3. Primary balance is at historical average minus one half standard deviations in 2006 and 2007									**54.0**	**52.2**	**50.8**	**49.9**	**49.1**	**-1.8**
	B4. Combination of B1-B3 using one standard deviation shocks									**54.4**	**53.0**	**51.9**	**51.2**	**50.8**	**-1.2**
	B5. One time 30 percent real depreciation in 2005/06 8/									**69.4**	**66.3**	**63.7**	**61.6**	**59.8**	**-2.1**
	B6. 10 percent of GDP increase in other debt-creating flows in 2005/06									**63.3**	**60.4**	**58.0**	**56.1**	**54.4**	**-1.9**

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

1/ Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.

2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi(1+g)$ and the real growth contribution as -g.

4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.

5/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

6/ Derived as nominal interest expenditure divided by previous period debt stock.

7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.

8/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Table 11. Pakistan: Low-Growth Medium-Term Fiscal Framework, 2002/03–2009/10
(In percent of GDP, unless otherwise indicated)

	2002/03 Est.	2003/04 Est.	2004/05 Est.	2005/06 Proj.	2006/07 Proj.	2007/08 Proj.	2008/09 Proj.	2009/10 Proj.
Revenue and grants	17.4	14.9	14.0	13.3	13.4	13.4	13.5	13.5
Tax revenue	11.5	11.1	10.0	9.9	10.0	10.0	10.1	10.2
of which: CBR	9.5	9.4	9.0	9.1	9.2	9.2	9.3	9.3
Nontax revenue	3.4	3.3	3.8	3.1	3.0	3.0	3.0	3.0
Grants	2.5	0.6	0.3	0.3	0.4	0.3	0.3	0.3
Expenditure	18.5	17.3	18.3	17.3	17.7	17.8	18.0	18.3
Current expenditure	16.6	14.0	14.4	13.6	13.9	14.0	14.2	14.4
Interest payments	4.3	3.5	3.2	3.2	3.6	3.7	3.7	3.8
Provincial	4.0	3.9	3.9	3.8	3.7	3.8	4.0	4.1
PSDP	2.7	2.9	3.5	3.6	3.7	3.7	3.8	3.9
Net-lending	-0.9	0.4	0.4	0.0	0.0	0.0	0.0	0.0
Statistical discrepancy	0.3	-0.6	-1.2	0.0	0.0	0.0	0.0	0.0
Overall balance								
Excluding grants	-3.8	-2.3	-3.3	-4.3	-4.7	-4.7	-4.8	-5.0
Including grants	-1.4	-1.8	-3.0	-4.0	-4.3	-4.4	-4.5	-4.7
Financing	1.4	1.8	3.0	4.0	4.3	4.4	4.5	4.7
External	-0.5	-0.7	1.7	3.7	2.3	2.1	1.6	1.8
Domestic	1.8	2.5	1.3	0.3	2.1	2.2	2.9	2.9
Memorandum items:								
Primary balance								
Excluding grants	0.5	1.2	-0.1	-1.1	-1.1	-1.0	-1.1	-1.2
Including grants	2.9	1.8	0.2	-0.8	-0.7	-0.7	-0.8	-0.9
Interest Payments/Revenue (ratio)	28.8	24.7	23.4	24.4	27.7	28.0	28.5	28.8
PRSP expenditure	3.5	3.8	4.6	4.4	4.6	4.7	4.8	4.9
Total government debt	74.3	67.9	61.1	55.2	54.6	53.9	53.6	53.4
Domestic	39.3	36.4	32.9	29.2	28.1	27.4	27.5	27.7
External	35.0	31.5	28.2	26.0	26.5	26.5	26.0	25.7
Implicit interest rate (in percent) 1/	5.9	5.4	5.4	5.9	6.9	7.1	7.3	7.5
Domestic	9.1	8.2	7.9	9.5	10.2	10.5	10.8	10.9
External	2.5	2.1	2.2	2.4	2.9	3.1	3.4	3.5
Nominal GDP (billions of PRs)	4,823	5,533	6,548	7,430	8,248	9,133	10,083	11,131

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

1/ Calculated by dividing interest expenditure by the outstanding debt stock at the end of the previous period.

Table 12. Pakistan: Low-Growth Medium Term External Scenario, 2000/01–2009/10

	2000/01	2001/02	2002/03	2003/04	2004/05		2005/06	2006/07	2007/08	2008/09	2009/10
					CR 04/411	Est.	Proj.	Proj.	Proj.	Proj.	Proj.
	(In millions of U.S. dollars)										
Current account (excluding official transfers)	-1,951	96	3,166	1,312	-70	-1,776	-3,222	-4,034	-4,610	-5,095	-5,734
Current account (including official transfers)	-1,112	1,591	4,204	1,886	384	-1,397	-2,853	-3,584	-4,160	-4,645	-5,284
Trade balance	-1,268	-292	-444	-1,212	-1,332	-4,353	-5,105	-5,565	-5,977	-6,340	-7,024
Exports f.o.b.	8,934	9,140	10,889	12,395	13,130	14,371	16,607	18,268	19,912	21,704	23,223
Imports f.o.b.	-10,202	-9,432	-11,333	-13,607	-14,462	-18,724	-21,712	-23,833	-25,888	-28,044	-30,247
Services (net)	-3,143	-2,617	-2,127	-3,586	-3,806	-5,873	-6,672	-7,323	-7,800	-8,247	-8,494
Of which: interest payments	-1,657	-1,579	-1,276	-1,050	-1,076	-936	-940	-1,230	-1,286	-1,359	-1,353
Private transfers (net)	2,460	3,005	5,737	6,110	5,069	8,450	8,555	8,854	9,166	9,492	9,784
Of which: workers' remittances	1,086	2,390	4,237	3,871	3,300	4,168	4,300	4,515	4,741	4,978	5,301
Official transfers (net)	839	1,495	1,038	574	453	379	369	450	450	450	450
Capital account	-623	-2,322	-1,709	-3,089	-2,475	-1,211	88	1,014	1,739	1,331	1,875
Public medium- and long-term capital	-652	-1,613	-1,656	-2,092	-1,796	-340	-89	27	515	11	383
Of which: project and nonproject loans	-332	-983	-1,840	-1,986	-1,291	-850	-42	-85	-135	-140	-172
Disbursements	1,463	531	581	434	742	583	1,000	1,000	1,000	1,000	900
Amortization 1/	-1,795	-1,514	-2,421	-2,420	-2,033	-1,433	-1,042	-1,085	-1,135	-1,140	-1,072
Public sector short-term (net)	-59	-1,064	-268	-856	-469	-353	-358	-150	-150	-300	-300
Private medium- and long-term	343	-80	164	493	315	852	1,275	1,610	1,839	2,084	2,256
Of which: FDI	322	368	612	752	500	1,162	1,200	1,380	1,587	1,777	1,937
Private short-term (including errors & omissions)	-256	435	51	-634	-525	-1,370	-740	-473	-465	-464	-464
Overall balance (before debt relief)	-1,735	-731	2,495	-1,203	-2,091	-2,608	-2,765	-2,569	-2,421	-3,314	-3,409
Financing	1,735	731	-2,495	1,203	2,091	2,608	2,765	2,569	2,421	3,314	3,409
Reserve assets (increase -)	-1,088	-3,082	-5,261	-404	-460	-213	-2,406	-634	-342	469	538
State Bank of Pakistan (including FE-25s)	-729	-2,717	-5,911	-427	-160	507	-2,076	-467	-167	651	592
Deposit money banks	-359	-365	650	23	-300	-720	-330	-167	-174	-182	-55
Fund repurchases	-194	-194	-418	-673	-294	-399	-150	-167	-197	-215	-188
Net exceptional financing	3,017	4,007	3,185	2,280	2,845	3,220	5,321	3,370	2,960	3,060	3,060
Of which: rollover of foreign deposits with banking system	1,676	1,314	900	1,200	1,200	1,200	1,200	1,200	1,200	1,200	1,200
Of which: program financing from IFIs	279	1,367	1,090	781	1,446	1,557	1,021	1,070	1,160	1,160	1,160
World Bank	0	698	213	192	540	725	600	600	650	650	650
AsDB	0	185	408	344	400	577	421	470	510	510	510
IMF	279	484	469	245	506	255	0	0	0	0	0
Of which: privatization receipts	0	117	186	199	99	363	3,000	1,000	500	600	700
	(In annual percentage change; unless otherwise indicated)										
Memorandum items:											
Current account (excl. official transfers, percent of GDP)	-2.7	0.1	3.8	1.4	-0.1	-1.6	-2.6	-3.1	-3.3	-3.4	-3.6
Current account (incl. official transfers, percent of GDP)	-1.6	2.2	5.1	2.0	0.4	-1.3	-2.3	-2.7	-3.0	-3.1	-3.3
Exports f.o.b. (growth rate, percent)	9.1	2.3	19.1	13.8	8.0	15.9	15.6	10.0	9.0	9.0	7.0
Imports f.o.b. (growth rate, percent)	6.2	-7.5	20.2	20.1	12.0	37.6	16.0	9.8	8.6	8.3	7.9
Export unit value	-2.5	-3.1	10.2	10.9	2.6	7.4	4.4	2.4	1.7	1.6	1.7
Import unit value	-1.0	-2.6	11.2	9.9	3.2	11.4	7.2	0.8	0.3	0.4	0.7
Export volume	11.9	5.6	8.1	2.7	5.2	8.0	10.7	7.4	7.2	7.3	5.2
Import volume	7.3	-5.1	8.0	9.3	8.5	23.6	8.2	8.9	8.3	7.9	7.1
Terms of trade	-1.6	-0.5	-0.9	0.9	-0.6	-3.6	-2.6	1.6	1.4	1.2	1.1
End-period gross official reserves (in millions of U.S. dollars) 2/	1,679	4,330	10,251	10,621	11,745	9,985	11,941	12,354	12,427	11,649	10,926
(In months of next year's imports of goods and nonfactor services)	1.7	3.7	6.9	5.0	7.4	4.1	4.5	4.3	4.1	3.6	3.2

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

1/ Includes accelerated repayments: (i) in 2002/03, $1 billion to the U.S.; and (ii) in 2003/04, $1.1 billion to AsDB.

2/ Excluding gold, foreign currency deposits held with the SBP, cash reserve requirement, and net of and outstanding short-term swap and forward contracts. Including sinking fund.

Table 13. Pakistan: Financial Soundness Indicators for the Banking Sector, 1999–2005

	1999 Dec	2000 Dec.	2001 Dec.	2002 Dec.	2003 Dec.	2004 Dec.	2005 Mar.	2005 Jun.
All banks 1/								
Capital adequacy								
Regulatory capital to risk-weighted assets	10.9	9.7	8.8	8.8	8.5	10.5	10.7	10.9
Tier I capital to risk-weighted assets	9.2	8.3	7.3	6.2	6.5	7.6	7.7	8.1
Capital to total assets	4.8	4.5	3.8	4.8	5.4	6.5	6.7	6.6
Asset composition and quality								
NPLs to gross loans	25.9	23.5	23.4	21.8	17.0	11.6	10.6	10.6
Provisions to NPLs	48.6	55.0	54.7	60.6	63.7	71.6	74.9	73.6
NPLs net of provisions to capital	149.8	131.3	150.5	85.5	55.4	28.8	23.0	24.1
Earnings and profitability								
ROA (after tax)	-0.2	-0.2	-0.5	0.1	1.1	1.2	1.3	1.4
ROE (after tax)	-3.9	-3.5	-12.6	3.2	20.5	19.5	19.7	22.1
Net interest income to gross income	55.6	62.3	70.4	67.1	60.5	64.0	70.6	71.1
Noninterest expenses to gross income	75.8	71.6	62.4	59.1	49.1	51.6	46.7	48.2
Liquidity								
Liquid assets to total assets	36.8	36.0	38.5	46.7	45.1	36.5	35.5	36.4
Liquid assets to total deposits	48.6	48.5	50.7	61.8	58.5	46.3	45.6	46.3
Commercial banks								
Capital adequacy								
Regulatory capital to risk-weighted assets	12.2	11.4	11.3	12.6	11.1	11.4	11.8	11.8
Tier I capital to risk-weighted assets	10.3	9.8	9.7	9.7	9.1	8.6	8.9	9.1
Capital to total assets	5.0	4.9	4.6	6.1	6.0	7.1	7.4	7.2
Asset composition and quality								
NPLs to gross loans	22.0	19.5	19.6	17.7	13.7	9.0	8.4	7.8
Provisions to NPLs	46.6	53.9	53.2	58.2	64.7	72.7	73.9	75.7
NPLs net of provisions to capital	117.4	96.7	100.7	54.2	37.5	19.2	16.7	14.6
Earnings and profitability								
ROA (after tax)	-0.3	0.0	0.0	0.8	1.2	1.3	1.6	1.6
ROE (after tax)	-6.2	-0.3	-0.3	14.3	20.5	19.8	22.7	22.9
Net interest income to gross income	54.3	61.2	68.9	66.1	59.4	62.5	69.6	70.6
Noninterest expenses to gross income	76.9	71.6	62.7	56.7	48.6	51.8	46.2	47.2
Liquidity								
Liquid assets to total assets	38.7	37.5	39.9	48.1	46.0	36.9	35.9	36.6
Liquid assets to total deposits	48.2	48.0	50.3	61.5	57.9	45.5	44.9	45.2

Source: State Bank of Pakistan.

1/ Includes commercial banks and specialized banks.

Table 14. Pakistan: Social Indicators, 2000/01–2004/05

	2000/01	2001/02	2002/03	2003/04	2004/05
A. Intermediate outcome indicators					
Health sector 1/					
Utilization rate of first level care facilities (average cases/day/facility)	34	113	115	110	112
Population covered by lady health workers 2/	30	41	44	50	58
Immunization coverage of children/pregnant mothers	76	80	69	65	n.a.
Birth attended by skilled birth attendants	13	13	14	12	11
Number of skilled female birth attendants (in thousands)	96	96	96	n.a.	n.a.
Percentage of first level care facilities not experiencing stock-outs of five key supplies	26	28	35	27	25
Share of first level care facilities meeting staffing norms	30	34	30	n.a.	n.a.
Education sector 1/					
Number of functioning schools (in thousands)	145	150	148	149	151
Primary	133	133	134	135	137
Middle	13	13	14	14	14
Share of functional schools with basic facilities (percent)					
Water	51	51	50	52	52
Electricity	21	21	22	30	n.a.
Sanitary	37	36	48	49	49
Housing conditions					
Houses with tap water as main source of drinking water (percent)	...	25	...	...	39
Houses without toilet (percent)	...	43	...	...	26
B. Outcome indicators					
Health					
Infant mortality (per 1,000 live births)	...	83	...	81	...
Under-five mortality (per 1,000 live births)	...	107	...	103	...
Life expectancy at birth (years)	...	61	...	63	...
Full imminization (children 12-23 months)	...	53	...	...	77
Education					
Primary school net enrollment ratio	...	42	...	...	52
Male	...	*46*	...	...	*56*
Female	...	*38*	...	...	*48*
Secondary school net enrollment ratio	...	16	...	...	18
Male	...	*17*	...	...	*20*
Female	...	*14*			*16*
Literacy rate (15 years and older)	...	43	...	49	50
Male	...	*57*	...	...	*63*
Female	...	*29*	...	*35*	*36*
Incomes					
Poverty rate	...	32	...	...	...
Average per capita GDP in US$	509	502	563	643	724
Average per capita consumption in PRs	22,541	22,902	24,178	27,083	34,324
Real per capita consumption (percentage change)	4.1	-0.9	2.4	7.1	16.0
Real wage skilled construction worker (percent change)	-4.1	-0.6	-2.5	-0.6	5.7

Sources: Pakistani authorities; United Nations Development Program.
PRSP Secretariat, *PRSP–Second Quarter Progress Report FY2004/05*, March 2005.
FBS, *Pakistan Social and Living Standards Measurement Survey*, 2004-05, June 2005.
UNDP, *2005 Human Development Report*, September 2005.

1/ 2004/05 data for health and education intermediate outcome indicatros as of December 2004.
2/ Lady health workers are outreach workers providing preventive health and family planning services through house-to-house visits.

Table 15. Pakistan: Millennium Development Goals, 1990–2003

	1990	1994	1997	2000	2003
Goal 1: Eradicate extreme poverty and hunger					
Percentage share of income or consumption held by poorest 20%	..	..	..	8.8	..
Population below $1 a day (%)	47.8	..	13.4	..	..
Population below minimum level of dietary energy consumption (%)	..	..	19	..	20
Poverty gap ratio at $1 a day (incidence x depth of poverty)	14.6	..	2.4	..	..
Poverty headcount, national (% of population)	..	28.6	..	32.6	..
Prevalence of underweight in children (under five years of age)	40.2	40	..	35	..
Goal 2: Achieve universal primary education					
Net primary enrollment ratio (% of relevant age group)	..	..	..	59.1	..
Primary completion rate, total (% of relevant age group)	..	..	..	..	..
Proportion of pupils starting grade 1 who reach grade 5	..	..	..	..	..
Youth literacy rate (% ages 15-24)	47.4	51.9	54.6	..	..
Goal 3: Promote gender equality and empower women					
Proportion of seats held by women in national parliament (%)	10	..	2	2	22
Ratio of girls to boys in primary and secondary education (%)	..	..	..	71.7	71.1
Ratio of young literate females to males (% ages 15-24)	49	52.9	55.9	..	..
Share of women employed in the nonagricultural sector (%)	6.6	8.1	8.1	7.4	8.2
Goal 4: Reduce child mortality					
Immunization, measles (% of children ages 12-23 months)	50	53	52	56	61
Infant mortality rate (per 1,000 live births)	96	90	..	81	74
Under 5 mortality rate (per 1,000)	138	125	..	108	98
Goal 5: Improve maternal health					
Births attended by skilled health staff (% of total)	18.8	..	18	23	..
Maternal mortality ratio (modeled estimate, per 100,000 live births)	..	..	..	500	..
Goal 6: Combat HIV/AIDS, malaria, and other diseases					
Contraceptive prevalence rate (% of women ages 15-49)	14	17.8	23.9	27.6	..
Incidence of tuberculosis (per 100,000 people)	181.3	181.3	181.3	181.3	181.3
Number of children orphaned by HIV/AIDS	..	..	..	..	..
Prevalence of HIV, total (% of population aged 15-49)	..	..	..	0.1	0.1
Tuberculosis cases detected under DOTS (%)	..	1	3.8	2.8	16.8
Goal 7: Ensure environmental sustainability					
Access to an improved water source (% of population)	83	..	..	..	90
Access to improved sanitation (% of population)	38	..	..	..	54
Access to secure tenure (% of population)	..	..	..	..	..
CO2 emissions (metric tons per capita)	0.6	0.7	0.7	0.8	..
Forest area (% of total land area)	3.6	..	..	3.1	..
GDP per unit of energy use (2000 PPP $ per kg oil equivalent)	3.9	4	4.1	4.2	4.3
Nationally protected areas (% of total land area)	..	..	..	..	4.9
Goal 8: Develop a global partnership for development					
Aid per capita (current US$)	10.5	13.4	4.6	5.1	7.2
Debt service (% of exports)	..	..	..	..	..
Fixed line and mobile phone subscribers (per 1,000 people)	7.5	14.7	20.8	24.5	44.2
Internet users (per 1,000 people)	..	0	0.3	2.2	10.3
Personal computers (per 1,000 people)	1.3	2.8	3.7	4.2	..
Unemployment, youth female (% of female labor force ages 15-24)	1.3	10	21	29.2	..
Unemployment, youth male (% of male labor force ages 15-24)	5.7	6.9	7.9	11.1	..
Unemployment, youth total (% of total labor force ages 15-24)	5.1	7.4	10	13.3	..
Other					
Fertility rate, total (births per woman)	5.8	5.3	5	4.8	4.5
GNI per capita, Atlas method (current US$)	420	450	500	480	520
GNI, Atlas method (current US$) (billions)	45.5	54.3	63.7	66.5	77.6
Gross capital formation (% of GDP)	18.9	19.5	17.9	16	15.5
Life expectancy at birth, total (years)	59.1	..	61.7	..	64.1
Literacy rate, adult total (% of people ages 15 and above)	35.4	38.5	40.9	..	..
Population, total (millions)	108	119.4	128.5	138.1	148.4
Trade (% of GDP)	38.9	35.3	36.9	34.3	40.8

Source: World Development Indicators database, April 2005

Table 16. Pakistan: Selected Social Indicators in International Comparison, 2003

	Pakistan	India	Sri Lanka	South Asia 1/	Low Income
Popuplation (millions)	148	1,071	20	1,408	2,310
GDP per capita (US$)	603	565	907	547	450
Per capita health expenditure (PPP US$)	62	96	131	88	...
Life expectancy at birth (years)	63	63	74	63	58
Infant mortality (per 1,000 live births)	81	63	13	63	82
Under 5 mortality (per 1,000 live births)	103	87	15	86	...
Literacy (% of population over 15 years)	49	61	90	58	63

Sources: UNDP 2005 Human Development Report; World Bank.

1/ Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, and Sri Lanka; averages weighted by population.

Table 17. Pakistan: Social- and Poverty-Related Expenditures, 2001/02–2005/06 1/

	2001/02	2002/03	2003/04	2004/05	2005/06
	(In billions of Pakistani rupees)				
Total	167.3	208.9	253.6	300.4	323.9
Current	140	165.4	192.0	209.8	...
Development	27.3	43.5	61.6	90.6	...
By selected functional area					
Education	66.3	78.6	97.7	106.7	...
Health	19.2	22.4	27.0	30.6	...
Rural development	12.3	16.9	18.4	15.6	...
	(In percent of GDP)				
Total	3.8	4.3	4.6	4.6	4.2
Current	3.2	3.4	3.5	3.2	...
Development	0.6	0.9	1.1	1.4	...
By selected functional area					
Education	1.5	1.6	1.8	1.6	...
Health	0.4	0.5	0.5	0.5	...
Rural development	0.3	0.4	0.3	0.2	...
	(Real per capita growth in 2000/01 prices in percent)				
Total	...	18.5	13.8	6.3	-3.8
Current	...	12.1	8.9	-1.9	...
Development	...	51.2	32.8	32.0	...
By selected functional area					
Education	12.0	12.5	16.6	-1.9	...
Health	4.7	10.7	13.0	1.7	...
Rural development	2.9	30.4	2.1	-23.9	...

Sources: Pakistani authorities, and Fund staff estimates.

1/ Social- and poverty-related expenditures as defined in the government's Poverty Reduction Strategy Paper.

PAKISTAN: RELATIONS WITH THE FUND

As of August 31, 2005

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	1,108.32	107.22
Reserve position in Fund	0.12	0.01

III. **SDR Department**:	SDR Million	% Allocation
Net cumulative allocation	169.99	100.00
Holdings	154.32	90.78

IV. **Outstanding Purchases and Loans**:	SDR Million	% Quota
Stand-by arrangements	13.13	1.27
Extended arrangements	61.61	5.96
PRGF arrangements	1,013.06	98.00

V. **Latest Financial Arrangements**:

Type	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
PRGF	12/06/2001	12/05/2004	1,033.70	861.42
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 Payments to the Fund**[1] SDR Million; based on existing use of resources and present holdings of SDRs):

	Overdue	Forthcoming				
	6/30/05	2005	2006	2007	2008	2009
Principal	0.0	43.77	72.03	97.88	116.16	146.36
Charges/Interest	0.0	3.32	7.14	6.10	4.96	3.98
Total	0.0	47.09	79.17	103.98	121.12	150.34

[1] This schedule presents all currently scheduled payments to the IMF, including repayment expectations and repayment obligations. The IMF Executive Board can extend repayment expectations (within predetermined limits) upon request by the member if its external payment position is not strong enough to meet the expectations without undue hardship or risk.

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. On May 19, 1999, the official exchange rate was eliminated and the exchange rate system unified, with all international transactions conducted at the FIBR. As of July 20, 2005, the FIBR was PRs 59.56 per $1. Pakistan’s exchange regime is classified as managed floating with no predetermined path for the exchange rate. Pakistan maintains a minor exchange restriction on payments for current international transactions subject to Fund approval under Article VIII, Section 2a, resulting from limitations on advance payments for certain imports.

VIII. Last Article IV Consultation

The last Article IV consultation discussions were held in Islamabad in August/September 2004. The staff report (IMF Country Report No. 04/411) was discussed by the Executive Board on December 1, 2004.

IX. Safeguards Assessments

In accordance with the Fund’s safeguards assessment policy, the State Bank of Pakistan (SBP) was subject to a full safeguards assessment under the Stand-By Arrangement that expired on September 30, 2001. This assessment, which included a safeguards mission to the SBP, was completed on February 13, 2001. The staff’s findings and recommendations were reported in IMF Country Report No. 01/58, Appendix IV. The authorities have implemented all of the recommended remedial measures that were included under SBA conditionality, and no new critical vulnerabilities were identified under Pakistan’s subsequent PRGF Arrangement.

X. ROSCs

Fiscal Transparency Module	11/28/2000	(refer to www.imf.org)
Fiscal Transparency Module—Update	11/22/2004	IMF Country Report No. 04/416
Financial System Stability Assessment	6/23/2004	IMF Country Report No. 04/215
Data Module and Detailed Assessment Using the Data Quality Assessment Framework	11/29/2004	IMF Country Report No. 04/398

XI. Recent Technical Assistance

a. **FAD**: 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 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 (TA) 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. In March 2003, a mission advised the authorities on customs administration reform. In April 2004, a mission advised the authorities on improving fiscal reporting at the subnational level.

b. **MFD**: In July 2000, a joint MFD/MCD 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 TA 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. In November/December 2004, a joint MFD/World Bank mission provided advice on public debt reform. In March/April 2005, a mission provided TA on the development of the insurance sector.

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. In April/May 2005, a mission provided TA on national accounts and consumer price statistics.

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

XII. Resident Representative

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

PAKISTAN: RELATIONS WITH THE WORLD BANK GROUP

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Partnership in Pakistan's development strategy

1. The government of Pakistan's Poverty Reduction Strategy Paper (PSRP) for 2002/03 to 2007/08,[1] completed in December 2003, constitutes a broad-based strategy for addressing poverty, including human development, governance, and vulnerability, and builds on the economic program first articulated in the fall of 1999 and further elaborated in the Interim-PRSP (I-PRSP) of 2001. The Bank-Fund Joint Staff Assessment (JSA), discussed by the Board of the IMF on March 8, 2004 and the Board of the World Bank on March 11, 2004, endorsed the PRSP and indicated it provides a good policy framework for the implementation of a reform program which can accelerate progress toward the Millennium Development Goals (MDGs).

2. The Fund takes the lead in the policy dialogue with Pakistan on macroeconomic policies including overall fiscal and monetary policy. As outlined more fully below, the World Bank has complemented the Fund's work through support to structural reforms in governance and social sectors and support of the growth agenda through reforms and investments in key sectors, such as power, oil and gas, transport, water and banking reforms.

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 Poverty Reduction Strategy. 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 Country Assistance Strategy (CAS) was presented to the World Bank's Board of Executive Directors on June 11, 2002. A CAS Progress Report, which was presented to the Board on April 20, 2004, confirms that the strategy set out in the 2002 CAS remains valid in light of the full PRSP. A new CAS for FY2006-2009 is being prepared.

4. The World Bank works closely with the Fund and the government on structural reforms underpinning macroeconomic stability. In this context, the World Bank's lending program has featured development policy lending to support 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. A Tax Administration Reform Project was approved in FY 2005. The Project to Improving Financial Reporting and Auditing (PIFRA) II project was approved in

[1] Government of Pakistan, 2003, *Accelerating Economic Growth and Reducing Poverty: the Road Ahead*.

September 2005. The World Bank has also approved structural and sector adjustment credits for three provinces (Punjab, Sindh and North West Frontier Province (NWFP)) supporting provincial reform strategies to improve resource management and strengthen provision of public services by local governments and communities. The first in a series of annual Poverty Reduction Support Credits was approved in September 2004. Further development policy lending at the provincial level is also planned.

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 as well as investment lending in key infrastructure sectors including water, power, and transport. The World Bank Group continues to perform analytical work to support the ongoing liberalization and modernization of trade, industrial, business, and labor regulations. The Bank is also providing assistance to strengthen the capacity of regulatory bodies.

6. In the social sectors, the World Bank Group's assistance is geared toward improving access to and quality of education and strengthening public health programs and maternal and child health and family planning. Inasmuch as social services are primarily the responsibility of provincial and local governments in Pakistan's federal structure, World Bank assistance is geared toward strengthening provincial and local governments' ability to deliver services while encouraging the development of appropriate supportive policies at the national level. In education, the emphasis is on assisting provincial governments to realign public spending towards education while implementing sector reforms to improve quality, access and governance. These programs have been supported through province-level development policy credits, particularly in Punjab. World Bank Group assistance to health sector includes support for the national HIV/AIDS control program, the national polio immunization program, and the National Program for Family Planning and Primary Health Care.

7. Supporting the rural sector through community-based infrastructure projects (particularly for water supply and sanitation services), investment projects in irrigation, and the increased availability of micro-credit have been part of the World Bank Group's strategy to improve the welfare and 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). Follow-on PPAF, CIP and on-farm water management projects were approved in FY 2004. In addition, the Bank is providing analytical support to the government's efforts to improve the targeting and efficiency of its safety net programs.

8. IBRD and IDA have approved 88 loans and 125 credits to Pakistan since 1952, totaling $7,372.7 million and $8,501.2 million, respectively. Since 2003, Bank lending has totaled $2,088.3 million (see Table 1). As of July 30, 2005, there were 169 outstanding IBRD and IDA loans and credits representing a total obligation of $9,070 million. The World Bank active portfolio in Pakistan consists of 17 lending operations with a total commitment of $1,089 million of which $874 million is undisbursed. In 2004/05, $984 million were disbursed, and for 2005/06, a disbursement of $936 million is expected.

Table 1. Pakistan: World Bank Lending FY 2003–05
(in millions of U.S. dollars, as of Sep 30, 2005)

Project Name	Fiscal year Approved	Amount	Disbursed
Community Infrastructure & Services	2003	20.0	8.2
Banking Sector Technical Assistance	2003	26.5	14.2
Sindh Structural Adjustment Credit	2003	100.0	106.4
NWFP Structural Adjustment Credit	2003	90.0	95.8
Partnership for Polio Eradication	2003	20.0	20.0
HIV/AIDS Prevention Project	2003	37.1	8.2
National Education Assessment System	2003	3.6	0.5
Highways Rehabilitation	2004	200.0	25.2
Poverty Alleviation Fund II'	2004	238.0	84.1
Punjab Education Reform Program	2004	100.0	100.6
Sindh On-Farm Water Management Project	2004	61.1	2.9
NWFP Community Infrastructure II (CIP2)	2004	37.1	2.1
PK Public Sector Capacity Building Project	2004	55.0	10.5
NWFP SAC II	2004	90.0	90.0
Poverty Reduction Support Credit I	2005	300.0	300.0
Tax Administration Reform Project	2005	102.9	3.1
Banking Sector Development Policy Credit	2005	300.0	300.0
Taunsa Barrage Emergency Rehabilitation	2005	123.0	3.1
Punjab Education Reform II	2006	100.0	100.0
Improving Financial Reporting and Auditing II	2006	84.0	0.0

Bank-Fund collaboration in specific areas

9. As part of 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:

a. **Financial sector reforms**. A major achievement of the reform process has been the transformation of a predominantly state-owned and weak banking system into a healthier, market-based system, owned primarily by the private sector. This has been supported by a considerable strengthening of the legal and regulatory environment and significant improvements in transparency, corporate governance, and credit culture. World Bank support is being provided through implementation of the Technical Assistance to the Banking Sector project. Privatization of state-owned banks was supported through the Banking Sector Restructuring and Privatization Project (FY 2002) and the Banking Sector Adjustment Credit (FY 2005). A joint World Bank/Fund Financial Sector Assessment Program (FSAP) was completed in FY 2004.

b. **Power sector reforms**. The Fund PRGF arrangement included conditionality related to energy tariff adjustments and other power sector reforms with the aim of reducing the sector's fiscal burden. In the context of the structural adjustment operations approved in FY 2001, FY 2002, and FY2005, the World Bank has taken the lead in working with the government of Pakistan to unbundle and corporatize the state-owned Water and Power Development Authority (WAPDA) with the eventual aim for privatizing the generation and transmission of electricity. The World Bank has also supported the development of a comprehensive medium-term adjustment program to improve the electric services to Pakistan's industry and households at lower cost and higher reliability. Planned investment lending will focus on modernization of distribution systems to improve efficiency and reduce technical losses.

c. **Public expenditure management**. The World Bank is taking the lead in supporting implementation of a reform program to improve the timeliness and accuracy of financial reporting and auditing while strengthening the overall framework of accountability for the use of public resources. World Bank support is being provided in the context of the ongoing PIFRA project through which the national accounting and audit systems are being modernized. A follow-on PIFRA II project will further these efforts. Analytical and diagnostic support is being provided in the form of a Country Financial Accountability Assessment (CFAA), which was completed in FY 2003, as well as provincial financial accountability assessments for the provinces of Sindh, Punjab, and NWFP. Policy measures relating to financial management have been included as prior actions for World Bank structural adjustment lending at both the national and provincial level. Procurement reforms are being supported through technical assistance and development policy lending.

d. **Tax policy and administration reforms**. 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 structural performance criteria of the PRGF included adoption of tax policy changes and implementation of CBR reform. A World Bank tax administration reform project to support CBR reforms was approved in FY 2005.

PAKISTAN: STATISTICAL ISSUES

1. The staff believes that data reporting and accounting procedures are broadly adequate for effective surveillance and program monitoring purposes. The authorities are responsive to data requests and report to the Fund, on a routine and timely basis, monthly data on external trade, prices, federal government expenditures and tax revenues, government bank borrowing, and money. Moreover, the authorities provide daily data through the resident representative's office on international reserves, exchange rates, and the Karachi Stock Exchange index. A data ROSC was published in December 2004. Follow-up STA technical assistance missions have assisted the authorities address some of the ROSC's key recommendations.

2. The Pakistani authorities are strongly committed to adhering to internationally accepted standards and good practices, as demonstrated by their participation in the General Data Dissemination System (GDDS) since 2003. Pakistan meets the recommendations for the coverage, periodicity, and timeliness of most GDDS data categories. The only exceptions are the timeliness of the GDP and the lack of annual data on wages/earnings. For subscription to the Special Data Dissemination Standard (SDDS), Pakistan will need to disseminate (a) the monthly analytical accounts of the SBP with a timeliness of two weeks; (b) monthly transaction data on central government operations with a timeliness of one month; (c) quarterly data on the national accounts, employment, unemployment, wages/earnings, and external debt, all with a timeliness of one quarter; (d) more detailed breakdown of data on central government debt and external debt; (e) annual data on its international investment position; and (f) update and expand the metadata on compilation and dissemination practices.

3. The Federal Bureau of Statistics (FBS) recently completed a revision of the national accounts, to bring them in line with the concepts and definitions of the *1993 System of National Accounts (1993 SNA)*. As part of this exercise, the base year was moved from 1980/81 to 1999/2000. There remains room for further improvement. As noted by the data ROSC, informal economic activities need to be better captured, while newly emerging activities, such as in the information technology sector, continue to pose challenges. Some of these gaps are being identified in the analysis of the results of the 1999/2000 Economic Census already available for agriculture, manufacturing, electricity, and education. The FBS intends to carry out another rebasing for 2004/05. Meanwhile, the FBS is also preparing the compilation of quarterly GDP data. Following up on the recommendations of the data ROSC, an IMF Quarterly National Accounts (QNA) mission visited Pakistan in April–June 2005 to assist the FBS in the development QNA and to advise on the dwelling rent component of the consumer price index (CPI). The compilation methods for QNA are very similar to those for the annual accounts. However, quarterly data sources are very limited and considerable use is made of forecasts and quarterly allocations in line with production calendars. In the process of reviewing the sources and methods used to compile QNA, a number of deficiencies in the annual compilation methods were discovered. The mission provided recommendations to address these shortcomings. With respect to labor market statistics, the FBS is investigating

the feasibility of compiling quarterly employment/unemployment data and of disseminating data on wages/salaries.

4. The FBS produces three price indices: the CPI, the wholesale price index (WPI), and the sensitive price indicator (SPI)). The CPI and WPI are compiled on a monthly basis. The SPI is compiled on a weekly basis and consists of 46 essential commodities that are consumed by the lowest income group. The concepts and definitions of the CPI and WPI follow international guidelines. For prices, plans are to introduce classification of individual consumption by purpose (COICOP) and complete work on development of a Producer Price Index (PPI), with base year 1999/2000; an IMF mission also provided some advise in this regard.

5. Government Finance Statistics (GFS) suffer from a lack of data on general government finances due to inadequate reporting by provinces and local governments on their fiscal operations. The concepts and definitions used in compiling GFS are broadly based on the methodology prescribed in *A Manual on Government Finance Statistics, 1986* (*GFSM 1986*), except that the treatment of privatization proceeds resembles the methodology of the *Government Finance Statistics Manual, 2001* (*GFSM 2001*). The scope of GFS is budgetary central government, which does not cover the activity of extra-budgetary funds. Classification and sectorization systems follow *GFSM 1986* standards only to a limited extent. Institutional sectors are not explicitly defined, since only budgetary data are covered in GFS. Although central and provincial governments are distinguished, local governments are included with the provincial governments. The classification of expenditure departs substantially from *GFSM 1986* methodology, because the economic and functional classifications are mixed in reporting, with defense and government administration expenditures not clearly distinguished according to economic classification. The basis of recording GFS is on, or close to, a cash basis, as required by the *GFSM 1986* guidelines. Transactions are recorded on a gross basis. Corrective transactions are not necessarily made in the original period, as required by *GFSM 1986*. Plans for improvement of GFS are taking place within the context of the Project for the Improvement of Financial Reporting and Auditing (PIFRA). Although there are no specific plans to migrate to the *GFSM 2001* standard—as recommended by the data ROSC—the MOF will consider adopting the *GFSM 2001* in the long term.

6. The analytical framework for monetary statistics reflects concepts and definitions that are based on the IMF's *Guide to Money and Banking Statistics in International Finance Statistics* of December 1984. The scope of the monetary statistics is comprehensive. The classification and sectorization of the monetary survey compiled by SBP's Statistics Department for reporting to the IMF and for internal use are broadly in line with the *Monetary and Financial Statistics Manual (MFSM)*. The basis for recording flows and stocks is largely consistent with *MFSM* and the SBP will continue to adopt the *MFSM* in order to further improve monetary statistics. In particular, the SBP plans to (a) disaggregate data on nonfinancial corporations and households within the private sector; (b) collect data on nonbank financial institutions to expand the coverage of the monetary aggregates; and

(c) disseminate the analytical accounts of the SBP within two weeks after the end of the reference month.

7. Pakistan's balance of payments statistics are compiled broadly in accordance with the concepts and definitions of the *Balance of Payments Manual, Fifth Edition (BPM5)*.. However, the presentation of the balance of payments on the web and in the publications of the SBP is still mostly based on the *BPM4*; recently, the SBP has commenced publishing the balance of payments based on *BPM5* on its website. In general, the scope of the balance of payments pertaining to residency conforms to *BPM5*. The exceptions include the enterprises operating in the export processing zones and offshore banks, which are regarded as nonresidents, and Pakistani nationals residing abroad but owning a dwelling in Pakistan, who are considered residents. Classification and sectorization systems also follow *BPM5* to some extent while the basis for recording transactions follows best international practices. The 2004 ROSC identified shortcomings in the treatment of oil exports under product sharing agreements and the estimation of reinvested earnings. The report also noted the absence of revisions studies. International investment position data are now compiled. Regarding the external sector, the SBP plans to (a) continue the implementation of the *BPM5*; and (b) disseminate the metadata for the template on International Reserves and Foreign Currency Liquidity on the SBP website.

PAKISTAN: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE
AS OF SEPTEMBER 22, 2005

	Date of latest observation	Date received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of publication[6]	Memo Items:	
						Data Quality – Methodological soundness[7]	Data Quality – Accuracy and reliability[8]
Exchange Rates	7/30/04	9/30/04	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]							
Reserve/Base Money	6/30/05	7/28/05	M	M	M	LO, O, LNO, LO	LNO, LO, O, O, O
Broad Money	6/30/05	7/28/05	M	M	M		
Central Bank Balance Sheet	6/30/05	7/28/05	M	M	M		
Consolidated Balance Sheet of the Banking System	6/30/05	7/28/05					
Interest Rates[2]	June 2005	7/06/05	M	M	M		
Consumer Price Index	July 2005	9/14/05	M	M	M	O, LO, LO, O	O, LO, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]						LO, LO, LNO, LO	O, O, LO, LO, LO
Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government	2004/05	8/01/05	A	A	A		
Stocks of Central Government and Central Government-Guaranteed Debt[5]							
External Current Account Balance	Aug 2004	9/10/04	M	M	M	LO, LO, LO, O	O, O, O, O, LNO
Exports and Imports of Goods and Services							
GDP/GNP	2003	8/27/04	A	A	A	LO, LNO, LO, LO	LNO, LNO, O, LNO, O
Gross External Debt	Q4 2003/2004	8/27/04	Q	Q	Q		

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A), Irregular (I); or Not Available (NA).
[7] Reflects the assessment provided in the data ROSC published on December 2004, and based on the findings of the mission that took place during December 1–16, 2003 for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O), largely observed (LO), largely not observed (LNO), or not observed (NO).
[8] Same as Footnote 7, except referring to international standards concerning source data, statistical techniques, assessment and validation of source data, assessment and validation of intermediate data and statistical outputs, and revision studies.

INTERNATIONAL MONETARY FUND

PAKISTAN

Staff Report for the 2005 Article IV Consultation
Supplementary Information

Prepared by the Staff Representatives for the 2005 Consultation with Pakistan

Approved by Juan Carlos Di Tata and Michael T. Hadjimichael

November 1, 2005

1. This supplement summarizes information that has become available since the staff report for the 2005 Article IV consultation (refer to www.imf.org) was circulated to the Board on October 11, 2005. It changes the thrust of the staff appraisal by accepting that some widening of the fiscal deficit now seems warranted and unavoidable in the aftermath of the earthquake. The additional uncertainties stemming from the fiscal impact of the earthquake and the delay in the privatization of the telecommunications company reinforces the need for a monetary policy geared towards containing inflation and supporting the external position.

A. The Earthquake and its Impact

2. **The northern part of Pakistan was hit by a devastating earthquake (7.6 on the Richter scale) on October 8, 2005**, after the staff report was finalized. The death toll is estimated to exceed 54,000, but could rise further; over 70,000 people were injured. Virtually all houses, hospitals, schools, and government buildings in the affected areas have been destroyed. Nearly 4 million people are affected in terms of loss of shelter and public amenities. Adverse weather and the remoteness of the region have complicated emergency assistance; with winter setting in, the immediate needs are for more tents and blankets to prevent further human tragedy. It may also be necessary to move people down from the mountains and house them in temporary shelters. Relief for the next six months (tents, medical aid, helicopters, etc.) is likely to cost $1–2 billion. Initial estimates put the total reconstruction costs at $5–10 billion over the next five to ten years. So far, international aid pledges amount to $1.5 billion. A U.N. sponsored donor conference took place on October 26, focusing on immediate relief needs. The World Bank and the Asian Development Bank are conducting a needs assessment, and a high-level conference on reconstruction is expected to take place in Islamabad on November 19. The authorities are considering whether to request Emergency Natural Disaster Assistance from the Fund.

3. **In addition to the human tragedy, the earthquake will have some adverse impact on Pakistan's economy**. The affected region accounts for a small fraction of national GDP. Still, with economic activity having been virtually wiped out in these areas, there will be some dampening impact on growth in 2005/06. This, together with downward revisions in

cotton and sugar production, suggest that GDP growth in 2005/06 could be at least 0.5 percent lower compared with the 7 percent projected prior to the earthquake. The relief and reconstruction efforts may also add some further pressures on the prices of nontradable goods, such as cement and other construction materials, but there should be little impact on food prices because of ample stocks. Over the medium term, the reconstruction of fixed assets may turn out to have a positive impact on growth. Capital markets have not reacted negatively to the earthquake. Pakistan's bond spread (over U.S. treasuries) has remained stable and moved with the overall market, while the Karachi stock exchange has risen in recent weeks.

4. **The fiscal deficit could be ½ to 1 percent of GDP higher than budgeted in 2005/06**. There is much uncertainty about the costs of the ongoing relief efforts and reconstruction needs. The government has made an initial allocation of PRs 5 billion (less than 0.1 percent of GDP) for 2005/06, which will be increased over time as needs are identified and costs assessed. The Pakistani army, international agencies, and nongovernmental organizations are providing most of the emergency relief; in-kind foreign grants and private donations will not be recorded in the budget and will be partly channeled through off-budget funds, such as the President's Relief Fund. Staff recognizes that an increase in the fiscal deficit in 2005/06 will occur. The recent progress toward reducing the debt burden has opened up fiscal space for additional relief and rehabilitation spending, which should not threaten fiscal sustainability. Reflecting the authorities' goal of maintaining macroeconomic stability, monetary policy needs to contain inflation and support the external position as public spending is raised.

5. **Reconstruction needs over the next five years will put pressure on the fiscal position, even though the authorities intend to accommodate a part of the reconstruction costs within the existing public sector development program allocation**. New grant pledges and additional loans from multilateral development banks will help to finance some of the costs. Staff will be working closely with the Pakistani authorities to prepare a revised macroeconomic framework.

6. **A possible widening of the external current account deficit in 2005/06 should be largely balanced by additional grants**. The relief effort could increase the trade deficit relative to the staff report projections, given the need to import emergency supplies. Such a widening should be covered in large part by emergency relief grants, fresh multilateral loans, and possibly higher remittances. Some pressures on reserves could emerge in the short-run if external assistance lags urgent spending needs; the overall balance of payments deficit and financing needs are yet to be determined. Over the medium term, the balance of payments will be affected by the timing and availability of additional external grants and concessional financing as well as the import content of reconstruction activity.

B. Other Developments in the First Quarter of 2005/06

7. **Domestic developments in the first quarter of 2005/06 are consistent with the projections in the staff report for the 2005 Article IV consultation (refer to**

www.imf.org). Year-on-year inflation in September was 8.5 percent (about the same as in August). Central Board of Revenue collection increased by 19 percent in July–September over the same period last year, slightly faster than projected. Broad money growth has slowed to 17½ percent year-on-year at end-August, as the State Bank of Pakistan tightened liquidity, though private sector credit growth remains high at 31 percent. Reserve money growth has also slowed somewhat to 15 percent at end-August, despite the State Bank having continued to meet part of the government's gross financing need. Partial data for September indicate that these trends have continued.

8. **The external current account deficit widened to $1.2 billion in July/August 2006**. Import growth increased further (reaching 52 percent in July–September over the same period in 2004/05), but exports performed better than expected (19 percent growth in July–September over the same period in 2004/05). As a result, the trade deficit increased, which was only partly offset by higher than projected remittances. Foreign direct investment was much more favorable than projected. During July–September, gross official reserves declined by $0.5 billion, to $9.5 billion. Expected multilateral loans, additional grants, and the planned Eurobond issue should help maintain official reserves in the coming months.

9. **Privatization of the telecommunications company has been delayed**. The October 28 deadline for the completion of the sale of 26 percent of the company has not been met. The authorities are considering whether the deal can still be completed. If not, other public assets would be sold to make up for part of the shortfall, possibly in the form of Global Depository Receipts for some major public companies. On the positive side, an agreement has been reached with a domestic investor group on the sale of the Karachi Electric Supply Company. This would constitute a major landmark in Pakistan's privatization process.

INTERNATIONAL MONETARY FUND

PAKISTAN

Ex Post Assessment of Longer-Term Program Engagement

Prepared by a staff team from the Middle East and Central Asia, Fiscal Affairs, and Policy Development and Review Departments[1]

Authorized for distribution by the Middle East and Central Asia and Policy Development and Review Departments

October 7, 2005

Contents Page

[1] The team comprised Tapio Saavalainen (head), Ron van Rooden (both MCD), Taimur Baig (FAD), and Carlos Leite (PDR).

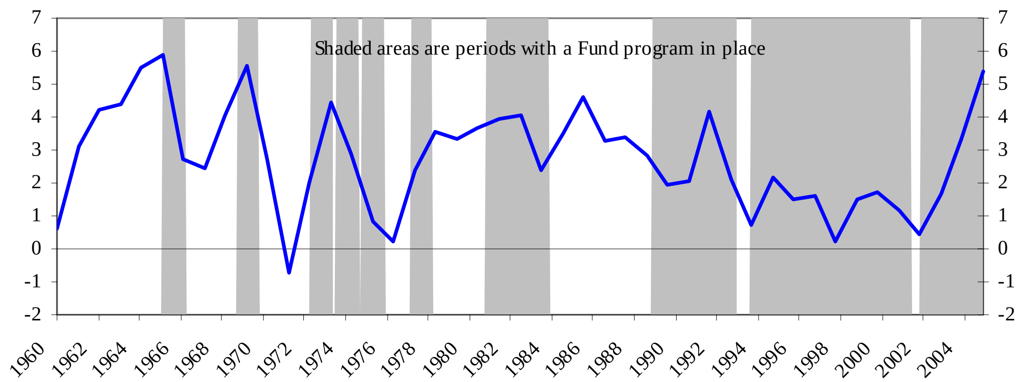
Tables

Figures

I. INTRODUCTION AND OVERVIEW

1. **Pakistan has been one of the most prolonged users of Fund resources.** In the last 46 years, the country has been under Fund-supported programs for about half of the time (Figure 1). Before 1988, Fund-supported programs were infrequent and mostly short term in nature. But as growth faltered in the late 1980s, and the failure to redress fiscal and external imbalances resulted in an unsustainable debt burden, Pakistan became more heavily dependent on Fund support. The period 1988–99 was marked by regional problems and political instability—there were as many Fund programs as governments (eight each). Economic growth slowed, poverty increased, and governance problems became increasingly evident. However, from 1999, the new government of General Pervez Musharraf began addressing the economic difficulties with a new commitment to turn around past trends. The economy started to recover and progress has been made in structural reforms, including in building institutions.

Figure 1. Pakistan: Real Per Capita GDP Growth and Fund Programs, 1960–2004



Sources: Pakistani authorities; and IMF.

2. **All but the last two Fund-supported programs suffered from substantial policy slippages.** Of the SDR 3.6 billion committed during 1988–99, 55 percent was not drawn as programs went off-track soon after their start (Table 1). Programs were either extended to accommodate delays in the completion of reviews, or were ended prematurely, to be replaced by new arrangements. In contrast, both the 2000 Stand-by Arrangement (SBA) and the 2001 three-year arrangement under the Poverty Reduction and Growth Facility (PRGF) were successfully completed without any extensions. All disbursements were made available upon completion of the program reviews, but the authorities decided not to draw the last tranche under the PRGF arrangement or seek a successor arrangement in light of Pakistan's improved external situation (Figures 2 and 3). The improved economic situation enabled Pakistan to re-enter the international financial markets in 2004 to help cover its financing needs, in addition to ongoing support from the World Bank and the Asian Development Bank (AsDB) and a few bilateral donors.

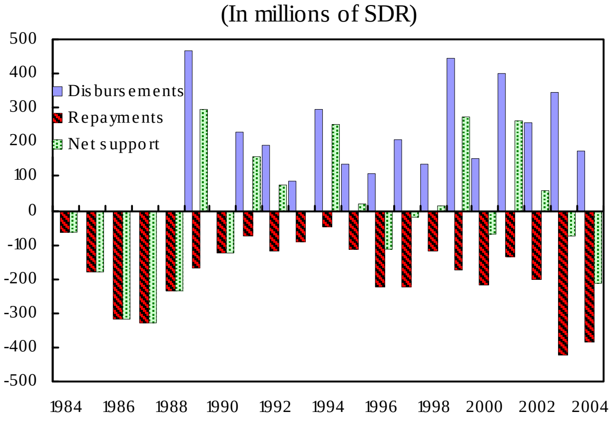
Table 1. Pakistan: History of Lending Arrangements, 1958–2004

Facility	Date of arrangement	Initial date of expiration	Actual date of expiration	Length of arrangement (years)		Amount agreed (thousands of SDRs)	Amount drawn (thousands of SDRs)	Percent undrawn
1 SBA	08-Dec-58	07-Dec-59	22-Sep-59	0.8		25,000	0	100
2 SBA	16-Mar-65	15-Mar-66		1.0		37,500	37,500	0
3 SBA	17-Oct-68	16-Oct-69		1.0		75,000	75,000	0
4 SBA	18-May-72	17-May-73		1.0		100,000	84,000	16
5 SBA	11-Aug-73	10-Aug-74		1.0		75,000	75,000	0
6 SBA	11-Nov-74	10-Nov-75		1.0		75,000	75,000	0
7 SBA	09-Mar-77	08-Mar-78		1.0		80,000	80,000	0
8 EFF	24-Nov-80	23-Nov-83		3.0		1,268,000	1,079,000	15
9 SAF 1/	28-Dec-88	27-Dec-91	15-Dec-92	4.0		382,410	382,410	0
9 SBA 1/	28-Dec-88	07-Mar-90	30-Nov-90	1.9		273,150	194,480	29
10 SBA	16-Sep-93	15-Sep-94	22-Feb-94	0.4		265,400	88,000	67
11 ESAF 1/	22-Feb-94	21-Feb-97	13-Dec-95	1.8		606,600	172,200	72
11 EFF 1/	22-Feb-94	21-Feb-97	13-Dec-95	1.8		379,100	123,200	68
12 SBA	13-Dec-95	31-Mar-97	30-Sep-97	1.8		562,590	294,690	48
13 PRGF 1/	20-Oct-97	19-Oct-00		3.0		682,380	265,370	61
13 EFF 1/	20-Oct-97	19-Oct-00		3.0		454,920	113,740	75
14 SBA	29-Nov-00	30-Sep-01		0.8		465,000	465,000	0
15 PRGF	06-Dec-01	05-Dec-04		3.0		1,033,700	861,420	17
Total		46.0		24.6	2/	6,840,750	4,466,010	35

Source: IMF.

1/ Blended arrangement.
2/ Total number of years under arrangement, with blended arrangements counted as a single arrangement.

Figure 2. Pakistan: Fund Financial Support, 1984–2004
(In millions of SDR)



Source: IMF.

Figure 3. Pakistan: Outstanding Loans and Credits, 1984–2004
(In millions of SDR)

Source: IMF.

3. **The Independent Evaluation Office (IEO), in its 2002 report evaluating the prolonged use of Fund resources (refer to www.imf.org, Vol. II), assessed Pakistan's program performance until 1999.** It found that the limited achievements of successive programs before 1999 were associated with considerable political and regional instability, but also reflected design and implementation problems. A basic problem was that successive governments did not have sufficient ownership of the programs and were often unable to sustain the reform and adjustment effort for more than a short period of time. In addition, programs typically suffered from overoptimistic macroeconomic assumptions and proved to be unrealistic about the pace and breadth of the structural reform agenda that was likely to be implemented by the government. Notably, limitations in implementation capacity were not sufficiently taken into account in program design, and the reform agenda was not prioritized enough.

4. **According to the IEO, most of the design and implementation problems had their roots in institutional factors.** In particular, decisions regarding the Fund's involvement in Pakistan appeared to have been heavily influenced by (a) geopolitical considerations; (b) the difficulty of not giving a new government the initial benefit of the doubt as regards its stated policy objectives; (c) a reluctance to disengage when a country faces difficulties; (d) the presumption of a short- to medium-term involvement only; and (e) collaboration with the World Bank that did not always produce an effective integration of priorities and timeframes in dealing with key structural issues. More generally, the IEO concluded that there had been too few attempts to "step back" and reconsider the overall strategy on the basis of a candid assessment of previous programs. The IEO considered the main lesson from Pakistan's prolonged-use experience to be a need for greater selectivity, based on a candid assessment of ownership, and disengaging from a country, if necessary. Also, greater efforts were needed to tailor program design to the specific circumstances and long-term needs of a country, focusing on key institutional changes.

5. **This report mainly focuses on the post-1999 period, where the IEO left off.** After a brief description of conditionality in Fund-supported programs during 2000–04 (Section II.A), economic achievements as well as those areas where progress has been limited or absent are discussed (Section II.B). The main issues addressed by the Ex Post Assessment are covered in Section III, starting with what caused the change in performance after 1999 (Section III.A). Section III.B asks whether Fund conditionality was appropriate and Section III.C focuses on the design of the monetary program. Other issues discussed are whether Fund-recommended policies helped to reduce poverty (Section III.D); was the size of Fund financial support appropriate (Section III.E); did Fund-Bank collaboration contribute to the success of the program (Section III.F); and whether the Fund's involvement in Pakistan changed following the 2002 IEO report (Section III.G). Section IV concludes with lessons for the Fund that can be derived from Pakistan's experience.

II. The Facts

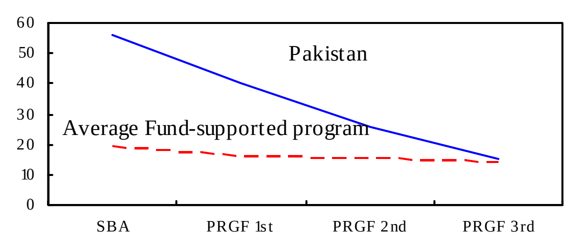
A. Program Conditionality

6. **Conditionality in Pakistan's Fund-supported programs became increasingly extensive after 1999.** In the 1990s, programs included fairly standard quantitative conditionality: a floor on the net foreign assets and ceilings on the net domestic assets of the State Bank of Pakistan (SBP), the overall budget balance, government bank borrowing, and net banking sector claims on public sector enterprises, as well as on government external borrowing and the accumulation of external arrears. To address shortcomings in performance in key areas, quantitative conditionality was augmented in the 2000 SBA and 2001 PRGF by a floor on Central Board of Revenues (CBR) revenues and a ceiling on the accumulation of budgetary arrears to the Water and Power Development Authority (WAPDA); and—in the PRGF—limits on SBP's foreign exchange reserves held with banks and on foreign currency swap and forward sales between the SBP and residents.[2] Nevertheless, the amount of quantitative conditionality was not out of line compared with the average PRGF program.

7. **In the 1990s, structural conditionality had typically been set in the form of broad commitments in the letter of intent or structural benchmarks.** But as ownership and implementation was often weak, the response of the staff was to gradually try and close as many loopholes as possible, through an increase in the number of both macroeconomic and structural conditions, especially through much larger recourse to prior actions and performance criteria (PCs).

8. **Structural conditionality peaked in the 2000 SBA.** The total of 56 PCs, benchmarks and prior actions in this arrangement was nearly three times the Fund-wide average of 19 conditions in GRA-supported programs (Table 2 and Figure 4).[3] The large number of conditions was justified on grounds of a need to establish a strong track record by making up for past policy slippages within a relatively short time frame (see below).

Figure 4. Pakistan: Structural Conditions per Year, 2000–04



Source: IMF.

[2] In addition, indicative targets were set for the net domestic assets of the banking sector (SBA only), federal tax revenues (SBA only), and social- and poverty-related expenditures. Halfway during the PRGF arrangement, the quantitative conditionality related to WAPDA was replaced by indicative targets for the accrual balance of WAPDA and the Karachi Electric Supply Corporation (KESC).

[3] Fund-wide averages for GRA- and PRGF-supported programs were obtained from the report on the "Review of the 2002 Conditionality Guidelines" (refer to www.imf.org).

Table 2. Pakistan: Structural Conditionality, 2000–04 1/

	SBA	PRGF		
		1st year	2nd year	3rd year
Prior actions	27	15	4	0
Structural performance criteria	12	11	11	11
Structural benchmarks	17	14	11	4
Total	56	40	26	15
Of which:				
General economic management	22	9	6	1
Trade liberalization	3	1	0	0
Financial sector reforms	10	5	3	3
Tax policy and administration	14	16	7	6
Enterprise reforms and governance	7	9	10	5
In percent of total number of conditions				
General economic management	39	23	23	7
Trade liberalization	5	3	0	0
Financial sector reforms	18	13	12	20
Tax policy and administration	25	40	27	40
Enterprise reforms and governance	13	23	38	33
Memoradum item:				
Average number of structural conditions in Fund-supported programs 2/	19	16	15	14
Of which:				
Prior actions	7	4	4	2
Structural performance criteria	2	4	4	5
Structural benchmarks	10	8	7	7

Source: IMF.

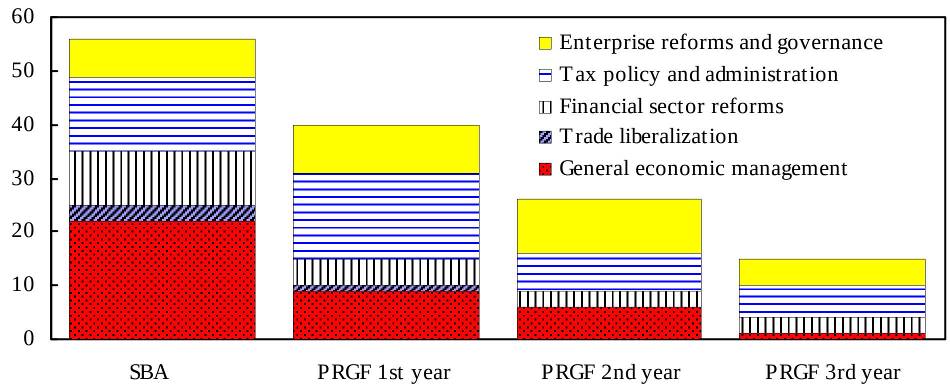
1/ Number of conditions effective per program year. Continuous performance criteria in effect in more than one year are counted as one in each year they are in effect. Prior actions that make up for missed performance criteria or benchmarks are not counted.

2/ Average of GRA-supported programs in first column (2001) and average of PRGF-supported programs in rest of table (2002–04).

9. **Following the 2000 SBA, structural conditionality was reduced gradually because of Pakistan's improved performance, as well as rising doubts in the Fund about the effectiveness of large policy matrices of conditions.** The new government generally delivered on its commitments and the number of structural conditions was steadily reduced during the 2001–04 PRGF arrangement. This steady decline in the number of conditions also reflected the overall drive in the Fund to streamline conditionality. Nevertheless, only in the last program year did the number of structural conditions (15) approach the Fundwide average for PRGF-supported programs (14).

10. **Structural conditionality became increasingly focused.** Measures to improve the tax system dominated conditionality in the 2000 SBA and the 2001 PRGF arrangements, reflecting the critical importance attached to increasing the revenue intake (Figure 5). Measures falling in the category of general economic management—such as the promulgation of a budget consistent with program understandings or a depreciation of the exchange rate—were numerous in the 2000 SBA, but declined sharply as macroeconomic performance strengthened. During the PRGF arrangement, conditionality focused also on financial sector reforms and public enterprise reforms. While efficiency factors were considered, ultimately these measures aimed to achieve budget savings, by reducing the financing costs of the government by aligning yields on National Savings Scheme (NSS) instruments to market rates, and by restructuring the energy sector, thus reducing its reliance on budget support.

Figure 5. Pakistan: Composition of Structural Conditions, 2000–04



Source: IMF.

11. **Program implementation in 2001–04 compared favorably to the average GRA- and PRGF-supported programs.** However, no review of the 2000 SBA or the 2001–04 PRGF arrangement was completed without requesting at least one waiver. On average, two waivers were requested per review. Still, waiver rates, on average, were comparable to, or even lower than, those in average Fund-supported programs (Table 3 and Figure 6).[4] In part, the frequency of waiver requests was a reflection of the large number of conditions. Moreover, waivers were often needed because of delays in implementation rather than an outright lack of implementation. This was particularly true for energy sector measures, which typically required more time to overcome political or technical hurdles, causing an increase

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[4] Fund-wide average waiver rates for quantitative performance criteria were 11 percent and 16 percent for GRA- and PRGF-supported programs, respectively, during 2001–03, compared to a waiver rate of 10 percent during Pakistan's SBA and 4 percent on average during its PRGF arrangement. For structural performance criteria, the Fund-wide average waiver rates for GRA- and PRGF-supported programs during 2001–03 were 50 percent and 42 percent, respectively, compared to a waiver rate of 25 percent during Pakistan's SBA and 45 percent during its PRGF-supported programs.

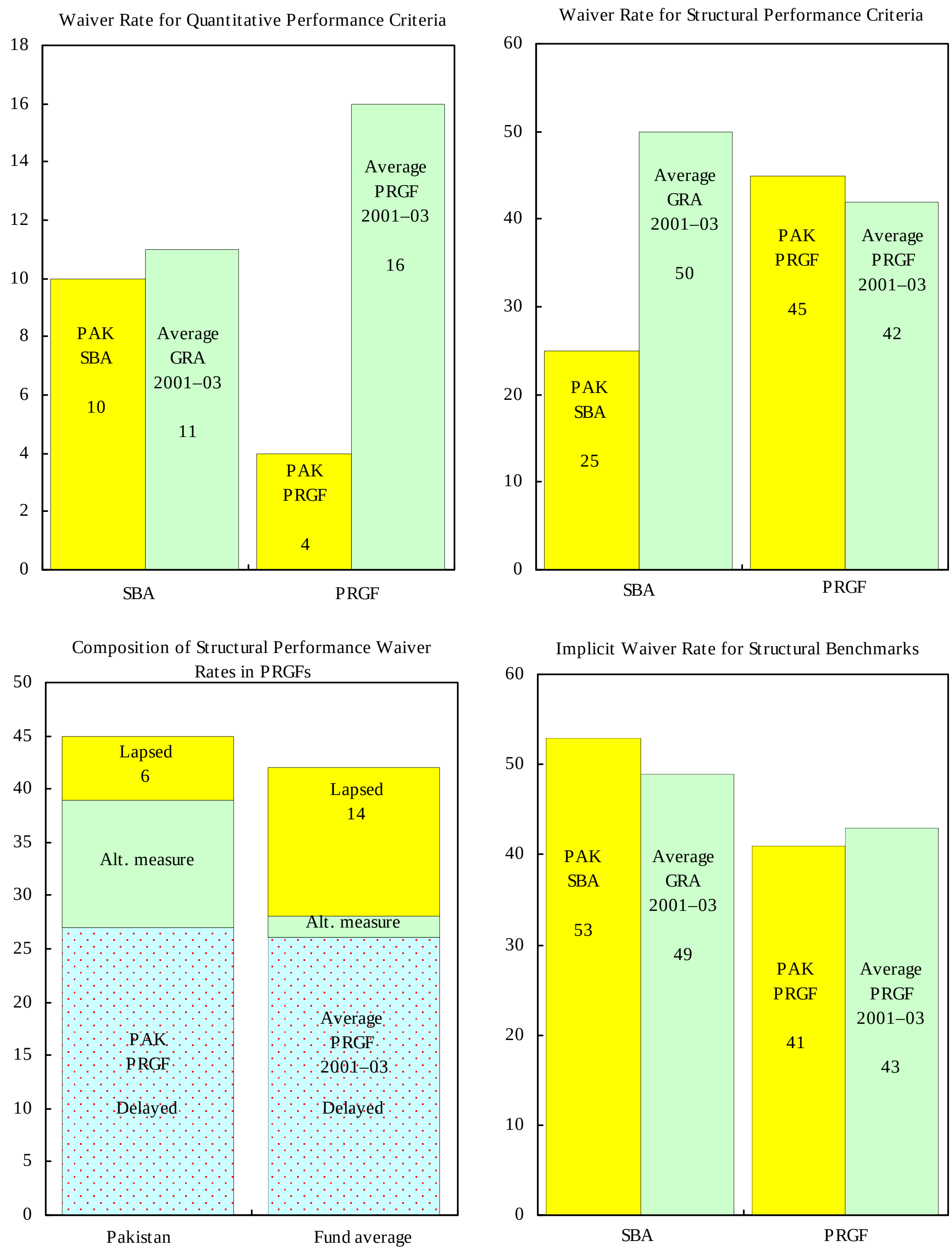
in the waiver rate for structural conditions in the last year of the PRGF arrangement. Looking at the share of lapsed measures—measures that never got implemented—implementation in Pakistan compared favorably relative to the average Fund-supported program during this period: only 6 percent of structural performance criteria were not implemented at all, compared to a Fund-wide average of 14–15 percent. Compliance with quantitative macroeconomic conditionality was also, on average, better than the average for Fund-supported programs.

Table 3. Pakistan: Implementation of Conditionality, 2000–04

	SBA	PRGF			
		1st year	2nd year	3rd year	Entire arrangement
I. Quantitative performance criteria					
Total number of criteria per year	30	52	33	22	107
Of which: waived	3	4	0	0	4
Waiver rate (in percent)	10	8	0	0	4
Waiver rate in average GRA-supported programs (2001–03)	11				
Waiver rate in average PRGF-supported programs (2001–03)					16
II. Structural performance criteria					
Total number of criteria per year	12	11	11	11	33
Of which: waived	3	3	4	8	15
Waiver rate (in percent)	25	27	36	73	45
Waiver rate in average GRA-supported programs (2001–03)	50				
Waiver rate in average PRGF-supported programs (2001–03)					42
Waived structural performance criteria					
Implemented after delay	2	1	3	5	9
Offsetting measures	0	1	0	3	4
Not imlemented	1	1	1	0	2
Implementation rate (incl. delays and offsets, in percent)	92	91	91	100	94
Lapsed rate	8	9	9	0	6
Lapsed rate in average GRA-supported programs (2001–03)	15				
Lapsed rate in average PRGF-supported programs (2001–03)					14
III. Structural benchmarks					
Total number of benchmarks per year	17	14	11	4	29
Implemented on time	8	9	5	3	17
Implemented after delay/partially met	8	5	6	0	11
Not implemented	1	0	0	1	1
Lapsed rate	6	0	0	25	3
Implicit waiver rate	53	36	55	25	41
Implicit waiver rate in average GRA-supported programs (2001–03)	49				
Implicit waiver rate in average PRGF-supported programs (2001–03)					43

Source: IMF.

Figure 6. Pakistan: Implementation of Conditionality, 2000–04



Source: IMF.

B. Goals and Achievements

Program objectives

12. **By the late 1990s, Pakistan's economy had run aground.** Per capita GDP growth had slowed to below 1 percent on average during 1996/97–1998/99. By end-1998/99, the country's foreign exchange reserves were virtually exhausted and covered only four weeks of imports. Public debt had risen to about 90 percent of GDP and debt service obligations could not all be met in 1998 when Pakistan came under sanctions following its nuclear tests. Using the official poverty line as a yardstick, the headcount poverty rate increased from 25 percent in the early 1990s to 32 percent in 2000/01.

13. **The new government that assumed office in 1999 aimed to make a clean break from past weak and erratic policy implementation.** In late 1999, the government formulated and started to implement policies aimed at reducing Pakistan's high debt burden to achieve sustainability and create more room for social spending. The government also requested support from the Fund and a SBA was approved in November 2000. The immediate objective of the SBA was to reduce quickly macroeconomic imbalances through a tightening of both fiscal and monetary policies. The exchange rate was to be allowed to adjust to market forces to help strengthen the external position. The authorities were also to press ahead with structural reforms to enhance the economy's growth potential and reduce poverty. As it was recognized that addressing Pakistan's deep structural problems required a long-term effort, the 2000 SBA was intended to establish a track record and pave the way for a medium-term program that could be supported under the PRGF.

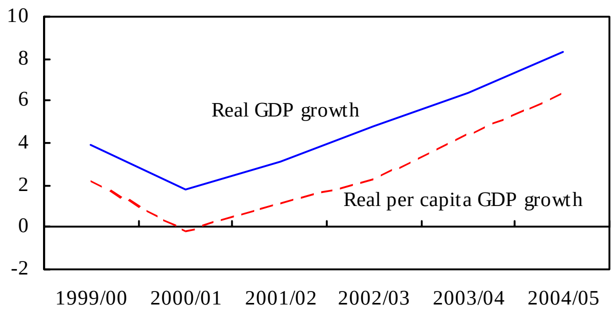
14. **Pakistan's request for a PRGF arrangement was approved in December 2001.** The PRGF arrangement had three main objectives: increasing growth, reducing vulnerability to shocks, and improving social indicators. Accordingly, macroeconomic policies aimed at further fiscal adjustment to reduce the public debt overhang, while simultaneously increasing the revenue intake and reducing transfers to state-owned entities to create additional room for social spending. External support, including a Paris Club rescheduling, was obtained to alleviate Pakistan's external debt burden. Monetary policy aimed at low inflation, with a view to replenishing foreign exchange reserves and thus reducing external vulnerabilities. Structural reforms were aimed at improving investor confidence and creating an environment in which the private sector could flourish.

What has been achieved?

15. **Economic growth has recovered convincingly from the crisis of 1998.** The rate of real per capita GDP growth accelerated from close to zero in 2000/01 to over 6 percent in 2004/05 (Table 4 and Figure 7). Initially, growth was driven by a strong rebound in exports, which recorded double-digit growth rates, and virtually closed the gap between exports and imports of goods and nonfactor services. Reflecting this, manufacturing recorded high growth rates. In later years, favorable weather conditions also contributed to a strong pick up in agricultural production adding to the overall strong growth performance. Although the

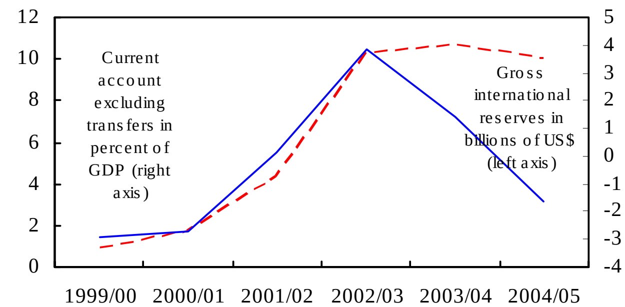
investment ratio has remained broadly unchanged at 16–17 percent of GDP since 1999/2000, the contribution of total factor productivity to growth has increased sharply. Rising real incomes eventually contributed to a strong pick up in private consumption and in 2004/05 domestic demand took over as the main driving force of growth. With the economy heating up, imports surged—showing a sharp increase in shipments of consumer goods, as well as of machinery—resulting in a shift of the current account balance (excluding official transfers) from a surplus of almost 4 percent of GDP in 2002/03 to a deficit of almost 2 percent of GDP in 2004/05 (Figure 8).

Figure 7. Pakistan: Economic Growth, 1999/2000–2004/05



Source: Pakistani authorities.

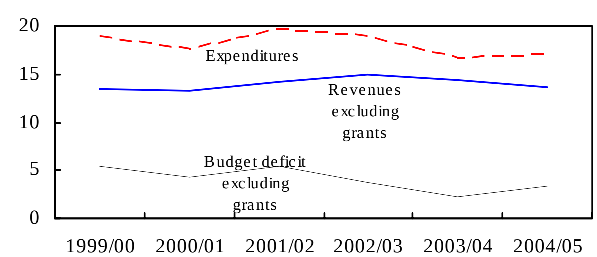
Figure 8. Pakistan: Balance of Payments and International Reserves, 1999/2000–2004/05



Source: Pakistani authorities.

16. **The fiscal position was strengthened to reduce indebtedness and to create additional room for social spending.** Fiscal consolidation was achieved to a large extent by increases in nontax revenues and savings on the interest bill. The latter reflected the restructuring of external debts, falling domestic real interest rates, and the decline in the government debt ratio from almost 90 percent of GDP in 2000/01 to 60 percent of GDP in 2004/05. The overall fiscal deficit (excluding grants) declined from 6.6 percent of GDP in 1999/2000 to about 3 percent of GDP in 2004/05 (Figure 9). Despite this adjustment, social- and poverty-related expenditures were raised by over 1 percentage point of GDP over the last three years, or by over 30 percent in real per capita terms. Nevertheless, the level of social spending remains quite low in comparison with other developing countries. While the goals that had been set at the start of the 2001 PRGF-supported program for raising social spending and reducing the debt burden were realized, more could have been accomplished if greater progress had been made in raising the tax-to-GDP ratio or reducing transfers to state-owned enterprises (see below).

Figure 9. Pakistan: General Government Budget, 1999/2000–2004/05



Source: Pakistani authorities.

Table 4. Pakistan: Selected Economic Indicators, 1999/2000–2004/05

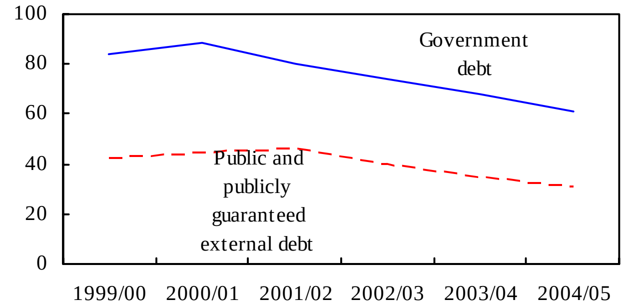
	1999/2000	2000/01		2001/02		2002/03		2003/04		2004/05
	Act.	Prog. 1/ 2/	Act.	Prog. 1/ 3/	Act.	Prog. 1/ 3/	Act.	Prog. 1/ 3/	Act.	Act.
Output and prices	(Annual changes in percent)									
Real GDP at factor costs	3.9	4.5	1.8	3.7	3.1	5.0	4.8	5.2	6.4	8.4
Consumer prices (period average)	3.6	6.0	4.4	5.0	2.5	5.0	3.1	5.0	4.6	9.3
Consumer prices (end of period)	5.1	...	2.5	5.9	3.4	...	1.9	...	8.5	8.7
Savings and investment	(In percent of GDP)									
Gross national savings	15.7	11.4	15.6	12.0	19.0	12.2	22.0	12.9	19.3	15.6
Gross capital formation	17.4	12.7	17.2	12.5	16.8	13.5	16.9	14.0	17.3	16.8
Public finances	(In percent of GDP)									
Revenue (including grants)	14.4	14.7	14.3	15.9	16.1	15.6	17.4	15.6	14.9	14.0
Expenditure (including statistical discrepancy)	18.9	17.9	17.6	18.1	19.7	17.8	18.8	17.3	16.7	17.1
Budget balance (excluding grants)	-6.6	-4.3	-4.3	-4.4	-5.5	-3.4	-3.8	-2.7	-2.3	-3.3
Budget balance (including grants)	-4.6	-2.6	-3.3	-2.1	-3.6	-2.2	-1.4	-1.7	-1.8	-3.0
External sector	(In percent of GDP, unless otherwise indicated)									
Current account excluding official transfers	13.1	-1.5	-2.7	-3.0	0.1	-2.6	3.8	-2.2	1.4	-1.6
Current account including official transfers	-1.6	-1.3	-1.6	-0.5	2.2	-1.2	5.1	-1.1	2.0	-1.3
Gross reserves (in millions of U.S. dollars) 2/	908	1,740	1,679	2,385	4,330	3,029	10,251	3,895	10,621	9,985
In months of next year imports of goods and services	0.9	1.7	1.7	2.2	3.7	2.7	6.9	3.3	5.0	4.1

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

1/ Program projections are expressed in percent of the rebased GDP. For this, the actual program figures are multiplied by the ratio of actual GDP before rebasing to actual GDP after rebasing.
2/ IMF Country Report No. 01/24.
3/ IMF Country Report No. 01/222.

17. **External vulnerabilities have been greatly reduced.** Fiscal consolidation and debt relief granted by external creditors resulted in a decline in the ratio of external public and publicly guaranteed debt to GDP to 28 percent by end-2004/05, down from the peak of 45 percent three years earlier (Figure 10). The balance of payments has turned around with strong export growth and sizable remittances, and international reserves were rebuilt to cover about five months of imports of goods and nonfactor services and over 250 percent of short-term external liabilities (up from a mere 11 percent in 1999/2000) at end-2004/05.

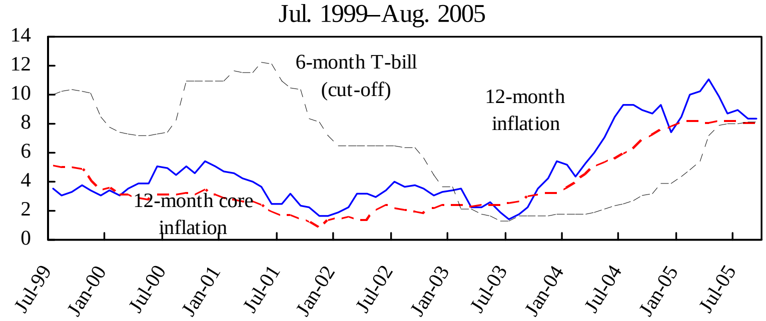
Figure 10. Pakistan: Debt Indicators, 1999/2000–2004/05
(In percent of GDP)



Source: Pakistani authorities.

18. **Inflation remained low and stable until mid-2003, but has become a concern more recently.** Initially, slack in the economy, that reflected the slow growth experienced in the late 1990s, and a steady increase in money demand, as confidence recovered, allowed the SBP to reduce interest rates, while inflation was kept in the low single digits (Figure 11). In the second half of 2003, however, with the economy starting to grow strongly, inflation began to pick up (from a low level). The SBP was slow to respond by tightening monetary policy, mindful not to choke off the economic recovery. As a result, key policy interest rates have been negative in real terms since 2003. The 12-month rate of inflation reached double digits in March 2005 for the first time since September 1997 and is currently at 8.4 percent.

Figure 11. Pakistan: Inflation and Interest Rates,
Jul. 1999–Aug. 2005



Source: Pakistani authorities.

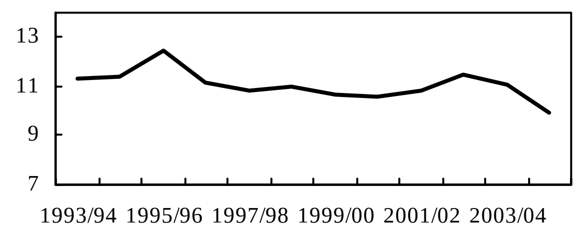
19. **Good progress was made in some areas of structural reform.** In the years prior to 1999, structural reforms had been started in the areas of interest rate, trade, and capital account liberalization. After 1999, the authorities continued to move ahead with liberalizing Pakistan's trade and exchange regime, and strong progress was made in financial sector reform. The banking sector is now largely privately owned and has become more competitive and efficient, following restructuring and privatization. This was complemented by a

strengthening of supervision and prudential regulations, as noted in the recent Financial System Stability Assessment (FSSA; IMF Country Report No. 04/215). With reforms and improving macroeconomic performance, banks' financial soundness indicators improved and dollarization was reduced substantially. The tax and customs administration has been strengthened and made more taxpayer-friendly, while customs tariffs and tax rates were reduced and rationalized. The Fiscal Responsibility Law, which established legal targets for reducing the public debt burden and for reporting requirements, was approved in 2005. In addition, the role of the state in the economy has been reduced and governance improved through strengthening macroeconomic institutions, an extensive privatization program, and the establishment of improved regulatory frameworks in such sectors as telecommunications, electricity, and oil and gas.

What has not been achieved?

20. **A major disappointment has been the lack of progress in raising tax revenues as a share of GDP.** One of the objectives of the last two programs was a significant expansion of the tax base to create room for achieving the twin goals of higher social spending and debt reduction. However, the tax-to-GDP ratio has remained broadly unchanged at about 11 percent since the late 1990s and dipped in 2004/05 (Figure 12). Revenue reforms may have resulted in a more efficient system of taxation of existing taxpayers and more modern tax administration, but the number of taxpayers has not increased enough to achieve an increase in the tax-to-GDP ratio. Large parts of the agricultural and services sector still remain outside the tax net, reflecting political difficulties in taxing these sectors (see below).

Figure 12. Pakistan: Tax Revenues, 1993/94–2004/05
(In percent of GDP)



Source: Pakistani authorities.

21. **Progress was also disappointing in addressing the quasi-fiscal deficit of public utilities.** The largest recipients of budget support by far are the companies in the power sector. The sum of subsidies and net lending to these companies has remained well over 1 percent of GDP. Large technical losses remain, tariffs do not cover cost, and allegations of corruption are widespread.

22. **Governance problems remain.** Governance has been improved in fiscal and monetary management, the financial sector, the exchange and trade system, and to some extent in tax administration. However, more broadly, while survey data show some improvement in governance and the control of corruption in Pakistan in recent years, the country still lags behind most of its South Asian neighbors. Corruption is widespread in public service delivery, with almost all respondents in a World Bank survey reporting corruption of one form or another. In particular, governance problems contribute to the large losses made by the power sector entities noted above, as well as to the low tax ratio.

What is still open?

23. **Despite the economic recovery and increased social spending, it is as yet unclear whether poverty has declined.** Comparable data to the 2000/01 household survey will become available only toward the end of 2005. However, a decline in poverty rates is expected, as average per capita incomes have risen by over 40 percent in U.S. dollar terms since 2000/01. Moreover, agricultural production has increased, though it is still unclear how well the benefits of higher growth have been distributed across the population in rural areas.

24. **Some recently available key social indicators show a significant improvement over the past three years** (Table 5). Survey results show a considerable improvement in a number of health and education outcomes, such as immunization, school enrollment, and literacy rates, reflecting the increase in social spending in recent years. But while social spending has increased, levels are still relatively low compared to some other countries in the region. In line with this, some social indicators remain modest compared with other low income countries (including in South Asia) (Table 6).

Table 5. Pakistan: Key Social Indicators, 2000/01–2004/05

(In percent)

	2000/01 PIHS 1/	2004/05 PSLM 2/
Population ever attended school	51	55
Gross enrollment at primary level	72	86
Gross enrollment at middle level	41	46
Literacy (10 years and older)	45	53
Male	58	65
Female	32	40
Urban	64	71
Rural	36	44
Children, aged 12–23 immunized	53	77
Urban	70	87
Rural	46	72
Treatment of diarrhea in children 5 years and under	83	91
Urban	87	92
Rural	81	90

Source: Pakistani authorities.

1/ Pakistan Integrated Household Survey.

2/ Pakistan Social and Living Standard Measurement. This survey was conducted using Core Welfare Indicators Questionnaire (CWIQ) methodology with a sample size of 76,520 household. Data are not necessarily comparable.

Table 6. Pakistan: Social and Demographic Indicators, 2003

	Pakistan	South Asia	Low-Income
Population, mid-year (millions)	148	1,408	2,310
GNI per capita (Atlas method, U.S. dollars)	430	510	450
Recent estimates (latest year available, 1997–2003)			
Poverty (% of population below poverty line)	33	...	...
Life expectancy at birth (years)	63	63	58
Infant mortality (per 1000 live births)	81	63	82
Access to an improved water source (% of populations)	90	84	76
Literacy (% of population age 15+)	49	58	63
Gross primary enrollment (% of school-age population)	86	95	94
Male	...	103	100
Female	...	88	88

Sources: World Bank; and UNDP 2005 Human Development Report.

III. Main Issues

A. Why the Change Between Pre- and Post-Crisis Period?

25. **The weak economic performance and poor implementation of the pre-2000 programs largely reflected political instability in Pakistan, as well as the limited program ownership by eight successive governments.** The main motivation for engaging the Fund tended to be short-term alleviation of foreign exchange shortages rather than sustained reforms for macroeconomic stability and long-term growth. Vested interest groups resisted deeper structural reforms while the quality of institutions eroded steadily. The top political leadership was either not committed or not able to overcome opposition to economic reforms.

26. **The government that came to power in 1999 put the economy at the top of its agenda.** President Musharraf took a personal interest in economic matters. Experienced technocrats, often expatriates, were recruited for key economic posts, such as the minister of finance and the central bank governor. The government did not face the same political constraints as earlier elected ones, and could take unpopular decisions, including reducing subsidies. It also dealt more efficiently with corruption at the top. Nevertheless, it still had great difficulties in expanding the tax net and getting the population to pay utility bills.

27. **The initial reform efforts in 2000–01 took place against the background of relative international isolation, reflecting sanctions because of nuclear tests and opposition to the military takeover.** However, with the government joining the coalition against terror in September 2001, considerable external financial support was mobilized, including more grants and a Paris Club debt rescheduling on very favorable terms. Pakistan was also compensated for costs incurred in the war on terror.

28. **A frequently asked question is whether Pakistan's improved economic performance after 1999 was the result of domestic policies or external support, and hence whether the gains are sustainable.** In practice, it is impossible to precisely disentangle policy and external effects. International financial support certainly created a favorable external environment for domestic policy adjustment. It would have been impossible to secure financing assurances for the first year of the PRGF program without the change in sentiment among donors that followed the September 11 events. The agreement by the Paris Club to provide an exceptional debt treatment and the willingness of major donors to contribute fresh cash contributed to the improvement in the fiscal and external positions in 2001/02 (Tables 7 and 8). The increase in defense-related receipts provided extra resources but these were used to cover additional costs incurred in the war on terrorism (Table 9). However, without the change in policies, instigated in 1999, the international support would have fallen on infertile grounds. Instead, the increased support helped the government to advance its reform agenda and to reduce the fiscal deficit substantially. There was some early success in raising tax revenues in 2002/03–2003/04, nontax revenues (excluding defense receipts) were raised substantially, and domestically financed defense expenditures (defense spending minus defense receipts) were reduced quite sharply.

Table 7. Pakistan: External Official Support, 1998/99–2004/05

(In percent of GDP)

	1998/99	1999/2000	2000/01	2001/02	2002/03	2003/04	2004/05
Official transfers 1/	0.8	1.3	1.2	2.1	1.3	0.6	0.4
Project and nonproject loans	0.3	-0.9	-0.5	-1.4	-2.2	-2.1	-0.6
Net exceptional financing 2/	5.3	5.4	4.2	5.6	3.9	3.4	3.6
Total	6.5	5.8	4.9	6.3	2.9	1.9	3.4

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

1/ Includes support under the Saudi Oil Facility that was phased out in 2003/04.

2/ Includes lending by the World Bank, the IMF, and AsDB. Also includes the flow impact of debt relief which is estimated for 2003/04 and 2004/05 at 1.0 percent of GDP and 0.8 percent of GDP respectively.

Table 8. Pakistan: Current Account Performance, 1998/99–2004/05

(In percent of GDP)

	1998/99	1999/2000	2000/01	2001/02	2002/03	2003/04	2004/05
Current account (excluding official transfers)	-3.8	-2.9	-2.7	0.1	3.8	1.4	-1.6
Balance of trade and nonfactor services	-4.1	-3.0	-3.2	-0.8	-0.4	-2.7	-7.1
Interest payments	2.1	2.2	2.3	2.2	1.5	1.1	0.8
Private transfers (net)	2.8	2.7	3.4	4.2	6.9	6.4	7.7

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

Table 9. Pakistan: Fiscal Performance, 1998/99–2004/05
(In percent of GDP)

	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05
Tax revenue	11.0	10.7	10.6	10.9	11.5	11.1	10.0
Nontax revenue	2.4	2.8	2.7	3.3	3.4	3.3	3.8
Defense related receipts	0.0	0.0	0.0	0.0	1.1	0.8	0.8
Grants	0.4	0.9	1.0	1.9	2.5	0.6	0.3
Expenditure	18.1	18.7	17.2	20.0	18.5	17.3	17.1
Current expenditure	15.7	16.5	15.5	15.9	16.6	14.0	14.4
Of which:							
Interest payments	6.0	6.5	5.6	5.6	4.3	3.5	3.2
Domestic	4.9	5.2	4.4	4.2	3.5	2.8	2.6
Foreign	1.1	1.2	1.2	1.4	0.8	0.7	0.6
Defense	3.5	4.0	2.5	3.4	3.3	3.3	3.2
Development expenditure and net lending	2.5	2.2	1.7	4.0	1.8	3.3	3.9
Budget balance (including grants)	-4.6	-4.6	-3.3	-3.6	-1.4	-1.8	-3.0

Sources: Pakistani authorities; and Fund staff estimates.

29. **The combination of external support and policy adjustment helped to restore confidence, resulting in lower interest rates and a reduction in the huge domestic interest bill.** On the external side, the increase in private transfers, rather than official support, was the main factor behind the increase in foreign exchange reserves. This may have partly reflected tighter scrutiny of bank accounts of Pakistanis abroad following the September 11 events, but also, to a large extent, resulted from increased confidence.[5] An even more pronounced surge in remittances had occurred during an earlier period of relative political and economic stability in the late 1970s and early 1980s. The considerable improvement in the balance of goods and services reflected weak domestic demand and improved competitiveness, as well as growing demand in partner countries.

B. Was Structural Conditionality Appropriate?

30. **The 2002 guidelines on structural conditionality emphasized national ownership, parsimony and criticality, tailoring to circumstances, coordination with other multilateral institutions, and clarity in specification.** Although the 2000 interim guidance note, which advised to limit structural conditions to macrorelevant measures in the Fund's core areas, had not yet been finalized when Pakistan's 2000 SBA was negotiated, the drive to streamline Fund conditionality was already well underway.

[5] A part of the increase in recorded remittances represented a shift into formal channels as a result of the economic reforms.

31. **Conditionality in the 2000 SBA clearly did not meet the test of parsimony.** In terms of numbers, structural conditions exceeded Fundwide averages by a wide margin. Moreover, conditions were not limited to just those areas that were macrorelevant and critical to the success of the program.[6]

32. **The wide array of structural conditions in the 2000 SBA appears to have been a response to Pakistan's weak performance under earlier Fund-supported programs.** Executive Directors at the Board discussion of the 2000 SBA request in November 2000 generally considered the program to be a way for Pakistan to establish a good track record—previously it had been known as a "one tranche country." Directors emphasized the need for prior actions and structural conditions, including at informal Board meetings prior to the approval of the program. The Acting Chairman noted that: "the uncertainty that remains has been the reason for the program to include many structural benchmarks and quantitative performance criteria." The view that the inclusion of so much conditionality entailed unnecessary risks for program implementation was clearly not valued sufficiently.

33. **In the end, the 2000 SBA was successful in establishing a good track record and in the subsequent PRGF arrangement conditionality was increasingly streamlined.** But because of the large number of conditions, the impression among some Pakistani officials was that the program was punitive and imposed. In their view, the fact that it broadly succeeded had more to do with the government, with no other options available, having to accept the conditions and do whatever it took to meet them. Others, however, stressed that most, if not all, of the SBA conditions were measures the government aimed to implement in any event, regardless of the Fund. The 2001 PRGF arrangement, by contrast, was publicly claimed by the government as its own program,[7] and structural conditionality was more limited and focused. It focused on three areas that were considered critical for the success of the program: (a) strengthening the tax system and expenditure management; (b) increasing the role of markets in the financial system; and (c) improving the performance of state-owned enterprises and governance, notably in the energy sector. While not a core area of Fund responsibility, the energy sector was deemed critical to achieve the program's fiscal goals because of its large drain on budget resources.

34. **But while conditionality became more parsimonious in the PRGF, it is questionable whether the chosen conditions sufficiently met the criteria of criticality, tailoring, and even ownership in some sectors.** As noted above, the revenue intake did not increase as planned, and transfers to the energy sector remained large. At the same time, however, the program's objectives in terms of reducing the debt burden and creating room

[6] Measures that can hardly be deemed macrorelevant and critical to the success of the program included, inter alia, the adoption of a plan to improve national accounts; implementation of an orderly process to resolve a dispute between two energy companies; elimination of nostro limits on banks' foreign exchange holdings with correspondent banks; and the publication of quarterly fiscal reports.

[7] The term "homegrown" had never been used before.

for social spending were met. While tax and energy sector reforms as a whole could be considered as critical ex ante, many of the individual structural conditions were not (see below).

35. **Fiscal conditionality placed emphasis on both streamlining taxation of existing taxpayers and on broadening the tax base.** The authorities enthusiastically embraced efforts to make the tax system more efficient and taxpayer-friendly, including as a way to improve compliance. However, efforts to widen the tax base—by eliminating numerous exemptions and expanding sales and income tax coverage—ran into resistance from interest groups, especially as regards extending the tax net further into the agricultural and services sectors. PCs were often breached, especially the one on no new tax exemptions, but waivers were granted as the impact of the measures was minimal, which raises the question of the choice of individual measures subject to conditionality. But it is doubtful whether tougher conditionality, or implementation of conditionality, would have been successful in the absence of full ownership, including at lower levels of government, as extending the tax base into agriculture and services required cooperation from provincial authorities. A system to tax agricultural incomes, for example, pursued through Fund-supported programs since 1981, had been put into place during the 2000 SBA, but actual collection fell short of expectations, reflecting a lack of political will at the provincial level to fully implement the new laws.

36. **Political constraints also prevented the government from moving faster and more decisively on power sector reforms.** Electricity tariffs and bill collection remain among the most difficult political issues in many developing countries—Pakistan is not unique in this respect. Tariffs have been raised over the past decade, but not enough to cover rising costs, let alone much-needed investment to repair and expand the system. Heavy Fund conditionality in the energy sector stemmed from the fact that the World Bank's efforts to push reforms had limited success. With the Bank stepping back at the time (see below), energy sector conditionality was included in the SBA and PRGF with a view to reducing the large drain posed by this sector on the budget.

37. **With limited understanding of power sector issues, it proved difficult to select the structural conditions best suited to advance reforms.** Fund conditionality focused mostly on tariff structures, financial performance of companies, and privatization. Conditions were often met, albeit mostly after delays. But slippages were never deemed serious enough, though, to warrant program interruption and waivers were frequently requested and obtained. Progress was made—including putting up KESC for sale, the break-up of WAPDA, and the design of a new tariff and subsidy regime—but technical losses in the system remained high, tariff collection weak, and as a result the sector's overall performance did not improve much. Thus, here too, one can argue that conditionality was not sufficiently tailored to address the sector's deep-rooted problems. Moreover, the reform of the power sector is a long-term process, with limited scope for quick results within a program's horizon.

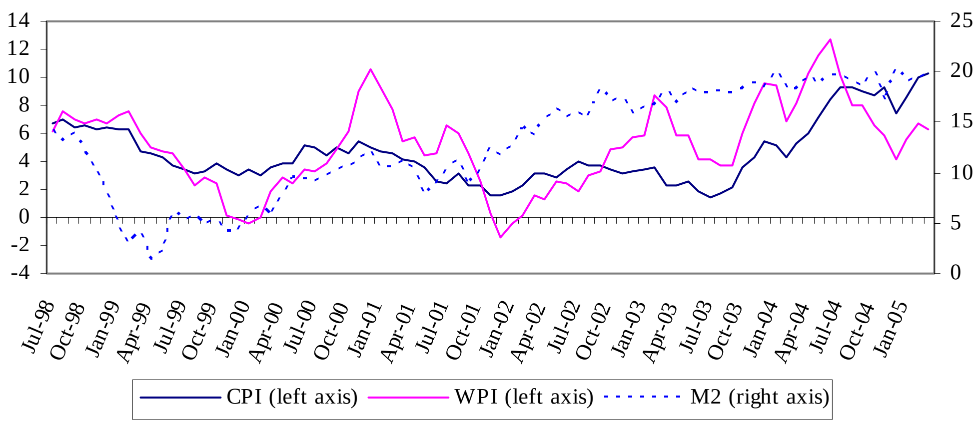
38. **Overall, it appears that Fund structural conditionality was not well-suited for areas that require longer-term institution building and the cooperation of more than just the central government.** Looking back also to the pre-1999 programs, various approaches have been tried to achieve the desired results in the tax and energy areas, ranging from developing broad sectoral plans, to large numbers of detailed measures, and to setting quantitative targets for tax collection or quasi-fiscal deficits. But without the adequate involvement of the World Bank (see below), and full government ownership at all levels, each of these approaches failed to deliver.

C. Should the Monetary Program Have Been Designed Differently?

39. **Throughout much of the period under review, the SBP succeeded in keeping inflation in the low single digits.** As noted above, however, in late 2003 inflation started to pick up, reaching double digits in early 2005. This raises the question whether the monetary program had become too accommodating toward the end of the PRGF arrangement.

40. **The monetary program followed the standard approach of setting floors for the net international reserves (NIR) and ceilings for the net domestic assets (NDA) of the central bank.** Initially, large post-September 11 inflows of capital (in particular unexpectedly high private transfers) facilitated overperformance on the NIR target, while the NDA target was met through partial sterilization of the associated liquidity growth. Monetary growth accelerated significantly in 2001/02 and eventually led to strong credit growth and a pickup in inflation, as the exchange rate was not allowed to appreciate substantially and sterilization was reversed (Figure 13). Should staff have insisted on greater exchange rate flexibility to contain inflation? Should the program instead have set ceilings for reserve money rather than NDA?

Figure 13. Pakistan: Inflation and Broad Money, 1998–2005
(y-o-y percent change)

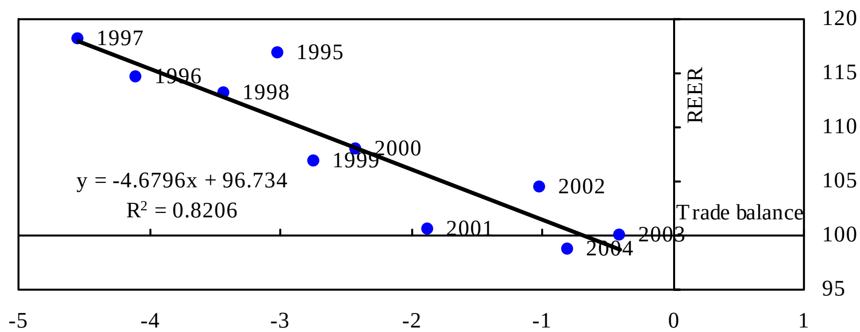


Source: Pakistani authorities.

41. **The authorities initially viewed economic conditions as favorable to a relatively accommodating monetary policy stance.** With the economy starting to recover, they wanted to maintain the momentum and feared that an appreciation of the nominal exchange rate, as well as an increase in interest rates, would dampen the expansion. They believed that the increase in liquidity was essentially demand driven, thereby negating the need for aggressive sterilization. Caution on exchange rate appreciation was supported by the initial expectation that the surge in both official and private inflows would prove temporary, and fears that the war on terror and the termination of the system of quotas under the multi-fiber agreement may adversely affect exports. These factors combined helped shape the authorities' view that a nominal appreciation could result in pressures on reserves.

42. **An assessment of external competitiveness fails to find evidence of a real exchange rate undervaluation.** There appears to be a strong relationship between the real exchange rate and the trade balance, and the 2003–04 levels of the real exchange appear broadly consistent with a sustainable balance (Figure 14).[8] The CPI-based real effective exchange rate (REER) had, on average, been depreciating by about 1 percent per year since mid-1990s in part explaining the strong growth of exports in 2001–04. While other factors have also been at work, the 2001–04 REER—unlike in the 1990s when the REER seems to have been overvalued—does not lend support to an undervaluation hypothesis.

Figure 14. Pakistan: Real Effective Exchange Rate
(year 2003=100) vs. Trade Balance (percent of GDP), 1995–2004



Sources: Pakistani authorities; and Fund staff estimates.

43. **Had reserve money been a performance criterion under the program, together with a NIR floor to ensure a sufficient reserve position, monetary expansion could have been contained through a more aggressive sterilization policy and higher interest rates.** This would have entailed greater exchange rate flexibility with less build-up of foreign reserves—an option that would not have enjoyed much ownership in view of the authorities' objectives to establish a strong reserve position, preserve competitiveness, and keep interest rates low. Thus, a reserve money target could have been counterproductive in the absence of

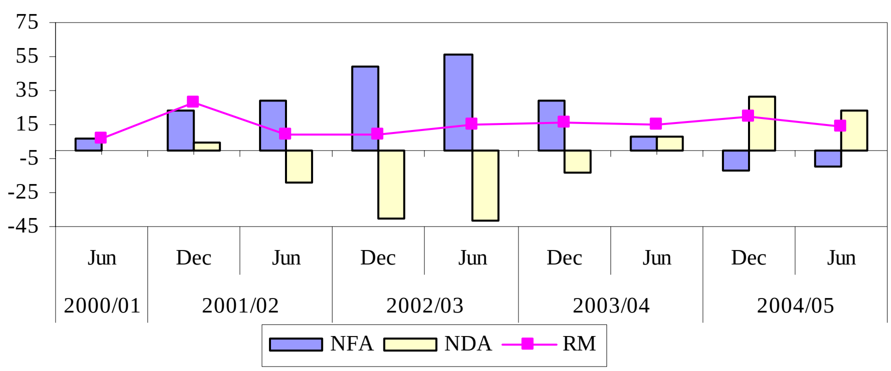
[8] The base year for the REER index was chosen 2003 when the external trade was broadly balanced.

any obvious initial misalignment of the real exchange rate. Rather than reflecting the architecture of the quantitative conditionality, the root of the acceleration of inflation was the emphasis placed by the authorities on growth compared with control of inflation.

44. **In August/September 2003, when understandings on performance criteria for the final program year were reached, the authorities and the staff still believed that there had been a structural upward shift in money demand.** This view was supported by the observation that sustained increases in money growth continued to be accompanied by little evidence of rising inflation (inflation was below 2 percent in June–August 2004). In these circumstances, fiscal policy correctly aimed at ensuring that the bulk of the official grants were either saved (i.e., the budgetary deficit excluding grants was unchanged) or allocated to development expenditures (within the spending envelope) while other expenditures were contained. The resulting fiscal consolidation was believed to keep inflationary expectations low while ensuring that the ceiling on central bank NDA would be met.

45. **Since mid-2003, however, the monetary expansion was driven by domestic sources, as opposed to capital inflows earlier** (Figure 15). Before, the SBP opted for accumulating foreign reserves and sterilized at least part of the liquidity effects. Starting in 2003/04, however, the SBP slowed the accumulation in reserves and cut sterilization operations. In fact, NDA became the source of monetary expansion as the central bank began financing the budget when commercial banks were no longer willing to roll-over treasury bills as interest rates were held negative in real terms. Indeed, the expansion of NDA sustained the growth in reserve money through 2004/05, thus accommodating the rising demand for private sector credit fueled by negative real interest rates. Private sector credit growth accelerated from 2.5 percent of the initial broad money stock in 2002/03 to 14.3 percent in 2003/04.

Figure 15. Pakistan: Reserve Money Growth, 2000/01–2004/05
(In percent)

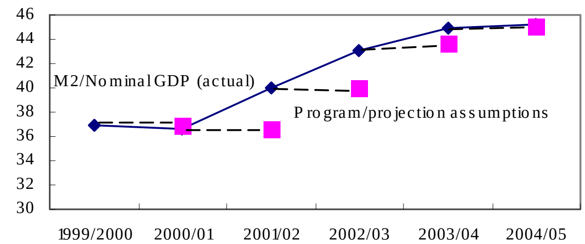


Source: Pakistani authorities.

46. **In late 2003, staff became concerned with the steady increase in inflation, but the authorities still preferred not to tighten monetary policy to avoid choking off the growth momentum.** Their view was that the increase in inflation largely reflected temporary supply side factors, especially the rise in the wheat support price. Only in 2005 did the continued increase in inflation lead the central bank to start tighten monetary policy more forcefully, although interest rates were still left negative in real terms.

47. **In retrospect, with the acceleration of inflation since June 2003, the program's NDA targets turned out insufficiently restrictive.** From the program design perspective, however, inflation was below the program target of 5 percent until March 2004, while the quantitative targets for the last PRGF review were set in August/September 2003. Staff did, beginning in December 2003, consistently advise the authorities to tighten monetary policy more aggressively by raising interest rates faster. The policy dialogue recognized the inflation risk but the evidence on program ownership—and thus the expected readiness to tighten policy, if needed—was strong enough, so that the actual design of the monetary program was justified ex ante. Comfort was also provided by the program's conservative velocity assumptions and the still very low inflation rates (Figure 16). But as the growth of money demand started to slow, with hindsight, tighter ceilings for the central bank's NDA could have helped to slow the rise in inflation, forcing a more rapid increase in interest rates.

Figure 16. Pakistan: Money Demand, 1999/2000–2004/05



Sources: Pakistani authorities; and Fund staff estimates.

D. Did Fund-Supported Policies Help to Reduce Poverty?

48. **The PRGF-supported program aimed to contribute to reducing poverty by establishing conditions for higher, sustainable economic growth, and, more directly, by creating room for higher social spending.** Beyond that, the program did not include any specific measures to aid the poor. A poverty reduction strategy was developed, and if implemented is expected to result in poverty reduction over the medium and long term.

49. **Who benefits from higher growth depends to a large extent on the prevailing socio-economic structure.** Pakistan is a society with a small, very well-educated upper class, a still relatively small middle class, and a very large, mostly rural, lower class that is poorly educated and has little or no assets. The economic well-being of the poor largely depends on developments that are external to them, leaving them vulnerable to adverse circumstances. It will require a prolonged period of strong growth to enable low income groups to start accumulating assets, thus reducing the risk that they will fall below the poverty line if economic conditions worsen. In this regard, the past two Fund arrangements can be said to have contributed to poverty reduction, albeit over a somewhat longer horizon, by helping to establish conditions for continued strong growth of per capita incomes.

50. **Considerable emphasis was placed on increasing social spending.** The improvement in social outcomes could have been greater if not for the still weak administrative and institutional capacity at the local government level. At the time of the PRGF request, major efficiency gains in the delivery of key social services were expected from the devolution process. However, devolution, as well as capacity building, takes time. It would have been difficult for the Fund to place a greater emphasis on social outcomes, as this would have implied entering into areas that are well outside its areas of expertise, and where support was already forthcoming from the World Bank and the AsDB. A constraining factor has been that political devolution has yet to be fully followed up with financial and administrative devolution, to ensure that local governments have the financial means and administrative authority to carry out their increased responsibilities. The Fund could have become more involved in financial devolution issues, but it would have required taking positions on the division of resources among the provinces and districts. This is a highly complex and sensitive internal political issue, and it is unlikely that any Fund involvement would have been helpful or successful.

51. **A number of specific measures may have had an adverse impact on the poor.** These measures include, for example, adjustment of energy prices, reducing subsidies on or taxation of agricultural inputs, expanding the coverage of the sales tax, and the alignment of NSS instruments with market interest rates. No social impact analyses were conducted, however, and no specific consideration was given to strengthen the social safety net. The existing social safety net schemes—the Kushal Pakistan Program, the Food Support Program, and Zakat—were largely viewed as black boxes by the staff. To the extent that these programs received budget support, it was left to the government to determine whether part of the increased room for social spending was allocated to them.

52. **In sum, during the period of the PRGF, growth has resumed, a poverty reduction strategy was developed, social spending was increased in line with expectations, some social indicators have improved, and it appears likely that poverty was decreased.** These developments are welcome, but poverty remains widespread in Pakistan. Given the prevailing socio-economic structure, it is to be expected that government efforts, supported by the World Bank and Fund, can produce results only gradually in Pakistan.

E. Was the Size of the 2001 PRGF Arrangement Appropriate?

53. **Pakistan's 2001 PRGF was by far the largest PRGF ever in nominal terms, and one of the five largest in terms of quota (100 percent).**[9] In view of the quick recovery of Pakistan's foreign exchange reserves in 2001–03 and the scarcity of PRGF resources, was such large access necessary?

[9] The other large access members were Democratic Republic of Congo, Honduras, Djibouti, and Sierra Leone.

54. **In the fall of 2001, Pakistan faced a perilous external environment.** The world economy was weakening in the wake of September 11, and war was expected in neighboring Afghanistan. Orders for exports were shrinking, and shipping costs increasing because of war risks. Export growth projections were revised downwards, resulting in a sizable balance of payments need.

55. **Under these circumstances, the large size of the PRGF arrangement clearly reflected not just international political considerations but real economic needs.** The briefing paper for the mission that negotiated the PRGF called for access of 60 percent of quota. The Pakistani authorities asked for higher access, and received the political support of major shareholders after the events of September 11. But the increased support was also consistent with the need to close a larger financing gap and additional uncertainty. At the Board meeting, some Executive Directors argued that access should have been even higher based on the recent strong track record of policy implementation and the strength of the program.

56. **The exceptionally large PRGF loan was very effective in signaling the confidence of the international community in Pakistan, and catalyzing public and private financial flows.** This support, together with political factors, encouraged Paris Club creditors to provide generous debt relief, and the World Bank and the AsDB to commit major financial support packages. Even more importantly, the signal of support from the international community helped rebuild confidence at home and encouraged large private inflows, especially remittances, which made a major contribution to the recovery of the external position.

57. **In hindsight, Pakistan's balance of payments appears overfinanced.** The combination of large official and private inflows contributed to high money growth, eventually resulting in inflationary pressures. And in the end, Pakistan only drew 83 percent of the PRGF loan. Although the financing outcome was impossible to predict under the difficult circumstances of 2001, a substantially larger-than-targeted increase in official reserves could have allowed the authorities to refrain from drawings on PRGF resources or repay more expensive external debt ahead of time, thus accelerating debt reduction and entering on a faster track to debt sustainability. A few Directors pressed for (and staff discussed) Pakistan ceasing to draw on PRGF resources earlier in light of the strong foreign exchange reserves. Regarding the access, however, the balance of payments outcome was partly endogenous—smaller financial support might not have had the same confidence effect that contributed to the outcome. Also, while vulnerabilities have diminished, they still exist, which suggests that Fund support for the balance of payments was justified also on economic grounds.

F. Did Fund-Bank Collaboration Contribute to the Success of the Program?

58. **There appears to have been good cooperation between World Bank and Fund staffs, especially during the crisis period of 2000–02.** In the financial sector, the World Bank took the lead in supporting bank reforms (especially privatization) through a sectoral loan, key elements of which were incorporated in the PRGF; the Fund focused on reform of the NSS. In tax policy and administration, the Fund took the lead in providing strategic advice, while the World Bank has provided financial resources to modernize the tax administration. As regards poverty alleviation, Fund staff pressed for an increase of spending at the macroeconomic level and improved reporting, while the World Bank focused on building capacity in the regions, where health and education services were delivered.

59. **Cooperation on energy sector issues was intense, but more difficult than in other structural areas.** This largely reflected the different objectives of the two institutions. World Bank staff were intent on Pakistan developing a power system based on international best practices in the medium term and stepped away when they felt that the authorities lacked commitment. Fund staff, on the other hand, were keen to reduce electricity subsidies in the short-run and could not step away as these subsidies were a major cause of the fiscal imbalance. Although World Bank staff worked closely with Fund staff and were on board with program measures in the power sector, they tended to be skeptical of the impact of partial measures and kept a distance in view of what they perceived as the lack of ownership. This may in itself have weakened the measures. A more systematic effort to reconcile long and short-term objectives in structural reform might have helped, but ultimately it was the lack of commitment to reform by several energy sector stakeholders (outside the Ministry of Finance) that undermined reform in the power sector.

G. How Did the Work of Fund Staff on Pakistan Evolve Following the IEO Report?

60. **In contrast to the IEO's findings for the period until 1999, program design in the successor arrangements was no longer affected by pressures to overpromise and downplay risks.** Staff working on Pakistan from 2000 felt no pressure to conclude programs or reviews, regardless of the possible catalytic effects, even after the events of September 11. In fact, there was considerable skepticism at the Board regarding Pakistan, especially in 2000/01. This situation was, for example, reflected in the wide array of conditionality in the 2000 SBA. The lack of political pressure on Fund staff was not recognized either in Pakistan or outside, and many observers felt that political factors were the key to Fund support.

61. **The recent programs did not overpromise in terms of macroeconomic performance.** The IEO had noted a tendency for overly optimistic projections for key program parameters (such as GDP growth, exports, and domestic savings and investment) and for some program targets (such as budgetary revenue) prior to 2000. But unlike the preceding period, program projections after 2000 were satisfactory. The trend in growth projections closely mirrors the

trend in actual data (Figure 17).[10] On average, the growth rate of GDP was overestimated by only 0.3 percentage points (compared to 1.5 percentage points in the previous programs according to the IEO). Projections for the external sector also conformed well with the time path of the actual data. The current account tended to overperform, mainly because of the abrupt and sustained increase in private transfers that was picked up by the projections only with a delay. For merchandise exports, the average forecast error was close to -4.5 percent, mostly due to conservative projections over the last two years. Fiscal balance projections under both the SBA and the PRGF were satisfactory although revenue forecasts were overly optimistic.

62. **High expectations may have been created as regards poverty reduction and improved governance, in response to Board and management concerns for these issues.** Even in the absence of specific targets, the heavy emphasis in staff reports on poverty reduction and improved governance may have suggested that major and prompt progress was possible. As noted above, some progress was made, but the challenges remain significant, and disappointment was often expressed by the Board. Staff could perhaps have emphasized more the socio-political factors constraining progress in poverty reduction and governance, and emphasized more that a longer time period would be needed to address these problems.

63. **Regarding selectivity in committing Fund resources,** it could be argued that the Fund should not have granted waivers for frequent breaches of structural performance criteria and interrupted the SBA and PRGF-supported programs in the view of the generally disappointing performance in the tax and energy reforms. However, macroeconomic objectives and fiscal targets were being met or exceeded, structural policies were making progress in many other areas, and overall waiver rates were lower than average in Fund programs, which appears to justify the waivers. Moreover, program interruption could have been highly disruptive, undermining the government's reform efforts.

64. **Despite the problems to which the IEO has drawn attention, without Fund (and World Bank) support during the 1990s, the economic situation at the end of that decade might well have been worse than it was.** The country could have accumulated sizable external arrears or had more severe macroeconomic imbalances. By 2000, Pakistan already had a fairly liberal trade and exchange system as opposed to protectionism and exchange controls. Thus, continued Fund support probably ensured that when a more committed government came to office, it had fewer hurdles to overcome than otherwise. The counterfactual—that an economic crisis, triggering reforms, might have occurred earlier, had the Fund disengaged in the 1990s—can, of course, only be speculated at.

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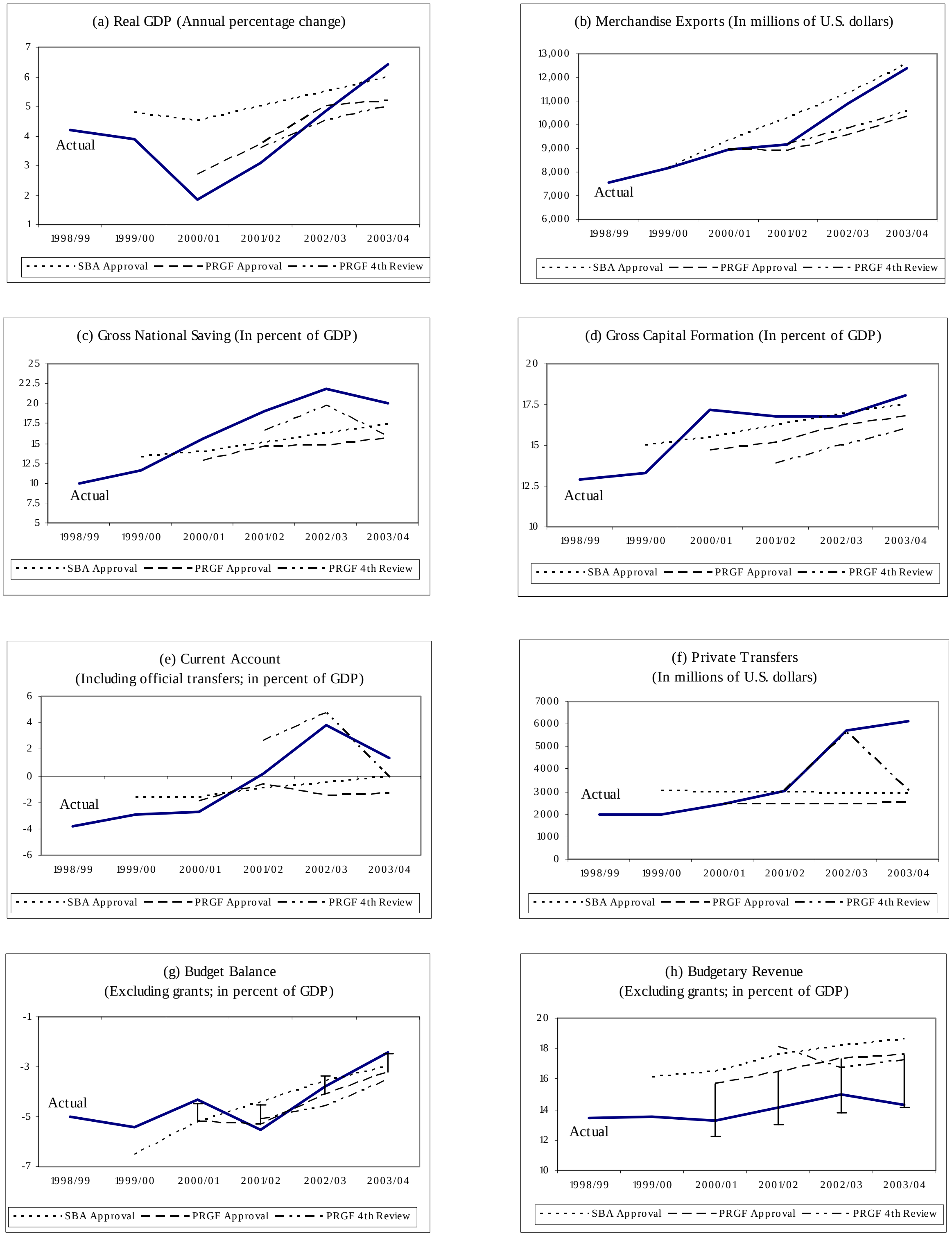
[10] In the accompanying figure, the first data observation on each program/review line is the point estimate for the preceding (pre-program) period. Thus, the starting point for the 2000 SBA (November 2000–September 2001) is the 1999/2000 preliminary estimate; the starting point for the 2001 PRGF (October 2001–September 2004) is the 2000/01 preliminary estimate; and the starting point for the fourth review of the PRGF (incorporating data available at November 2002) is the 2001/02 preliminary estimate. Therefore, the program projections start with the second data point in each program/review line, and a starting point, which is off the "actual" line, indicates subsequent revisions to the most recent data on which the program projections were based.

Figure 17. Pakistan: Were the Main Assumptions/Projections Overoptimistic?



Sources: Pakistani authorities; and Fund staff estimates.

65. **The recent programs by and large appear to have pursued the right goals.** Stabilizing the macroeconomic situation was of immediate concern in 2000. The 2001 program design appropriately took a longer-term view, aiming to increase Pakistan's growth potential, improving social outcomes, and reducing external vulnerabilities. The quantitative conditionality (as well as some prior actions) focused on consolidating macroeconomic stability, reducing vulnerability, and ensuring an increase in social spending. Unlike in the previous period, public debt sustainability was a central issue in the PRGF-supported program, and indeed was the key factor in determining the required amount of fiscal adjustment.

66. **Structural conditionality focused on critical issues, but could have been more selective—individual measures subject to conditionality were often not critical.** The results varied according to the authorities' commitment in particular areas and their ability to overcome vested interests. Especially in those areas where success would have required cooperation at lower levels of government, or in public enterprises, progress appears to have been less satisfactory.

67. **Article IV reports from 2000 on made a greater effort to identify risks and vulnerabilities.** Issues on which the authorities and staff differed were discussed in the reports. The 2002 Article IV report was considered a good example of how to treat program review and Article IV issues in the same report, without neglecting the surveillance side. Nevertheless, to what extent the staff were able to step back and take a broader view is debatable. Alternative strategies to the PRGF were not discussed.

IV. Lessons for the Fund

68. **The Pakistan experience during 2000–04 confirms that program ownership is decisive.** But even in one country, it can vary widely across issues, depending on a complex set of political, economic, and security factors. The more difficult question is whether the Fund should be selective and step back, as the IEO report suggested, in cases where the political environment is not right for reform and ownership is lacking. In the case of Pakistan, it is quite possible that it would have had been more difficult for the country to take advantage of the change in government and external environment that came about in 2001 if the Fund (and other international institutions) had had disengaged earlier because of the past weak program implementation.

69. **The staff experience with Pakistan underscores the complexities involved in designing structural conditionality under the Fund programs that achieves both country ownership and the objectives of the program.** First, while it is relatively straightforward to identify critical issues (e.g., tax collection) it is much more difficult to find individual measures that are macrorelevant, let alone critical, to the success of a program. This is partly because many structural reforms show effects only well beyond the program horizon. Second, overall ownership of policies by a government is important, but ownership and political constraints need to be assessed also with respect to specific reforms. Without ownership at all necessary levels, it is virtually impossible to ensure effective

implementation of many reforms, and there is little point in adding more conditions and trying to close every possible loophole. Third, if a measure is truly critical and there is no political will, there may be a case for stepping back, but caution, and some humility, needs to be exercised by Fund staff in determining what is truly critical.

70. **Fund structural conditionality is best suited to areas where a few individual measures taken by the central government can bring progress.** Where prolonged institution-building and capacity-enhancement are needed, particularly in areas outside the Fund's core expertise, World Bank (and other IFIs) involvement is essential, and the Fund should not embark on such reforms without the World Bank fully on board. Areas that require cooperation at lower levels of government may also pose considerable difficulties, particularly when special interest groups are strong. All these considerations suggest a greater need for selectivity and leaving more areas of reform to be treated as less time-bound commitments.

71. **Fund advice on tax reforms needs to balance the requirement to increase tax ratios with the need to develop an efficient, client-friendly system based on best practices.** Political will and implementation capacity to bring new taxpayers into the net need to be assessed explicitly when setting conditionality. If either true commitment or technical capacity to implement revenue-gaining reforms is lacking, other reforms that enhance efficiency but are revenue-losing in the short-run may need to be delayed. With the benefit of hindsight, the reduction of tariffs and other revenue-losing measures could have been delayed until alternative sources of revenue were fully implemented. In coming years, as interest costs are likely to rise and nontax revenues may not continue to increase at the same pace as in the last few years, broadening the tax base will be crucial to meet the rising demand for social and development spending, while continuing to reduce the debt burden.

72. **Pakistan's experience with strong foreign exchange inflows raises the question of whether exchange rate adjustment should always be the preferred option to maintain price stability.** This is a fairly common problem, for which there are no easy answers. Pakistan's real exchange rate does not appear to have been significantly undervalued. A real appreciation could have made it more difficult for Pakistan's textile manufacturers to position themselves ahead of the elimination of the quota regime. Thus, with hindsight, the SBP appears to have made the right choice when it was leaning against a nominal appreciation. However, the SBP should have moved faster in raising interest rates once inflation started to pick up, as was recommended by the staff.

73. **The experience with Pakistan's recent programs suggests that Fund staff should not overpromise in terms of short-run poverty reduction.** Poverty is often caused by deeply ingrained socio-economic factors. Apart from focusing on growth in average per capita incomes, Fund staff can press for more and better targeted social spending, as well as better management of such spending programs. But these are not the only elements in a successful poverty reduction strategy, and they may not be sufficient to address poverty in the short-run.

74. **Better macroeconomic governance and transparency can be achieved even in the most difficult program cases.** However, overall perceptions of governance in a particular country are often determined by performance in areas such as utilities, civil service, law and order, and the judiciary, which are outside the Fund's mandate. As the Pakistani experience shows, achieving tangible results in governance through Fund-supported programs should not be oversold.

75. **Even in cases of very successful World Bank-Fund collaboration, the issue of short versus long-term reforms needs to be addressed.** Rather than setting its own specific conditionality for the power sector, Fund staff could have focused more forcefully on the overall quasi-fiscal deficit of the sector and asked the World Bank staff to design the specific measures that would improve performance in the short-run, by raising the average tariff, strengthening bill collection, and reducing losses, even if there was a lack of commitment for fundamental energy sector reform. This would have required a clear accord at the senior management level.

76. **The Pakistani experience shows that large, up-front Fund financial support, together with strong domestic policy implementation, can be very effective in catalyzing public and private sector support even in a very uncertain political and security situation.** To consolidate success in Pakistan requires perseverance and the authorities and Fund staff need to be prepared to deal with shocks and avoid policy slippages. On the macroeconomic front, the risk of excessive inflation has become apparent and tax revenue continues to lack buoyancy. Energy sector reforms are not yet complete. Governance needs to be further strengthened in public institutions, which would also help to ensure that the benefits of growth reach the poor.

77. **Pakistan and the Fund will need to continue to cooperate closely.** In the context of surveillance and technical assistance, Fund staff will continue to provide advice to the authorities on the macroeconomic policy mix; financial, fiscal, and external vulnerabilities; and the creation of fiscal space to allow for increased social and development spending.

Statement by Abbas Mirakhor, Executive Director for Pakistan
and Iqbal Zaidi, Senior Advisor to Executive Director
November 2, 2005

Key Points:

- *Steadfast implementation of prudent financial policies and bold structural reforms has led to a remarkable turnaround in the economy, which went from the brink of financial crisis to one of the highest growth rates in the world;*

- *The authorities have taken welcome steps to protect their fiscal deficit target in the wake of recent international oil price hikes, including significant increases in domestic petroleum retail prices. The CBR reform project should enhance revenue collection significantly. Various indicators point to progress toward poverty reduction;*

- *The overriding objective in the conduct of monetary policy is to contain inflation, and the SBP has tightened monetary policy in recent months to combat inflation;*

- *Considerable progress has been made in strengthening the financial sector, and banks' financial soundness indicators have improved;*

- *The authorities scaled new heights in their ambitious privatization program, with the completion of the largest privatization transaction in Pakistan's history;*

- *The main findings of the ex post assessment are that Pakistan's Fund-supported programs during 2000–04 were successful because of the authorities' strong ownership. Considerable progress was made in most areas, including some difficult structural reforms, such as financial sector and public enterprise reforms; and*

- *In answering the question whether structural conditionality was appropriate, staff have noted that the "conditionality in the 2000 SBA clearly did not meet the test of parsimony." Although recent experience with Fund-supported programs has shown that judicious streamlining of conditionality provides the welcome result that 'less is more,' unfortunately, this valuable lesson was not applied to Pakistan.*

The Pakistan authorities express their sincere appreciation and gratitude for the compassionate response by the international community in the aftermath of the devastating earthquake, measuring 7.6 on the Richter scale. The earthquake has caused untold suffering and unprecedented damage, taking 80,000 lives, severely injuring over 70,000, and breaking up hundreds of thousands of homes and families. The infrastructure damage will take billions of dollars and five to ten years to rebuild, according to the UN relief mission. But even with many countries responding in a timely and significant way to provide material help in the wake of this calamity, it is clear that this is a devastating humanitarian disaster that requires a scaled-up response from the international community. Medical relief teams have predicted that thousands of earthquake victims could die from the effects of cold weather as winter approaches and as illnesses and infections go untreated. The biggest problem is that 3.3 million have become homeless, and thousands of survivors face death from exposure; entire villages have been living outdoors in increasingly harsh conditions, with many, including children, lacking warm clothing or blankets. The authorities and volunteers from all over Pakistan are doing their utmost, but they need help.

I. Staff Report for the 2005 Article IV Consultation

The authorities wish to convey to Fund management and staff their appreciation for the continued support to Pakistan through policy dialogue and technical advice over the years, and, until recently, Fund-supported programs. This relationship, based on mutual trust and respect, has been of considerable value to the authorities in implementation of their "homemade" policies—supported by a strong commitment from all segments of the society—that has led to a remarkable turnaround in the economy, which went in the short spate of five years from the brink of financial crisis to one of the highest growth rates in the world.

As noted in Chapter II of the Selected Issues paper, economic growth reached 8.4 percent in 2004/05 and is expected to remain high despite the deterioration in the terms of trade. Economic growth has averaged 5½ percent per year since 1960, meaning that real per capita GDP has been growing at about 2¾ percent per year, or that real incomes have more than tripled during this period. It is noteworthy that the recent growth acceleration has come largely from an increase in total factor productivity (TFP). The robust TFP growth may be attributed, in part, to the growing contribution of the services sector to growth, and that there was not much need for new investments due to the slump of the late 1990s and the excess capacity in the economy. However, it should be stressed that structural reforms aimed at fostering both productivity gains and higher investment, including in the domain of infrastructure and governance, were major factors behind this growth performance. Furthermore, many indicators show that investment rose last year and new capacity will come on stream during 2005/06, even though the national accounts data appear to understate private investment because of incomplete coverage of firms.

Fiscal Policy

Staff have noted that the government has taken welcome steps to protect their fiscal deficit target of 3.8 percent of GDP in the wake of recent international oil price hikes, including significant increases in petroleum retail prices in September and October. The authorities are well aware that tax buoyancy has been low, and Central Board of Revenue (CBR) tax collection declined when measured as a percent of GDP in 2004/05. The decline reflected mainly the transition costs of streamlining the tax system to improve the business climate, but they are taking corrective measures to bolster tax collection. Recent work done at CBR has shown that two-thirds of corporate tax filers had reported declining or unchanged income in 2004/05 even though overall growth had accelerated. While some of this inconsistency may be explained by differential growth rates and varying tax coverage across sectors, the authorities are confident that additional efforts should lead to higher collections from existing taxpayers. The authorities recognize that medium-term fiscal objectives can only be met with a marked improvement in revenue performance, and they have taken important steps toward that goal. In particular, the CBR reform project, supported by the World Bank, should enhance revenue collection, and the move to a greater reliance on self-assessment and risk-based auditing should make the tax machinery more efficient and taxpayer-friendly; taxpayer disgruntlement with the heavy tax machinery and low tax compliance have been perennial problems. The need for further extending the tax net into the service and agriculture sectors in a meaningful way has been recognized by the authorities, but this has been a laborious process that has required the cooperation of the provincial governments; past strenuous efforts at the federal level have resulted in only limited gains.

The government is targeting higher social and development spending, while further reducing the debt-to-GDP ratio. The authorities and staff agreed that it was crucial to increase the quality and effectiveness of social spending, including through the implementation of a medium-term budget framework, and enhancing administrative and financial capacity at the district level. To build up on the progress in poverty reduction, the authorities have planned further increases in social spending, particularly on health and education. Debt dynamics are distinctly favorable over the medium term: staff projects domestic and external debt to continue on their downward path, and international reserves to remain at adequate levels. The recently approved Fiscal Responsibility Law should provide additional confidence to official donors and private investors because it mandates continued debt reduction by at least 2½ percent of GDP per year.

Poverty Reduction

Although various indicators point to progress toward poverty reduction, the authorities have reiterated their commitment to make further inroads in this top priority issue. In particular, they are determined to increase spending in health and education because that is a *sine qua non* for achieving the Millennium Development Goals. It is comforting to note that results from the Pakistan Social and Living Standards Measurement Survey show improvements in various health and education outcomes. Recently, there has also been significant increases in indicators for wages and employment, while the high growth in agriculture is estimated to have raised disposable incomes in rural areas. Pakistan has further improved its ranking in the 2005 United Nation’s Human Development Index.

Monetary Policy

The overriding objective in the conduct of monetary policy is to contain inflation. The authorities have tightened monetary policy significantly, which, combined with measures to increase domestic food supply, should be sufficient to achieve the 8 percent inflation target in 2005/06. Since the beginning of 2005, the SBP has raised the six-month treasury bill (T-bill) rate by more than 4 percentage points to 8 percent in May. Nevertheless, as stated in the July 2005 monetary policy statement, the SBP stood ready to raise T-bill rates further, if necessary.

Exchange rate policy has served Pakistan well in recent years, contributing to strong export growth and reduced external vulnerabilities. The SBP is committed to exchange rate flexibility; intervention in the foreign exchange market is limited to preventing excess volatility. The sharp increase in international reserves since 2001 has allowed Pakistan to catch up with levels maintained by similarly-placed countries, and a further increase in reserves should be realized in 2005/06.

External competitiveness has been enhanced, as the real effective exchange rate has been on a depreciating trend for the last five years. The modest appreciation in the first half of 2005 and the shift of the current account into deficit should not raise concerns about the appropriateness of the real exchange rate. The strong performance of Pakistan's exports, including the shift toward manufactured exports and the increase in market share, is an important, if not definitive indicator, of competitiveness. Furthermore, the widening trade deficit has been partly financed by a significant increase in private transfers, and the recent surge in imports has been mainly due to imports of machinery, which suggests that once the equipment is installed, there should be a major boost in the export-oriented industries.

Financial Sector

Considerable progress has been made in strengthening the financial sector. The banking system has become more competitive, banks' financial soundness indicators have improved, and the sector shows resilience in standard stress tests performed by Fund and SBP staff. Although the high rate of credit growth may raise concerns about prudential standards because of a rebound in corporate indebtedness, the stress tests show that, in general, corporate vulnerabilities were declining and in line with comparator countries. Even though the authorities were confident that banks had strengthened substantially their risk management, SBP has again demonstrated its willingness to err on the side of caution, and recently mandated special provisioning requirements for secured and unsecured consumer financing of 1.5 percent and 5 percent, respectively.

Investment Climate and Governance

The authorities have pursued their structural reform agenda forcefully: staff have noted that the overall business climate and governance in key macroeconomic institutions have clearly improved, as attested to the data on fiscal transparency and various financial ROSCs. Also, according to the 2005 Doing Business survey of the World Bank, Pakistan has made progress in enhancing the business climate and compares well within the region. Notwithstanding this progress, the authorities have stressed that improving governance in all public institutions remains a high priority, and they are determined to create an environment conducive to investment.

Privatization

The authorities scaled new heights this year in their ambitious privatization program when the largest privatization transaction in Pakistan's history took place, with the sale, together with management control of 26 percent of the telecommunication company. The winning bid amounted to \$2.6 billion (2¼ percent of GDP). The sale of other major companies—large and strategic companies, such as Pakistan Steel and Pakistan Petroleum—is underway.

II. Ex Post Assessment of Pakistan's Longer-Term Program Engagement

The main findings of the ex post assessment are that Pakistan's Fund-supported programs during 2000–04 had been successful because of the authorities' strong ownership. Recognizing that the previous programs had suffered from substantial policy slippages, the new government addressed the economic difficulties with a new commitment to break away from past trends. Considerable progress was made in most areas, including some difficult structural reforms, such as financial sector and public enterprise reforms. The economy not only recovered, but entered a high growth with low inflation phase. The 2000 Stand-by Arrangement (SBA) and the 2001 three-year arrangement under the Poverty Reduction and Growth Facility (PRGF) were successfully completed without extensions.

Notwithstanding the noteworthy progress made in most areas under the last two Fund-supported programs, staff have noted that progress was slower in areas where broader institution building or cooperation from lower levels of government was needed. One of the objectives of the last two programs had been a significant expansion of the tax base to create room for achieving the twin goals of higher social spending and debt reduction, but tax collection remained disappointing. Another area that has been subjected to much criticism in the review by staff is conditionality in Pakistan's Fund-supported programs, which became increasingly extensive after 1999. Structural conditionality peaked in the 2000 SBA: the total of 56 PCs, benchmarks and prior actions in this arrangement was nearly three times the Fund-wide average of 19 conditions in GRA-supported programs.

Staff note that following the 2000 SBA, structural conditionality was reduced gradually not only because of Pakistan's improved performance, but also because of rising doubts in the Fund about the effectiveness of large policy matrices of conditions. Nevertheless, it is worth noting that, notwithstanding the overall drive in the Fund to streamline conditionality, Pakistan had remained burdened with an excessive number of structural conditions, and only in the last program year did their number approach the Fundwide average for PRGF-supported programs, but even then it was slightly higher. It is a tribute to the authorities' dedication and steadfast adherence to program implementation in 2001–04 that their program compared favorably to the average PRGF-supported programs. For example, waiver rates were comparable to, or even lower than, those in average Fund-supported programs despite the larger number of conditions attached to the program. Furthermore, not only was the frequency of waiver requests lower than the average for all programs, but most of the waivers were needed because of delays in implementation rather than an outright lack of implementation. This was particularly true for energy sector measures, which typically required more time to overcome political or technical hurdles.

In answering the question of whether structural conditionality was appropriate, staff have noted that the "conditionality in the 2000 SBA clearly did not meet the test of parsimony. In terms of numbers, structural conditions exceeded Fundwide averages by a wide margin. Moreover, conditions were not limited to just those areas that were macrorelevant and critical to the success of the program." Staff are correct in stressing that "[s]tructural conditionality focused on critical issues, but could have been more selective—individual measures subject to conditionality were often not critical." A main conclusion of the ex post assessment is that "[o]verall, it appears that Fund structural conditionality was not well-suited for areas that require longer-term institution building and the cooperation of more than just the central government." All in all, it would be fair to say that although the recent experience with Fund-supported programs has shown that judicious streamlining of conditionality provides the welcome result that 'less is more,' this valuable lesson was, unfortunately, not applied to Pakistan.

In light of staff's criticism on the conditionality attached to the programs, one comes away from reading this review with all the more admiration for the authorities for their perseverance with program implementation. The authorities and staff are rightly satisfied that all disbursements were made available upon completion of the program reviews. In fact, the authorities decided not to draw the last tranche under the PRGF arrangement or seek a successor arrangement because of the vastly improved external situation, reflecting that growth in 2004/05 was among the highest in the world, vulnerabilities had been greatly reduced, and Pakistan had successfully re-entered the international financial markets.

That said, the authorities have expressed frustration with the frequent need for waivers of structural performance criteria, even for minor deviations or brief delays. They are correct to ask the Fund to review its procedures for deciding whether a performance criterion has been met, or not. This also leads us to today's report on the noncomplying disbursements and recommendation for waiver of nonobservance of performance criterion, which is truly bewildering, and we discuss it in a separate statement. How could there be a misreporting in this case, even if one only juxtaposes the following two quotes from staff and the authorities? Staff note in the ex post assessment that "[m]easures to improve the tax system dominated conditionality in the 2000 SBA and the 2001 PRGF arrangements, reflecting the critical importance attached to increasing the revenue intake." The authorities note in their letter to the Managing Director on the purported misreporting: "…it is hard to understand why there would have been no reference to SRO 207 in the communication between the Resident Representative and Central Board of Revenue (CBR) officials, because there were several use of Fund resources missions to Pakistan in 2002, and it is routine to ask for this information in advance of the arrival of the mission."

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IMF Executive Board Concludes 2005 Article IV Consultation with Pakistan

On November 2, 2005, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV Consultations with Pakistan.[1]

Background

In 2004/05 (July/June), Pakistan's macroeconomic performance continued to be favorable, despite some inflationary and external pressures. Economic growth is estimated to have reached 8.4 percent in 2004/05, driven by manufacturing, and bumper harvests that benefited from timely rains. However, 12-month inflation reached 11 percent in April 2005, before easing to 8.4 percent in August. Strong growth, including in agriculture, combined with rising wages and employment according to some indicators, is expected to have yielded some reduction in poverty. Data from a household survey to be released later this year will provide further information in this regard.

Fiscal targets for 2004/05 were broadly met, with the overall deficit (excluding grants) at 3.3 percent of GDP. Government debt was reduced to just below 60 percent of GDP. The tax-to-GDP ratio fell because of the elimination of excises on petroleum products to offset the impact of rising international oil prices, and a number of tax relief measures in the 2004/05 budget.

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

Concerned with double digit inflation and high capacity utilization, the State Bank of Pakistan (SBP) has tightened monetary policy. Since the beginning of 2005, the SBP has raised the six-month treasury bill rate by more than 4 percentage points to 8 percent in May, but has kept it broadly unchanged since then; key interest rates remain slightly negative in real terms. Despite the tightening, reserve money growth has not slowed down because the SBP provided substantial budget financing during the year as the government's gross financing needs could not be fully met from the market at prevailing rates.

Despite higher worker's remittances, the current account moved into deficit in 2004/05. Exports, and in particular textile exports following the end of the textile quota system, have performed well in the first six months of 2005. But import grew even faster, reflecting higher oil prices and strong demand, including for machinery. Gross reserves fell somewhat in 2004/05, notwithstanding a continued increase in non-debt-creating inflows and substantial concessional financing. The real effective exchange rate has appreciated modestly over the last few months given the stable U.S. dollar–Pakistani rupee exchange rate and the substantial inflation differential.

The 2005/06 budget targets a deficit (excluding grants) of 3.8 percent of GDP. The budget shows little revenue buoyancy; again, a number of tax relief measures were introduced for exporters and the manufacturing sector. Nonetheless, even with the increase in the fiscal deficit, government debt would fall to 52 percent of GDP. The government has taken steps to offset pressures on fiscal policy from rising international oil prices and should be able to achieve the budget target. In particular, significant increase in domestic retail prices of petroleum products was implemented in September and October. Expenditures will be tightly controlled, but priority will be given to achieving the development expenditure target.

Progress has been made on the government's structural reform agenda, in particular in the area of privatization. In June 2005, the largest transaction so far in Pakistan's privatization program took place, with the sale of 26 percent, together with management control, of a large telecommunication company. The sale of several other major companies is underway. Energy sector reforms have again proven to take longer than envisaged. While the unbundling of the other large power utility is almost complete, the individual distribution companies cannot start to operate independently because regional tariffs have yet to be notified.

Cooperation with the Fund has been fruitful. In contrast to earlier experience, the 2000 Stand-by Arrangement and the 2001–04 Poverty Reduction and Growth Facility (PRGF) were in large part implemented steadfastly. Moreover, many recommendations made at the time of the 2004 Article IV consultations have been implemented. In analyzing policy implementation under the PRGF arrangement, it was noted that the correction of a tax anomaly that had not been previously discussed between the authorities and the Fund had resulted in an insignificant deviation from a structural performance criterion but without any effect on fiscal outcomes. This does not change the Fund's favorable assessment of policy implementation under the program.

Executive Board Assessment

Executive Directors expressed their sympathy and condolences for the loss of life and the large-scale destruction caused by the recent earthquake that hit the northern parts of

Pakistan. They welcomed the pledges of support that have been made by the international community to address urgent needs and assist with the reconstruction, and called for substantial additional assistance, especially grants, to help the government overcome the crisis without adversely affecting implementation of broader economic policies. In this regard, several Directors noted that they would support a request for Emergency Natural Disaster Assistance from the Fund, if the Pakistani authorities were to make such a request.

Directors commended Pakistan's impressive macroeconomic results in recent years—in particular, the acceleration of economic growth—which have laid the ground for a decline in government debt, financial market stability, and the recent re-access to international capital markets. Directors noted the significant improvement in various health and education indicators. At the same time, they observed that poverty remains widespread, and that achieving the Millennium Development Goals will be a challenge, particularly given the added need to rebuild northern Pakistan. Going forward Directors considered that the key challenge for the medium term will be to sustain the high growth rate and reduce poverty in the context of price stability. Directors therefore welcomed the Pakistani authorities' determination to maintain macrostability in the face of the earthquake. They also emphasized the importance of continued structural reforms, particularly the need to create a business climate conducive to investment.

Directors noted that, in light of the earthquake, some widening of the budget deficit in 2005/06 might be unavoidable. However, they did not expect this to alter significantly the declining trend of Pakistan's debt indicators. They cautioned, however, that the overall debt burden continues to be high and needs close monitoring, and welcomed the adoption of the Fiscal Responsibility Law that requires a further reduction of the debt burden. Directors commended the authorities for having passed on much of the increase in international oil prices to consumers to help contain fiscal pressures, and recommended a continuation of this policy.

Directors stressed that meeting the authorities' medium-term fiscal objectives will require a marked improvement in revenue performance. In this regard, they were disappointed by the lack of progress made over the last five years in raising the ratio of tax revenue to GDP. A few Directors expressed concern that the authorities have returned to the past practice of granting exemptions and zero ratings. While agreeing that improving compliance by existing taxpayers is important to increase tax collections, Directors urged the authorities to extend the tax net to the services sector and to work with provincial governments to have the agricultural sector pay its fair share of taxes.

Directors expressed concern about the increase in inflation in the last two years and the widening of the current account deficit. They cautioned that relief and reconstruction efforts could add further pressures on both prices and the balance of payments. Directors commended the State Bank of Pakistan for raising interest rates sharply in the first half of 2005, and some urged the central bank to raise interest rates further if inflationary pressures persist. Directors stressed the need to sterilize effectively central bank financing of the budget. Directors welcomed the continuing improvement in the health of the financial sector. While noting that the strong credit growth currently appears in part to be the encouraging outcome of financial liberalization, Directors cautioned that this could be a source of vulnerability in the future. They advised the State Bank of Pakistan to monitor credit development carefully. Directors generally considered that the current exchange rate regime has served Pakistan well.

Directors were impressed by the overall progress made in privatizing state-owned enterprises, and welcomed the authorities' plans for further sales. However, they expressed concern about the electricity sector's sizable drain on the budget and urged stepped-up reform in this sector. They urged the authorities to complete the new tariff framework so that the successor companies of the Water and Power Development Authority could start functioning independently. Directors were encouraged by the prospects of the Karachi Electric Supply Corporation being transferred into private hands. More generally, Directors urged the authorities to continue with structural reforms aimed at improving the business environment and governance.

Directors encouraged the authorities to further improve the quality and timeliness of data, including data on the domestic debt, in order to allow better analysis and policy formulation, and with a view to subscribing to the Special Data Dissemination Standard.

Directors welcomed the ex post assessment of the Fund's involvement in Pakistan. They noted the dramatic change in ownership of economic policies compared to much of the 1990s. While acknowledging the importance of international support, Directors emphasized that steadfast implementation of sound policies and broad-based structural reforms were mainly responsible for the economic recovery. Directors agreed that conditionality under the 2000 Stand-By Arrangement had been extensive; nevertheless, the authorities demonstrated commendable perseverance in the implementation of strong policies and established a strong track record that paved the way for the 2001 arrangement under the PRGF. Directors note that Pakistan's program performance since 2000 compared favorably to the average Fund-supported program, and even though Pakistan had a larger number of structural conditions, the waiver rates were lower than the Fund-wide average, some of which involved minor or temporary deviations from program targets.

Directors supported management's recommendation to waive the nonobservance in 2002 of the performance criterion precluding new tax exemptions, stemming from a minor sales tax adjustment that has had no revenue impact and which had not been previously discussed between the authorities and the staff. Many Directors, although not representing a majority of the vote, questioned, however, whether there had been a breach of a performance criterion, since the sales tax exemption was immaterial as it had no revenue implication, and saw no need for the Board to grant a waiver.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

Pakistan: Selected Economic Indicators, 2000/01–2004/05 1/
(In percent of GDP, unless noted otherwise)

	2000/01	2001/02	2002/03	2003/04	2004/05 Est.
Output and prices					
Real GDP growth, at factor costs (percentage change)	1.8	3.1	4.8	6.4	8.4
Consumer prices (period average, percentage change)	4.4	2.5	3.1	4.6	9.3
Consumer prices (end of period, percentage change)	2.5	3.4	1.9	8.5	8.7
Gross national savings	15.6	19.0	22.0	19.3	15.6
Gross capital formation 2/	17.2	16.8	16.9	17.3	16.8
GDP at market prices (in billions of Pakistani rupees)	4,163	4,402	4,823	5,533	6,548
Public finances					
Revenue (including grants)	14.3	16.1	17.4	14.9	14.0
Expenditure (including statistical discrepancy)	17.6	19.7	18.7	16.7	17.1
Budget balance (excluding grants)	-4.3	-5.5	-3.8	-2.3	-3.3
Budget balance (including grants)	-3.3	-3.6	-1.4	-1.8	-3.0
Primary balance (including grants)	2.3	2.0	2.9	1.8	0.2
Total government debt	88.8	80.2	74.3	67.8	61.1
Monetary sector					
Net foreign assets (end of period, change in percent of broad money)	5.1	13.4	18.9	2.1	2.2
Net domestic assets (end of period, change in percent of broad money)	3.9	2.0	-0.4	17.5	17.1
Broad money (end of period, percentage change)	9.0	15.4	18.3	19.6	19.3
Six-month treasury bill rate (period average, in percent)	10.4	8.1	4.1	1.7	4.7
External sector					
Merchandise exports	12.5	12.7	13.2	12.9	13.0
Merchandise imports	14.3	13.1	13.7	14.1	17.0
Current account excluding official transfers	-2.7	0.1	3.8	1.4	-1.6
Current account including official transfers	-1.6	2.2	5.1	2.0	-1.3
External public and publicly guaranteed debt (in percent of exports of goods and nonfactor services)	309.4	295.8	238.0	218.2	191.8
Gross reserves (in millions of U.S. dollars) 3/	1,679	4,330	10,251	10,621	9,985
In months of next year imports of goods and services	1.7	3.7	6.9	5.0	4.1
Pakistani rupees per U.S. dollar (period average)	58.3	61.3	58.4	57.5	59.3
Real effective exchange rate (annual average, percentage change)	-2.5	-1.1	-1.5	-3.4	-0.1

Sources: Pakistani authorities; and IMF staff.

1/ The fiscal year runs July 1 through June 30.
2/ Including changes in inventories.
3/ Excluding gold, foreign deposits held with the SBP, and net of outstanding short-term foreign currency swap and forward contracts.