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Pakistan: 2006 Article IV Consultation—Staff Report; 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 2006 Article IV consultation with Pakistan, the following documents have been released and are included in this package:

- the staff report for the 2006 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on September 2, 2006, 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 November 1, 2006. 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 Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its November 22, 2006 discussion of the staff report that concluded the Article IV consultation; and

- a statement by the Executive Director for Pakistan.

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

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INTERNATIONAL MONETARY FUND

PAKISTAN

Staff Report for the 2006 Article IV Consultation

Prepared by the Staff Representatives for the 2006 Consultation with Pakistan
(In consultation with other departments)

Approved by Juan Carlos Di Tata and Scott Brown

November 1, 2006

- Discussions for the 2006 Article IV consultation were held in Islamabad and Karachi during August 21–September 2. The team comprised Mr. Savastano (head), Mr. Bartsch, Ms. Hakura and Mr. Moriyama (all MCD), Mr. Cossé (PDR), and Mr. Fletcher (FAD). The mission was assisted by Mr. Lorie (Senior Resident Representative). Mr. Khan (MCD) and Mr. Zaidi (OED) participated in some of the policy discussions.

- The mission met with Prime Minister Aziz, State Bank of Pakistan (SBP) Governor Akhtar, Finance Advisor Shah, Finance Secretary General Ahsan, Finance Secretary Agha, other senior officials, and private sector representatives. A press statement was released at the conclusion of the mission (http: //www.imf.org/external/np /sec/pr/2006 /pr06191.htm).

- The last Article IV consultation was concluded on November 2, 2005. Directors' comments may be found at http://www.imf.org/ external/np/ sec/pn/2005/pn05157.htm.

- 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 regime has been classified de facto as a conventional peg since 2005. Pakistan has participated in the GDDS since 2003. At end-September 2006, total Fund credit and loans outstanding to Pakistan amounted to SDR 1,001 million (96.8 percent of quota).

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Executive Summary

Economic performance during 2005/06 was strong. Real GDP growth remained buoyant and inflation declined slightly. Domestic demand and non-oil import growth, however, remained high and the current account deficit increased to nearly 4 percent of GDP. Record-high inflows of foreign direct investment (FDI), including from privatization, and government borrowing from international markets at favorable terms more than covered the larger deficit, resulting in a balance of payments surplus of over US$1 billion.

Pakistan's main near-term challenge is to strengthen the balance of payments, in particular the external current account. Given the favorable prospects for non-debt-creating capital flows, meeting the above challenge requires placing the external current account deficit relative to GDP on a declining path, and increasing international reserves. A further tightening of monetary policy in 2006/07 that quickly aligns domestic demand growth with output growth is necessary to attain this outcome. To be effective, the monetary tightening should be supported by greater exchange rate flexibility and some fiscal restraint. The authorities are of the view, however, that the external current account deficit can be stabilized without major changes in the current stance of macroeconomic policies; they believe that the unwinding of transitory, nonrecurrent factors that influenced last year's level of imports (e.g., oil price spike, foodstuff shortages) would lead to a significant deceleration in import growth in the coming months.

Beyond 2006/07, the favorable prospects for sizable FDI flows bode well for future gains in productivity and investment, but also present challenges for macroeconomic policy. Continued reliance on FDI flows of uncertain size and timing to finance relatively large deficits in the external current account would require a high degree of flexibility in economic policymaking. An improved capacity to generate timely policy responses to shortfalls of external financing arising from negative balance of payments shocks would help safeguard macroeconomic stability during that period. Given the goal of strengthening the official international reserves position, the option of resorting to the use of international reserves to cover shortfalls of external financing should be used sparingly.

Sustaining high growth and poverty reduction through higher rates of saving and investment remains Pakistan's main medium-term challenge. Structural reforms conducive to these goals (including ongoing efforts to improve the investment climate, financial market reform, tax reform, improvements in public service delivery, and trade liberalization) should be prioritized.

I. Introduction

1. **Pakistan's economic performance since 2001/02 has been impressive**. Growth has accelerated, improvements in public spending and wide-ranging structural reforms have reduced the debt burden and increased efficiency, and pro-poor policies have helped lower poverty rates (Box 1). To maintain this momentum it is necessary to focus macroeconomic policies on containing domestic demand growth and reducing the possible associated vulnerabilities. Over the medium term, the challenge remains to deepen structural reforms in areas critical for raising saving and investment, improving external competitiveness and sustaining high output growth.

2. **The devastating earthquake of October 8, 2005 gave rise to additional demands for government spending**. The earthquake left a heavy toll in terms of human lives and physical and social infrastructure, though it had relatively minor effects on macroeconomic indicators (other than government spending) owing to weak links between the affected areas and the rest of the economy. The bulk of government spending on relief and reconstruction during 2005/06 was financed by external grants and loans, but higher-than-budgeted fiscal resources also were allocated to this end. Reconstruction-related spending is expected to decline gradually over the next four years.

3. **The political and security situation remains relatively calm**. There has been some domestic unrest, however, especially near the border with Afghanistan and in the Baluchistan province. Relations with India are progressing slowly, following the ratification of the South Asian Free Trade Area (SAFTA) in early 2006. Parliamentary and presidential elections are scheduled for October 2007.

4. **The implementation of recent Fund advice on macroeconomic policy and structural reforms has been mixed**. **During 2005/06, large negative shocks, especially the earthquake, limited the scope for fiscal maneuver, and the overheating pressures that were identified during the last Article IV consultation continued**. Declines in inflation and, especially, domestic demand growth were relatively small, the external current account deficit widened by more than envisaged in mid-2005, and the rupee appreciated in real terms. The import coverage of reserves, however, remained stable. Against this background, the 2006 Article IV discussions focused on the macroeconomic policies needed to moderate demand pressures and contain the external current account deficit, appropriate policy responses to adverse external shocks, and structural reforms to help sustain rapid growth and reduce poverty.

Box 1. Poverty in Pakistan—New Estimates

Poverty declined during the last four years. Estimates based on the recent Household Integrated Economic Survey (HIES) show that the share of Pakistan's population living below the poverty line (poverty headcount ratio) declined by over 10 percentage points from 2000/01 to 2004/05. The decline was more than twice the size of the increase recorded in this indicator during 1996/97–2000/01. Despite this impressive outturn, nearly one quarter of Pakistan's population continues to live below the poverty line. Two other key measures of poverty incidence (the poverty gap and severity of poverty) also showed improvement during the last four years. Unlike the poverty headcount ratio, however, the improvement in these indicators was not sufficiently large to bring them below their 1996/97 levels.

Pakistan: Poverty Indicators

	1996/97	2000/01	2004/05
	(In units as indicated)		
Poverty headcount ratio 1/	29.8	34.5	23.9
Poverty gap 2/	4.1	7.0	4.8
Severity of poverty 2/	1.1	2.1	1.5
Memorandum item:			
Real GDP growth 3/	4.4	3.4	6.0

Source: Pakistani authorities; and Fund staff estimates.
1/ Share of the population whose average spending falls below the poverty line.
2/ In percent. Both indicators measure the extent by which spending of poor households falls below the poverty line. The larger the value of these indicators, the larger the share of poor households that is "close" to (below) the poverty line.
3/ In percent. Average of previous four years.

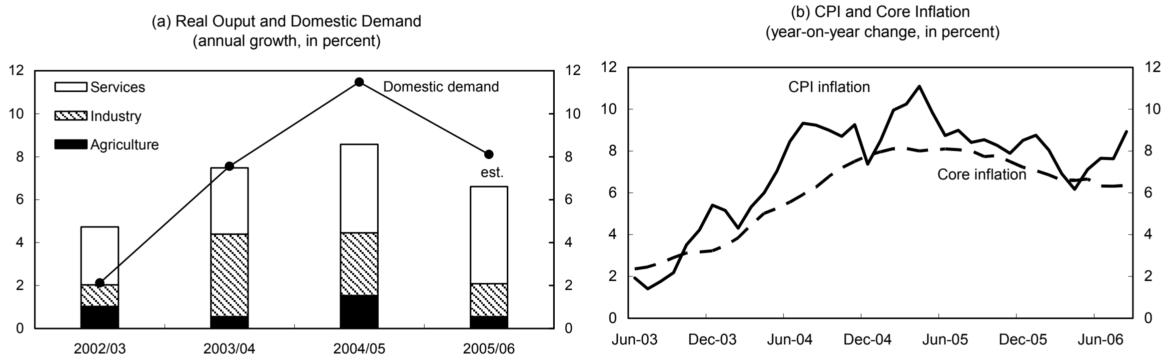
The decline in poverty coincided with a strong pick up in economic growth. This is in line with cross-country studies that find evidence of a robust inverse relationship between growth and poverty. The large decline in the poverty headcount following the pick up in growth may also be related to the high concentration of households that had fallen just below the poverty line in 2000/01.[1/]

1/ See "Poverty, Risk and Vulnerability in Pakistan," Centre for Research on Poverty Reduction and Income Distribution, Karachi: Pakistan, March 2006.

II. Recent Economic Developments

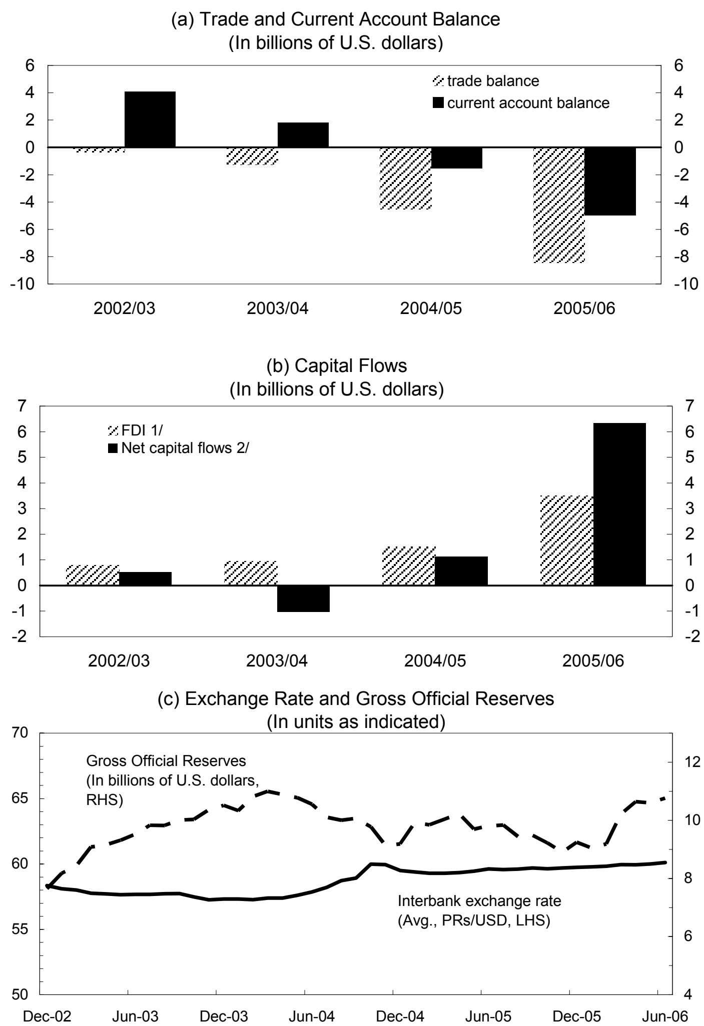
5. **Economic developments during 2005/06 were broadly favorable, but the external current account deficit widened**. Real GDP growth remained buoyant at 6.6 percent, and average inflation (12-month rate) declined from 9.3 percent to 7.9 percent. Domestic demand and import growth remained high, and the current account deficit increased to US$5 billion (3.9 percent of GDP), from US$1.5 billion (1.4 percent of GDP) a year earlier. Record-high net capital inflows (including from FDI and privatization) more than covered the larger deficit and allowed an increase of nearly US$1 billion in gross official reserves. As of end-June 2006, gross international reserves stood at US$10.8 billion (3.6 months of next year's imports of goods and services), and the interbank market exchange rate was broadly unchanged from end-June 2005.

Growth and Inflation



Sources: Pakistani authorities; and Fund staff estimates.

Balance of Payments Developments



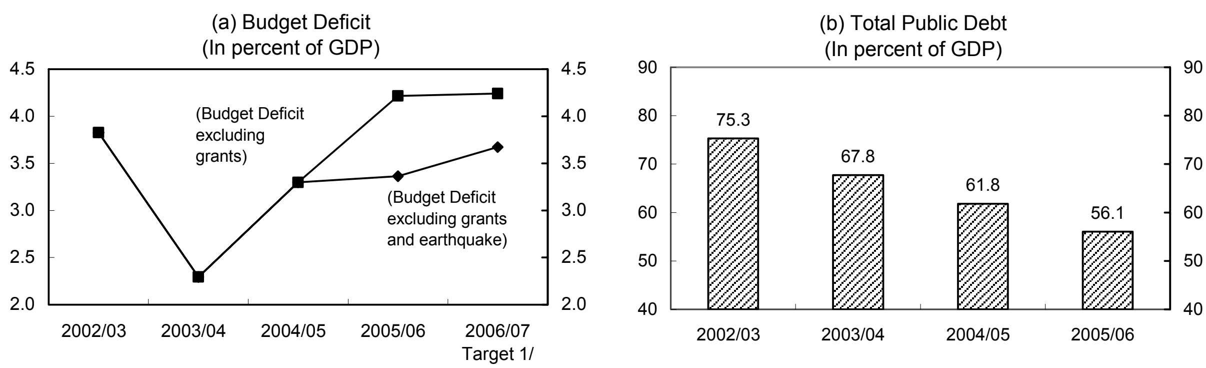
Sources: Pakistani authorities; and Fund staff estimates.

1/ Foreign direct investment; including privatization.

2/ Defined as the overall balance minus the current account balance.

6. **The fiscal deficit exceeded the original budget target for 2005/06 owing to earthquake-related spending**. Excluding the latter (0.9 percent of GDP), revenues and expenditures both rose slightly (by roughly the same amounts) compared to the outturn in 2004/05. Strong corporate profits, higher petroleum taxes, and continued improvements in tax administration more than offset lower nontax revenue. The increase in total expenditure was mainly driven by development spending. The government debt-to-GDP ratio fell to 56 percent by end-June 2006, below the 60 percent ceiling stipulated in the 2005 Fiscal Responsibility Law.[1] The budget for 2006/07, approved in early June, targets a deficit of 4.2 percent of GDP (excluding grants), unchanged from the estimated outturn for 2005/06. The underlying fiscal deficit (defined as the overall deficit excluding grants and earthquake-related spending) is budgeted to increase by about 0.3 percent of GDP.

Fiscal Balance and Public Debt



Sources: Pakistani authorities; and Fund staff estimates.
1/ Authorities' target based on the budget for 2006/07

7. **Domestic credit was, for the third year in a row, the main source of monetary expansion**. The growth of broad money and bank credit to the private sector decelerated, but private sector credit still grew at the relatively high rate of 23 percent (Box 2). Bank lending rates became increasingly positive in real terms as inflation declined, but the real return on bank deposits remained negative. SBP claims on the government increased by more than total government borrowing from banks (as commercial banks continued reducing their holdings of government paper), and was the main factor behind the 10.2 percent increase in reserve money. Interest rates on 6-month treasury bills remained stable at 8.2 percent throughout 2005/06, and the discount rate was kept at its May 2005 level (9 percent) until end-June.

[1] Among other requirements, the law stipulates that the government debt-to-GDP ratio should: (a) fall below 60 percent by 2012/13, (b) remain below 60 percent thereafter; and (c) decline by at least 2½ percentage points of GDP every year. According to the authorities, requirement (c) ceases to be binding once requirement (a) has been met. Upward revisions to the nominal GDP series made in 2006 did not have a large influence on the recorded decline in the debt-to-GDP ratio.

Box 2. Banking System Update

Pakistan's banking system continued to strengthen since the last Article IV consultation. From December 2004 to June 2006 most financial soundness indicators (FSI) improved. The rise in earning and profitability indicators was particularly noteworthy, partly reflecting the high spread between deposit and lending rates (700 basis points). Pakistan's banks maintained their ranking among the top half in a group of 44 emerging market countries in terms of indicators of capital adequacy and asset quality, but moved to near the top of the ranking in terms of profitability—from a position near the bottom in 2001.

Pakistan: Selected Financial Soundness Indicators, Banking System, 1997–2006

	1997	2002	2004	2006 1/
Capital adequacy ratio	4.5	8.8	10.5	11.9
Gross NPLs to gross loans	23.5	21.8	11.6	8.0
After tax return on average assets	-1.2	0.1	1.2	2.1
After tax return on equity	-36.2	3.2	20.3	26.5

Source: Pakistani authorities.
1/ End-December for 1997–2004; end-June for 2006.

Banking Profitability in Selected Emerging Markets 1/

	2005 Rank	2005 Value	2001 Rank	2001 Value
Colombia	1	3.0	9	1.8
Venezuela	2	2.9	2	2.8
Pakistan	**3**	**2.8**	**39**	**0.0**
Costa Rica	4	2.5	8	1.9
Panama	5	2.4	13	1.3
Mexico	5	2.4	24	0.8
Peru	7	2.3	35	0.4
Brazil	7	2.3	40	-0.1
Estonia	9	2.2	3	2.7
Latvia	10	2.1	10	1.5
Bulgaria	11	2.0	1	2.9
Hungary	11	2.0	12	1.4
Ecuador	11	2.0	45	-6.6
Romania	14	1.9	4	2.5
Argentina	14	1.9	43	-0.2
Kazakhstan	16	1.8	21	0.9
Indonesia	17	1.7	31	0.6
Dominican Rep.	18	1.6	7	2.1
Thailand	19	1.5	10	1.5
Poland	19	1.5	17	1.0
Chile	21	1.4	13	1.3
Czech Rep.	21	1.4	28	0.7
Ukraine	23	1.3	15	1.2
Malaysia	23	1.3	17	1.0
El Salvador	23	1.3	21	0.9
Korea	23	1.3	24	0.8
Croatia	23	1.3	28	0.7
Lithuania	23	1.3	40	-0.1
South Africa	29	1.1	17	1.0
Philippines	29	1.1	35	0.4
Russia	31	1.0	5	2.4
Jordan	31	1.0	28	0.7
Slovenia	31	1.0	32	0.5
Jamaica	34	0.9	5	2.4
Slovak Rep.	34	0.9	17	1.0
India	34	0.9	32	0.5
Uruguay	34	0.9	40	-0.1
Lebanon	38	0.8	32	0.5
Israel	38	0.8	37	0.2
China	38	0.8	38	0.1
Bosnia & Herzeg.	38	0.8	44	-0.6
Tunisia	42	0.6	16	1.1
Egypt	42	0.6	24	0.8
Morocco	44	0.5	21	0.9
Algeria	45	0.4	24	0.8
Average		1.5		0.9
Median		1.3		0.9

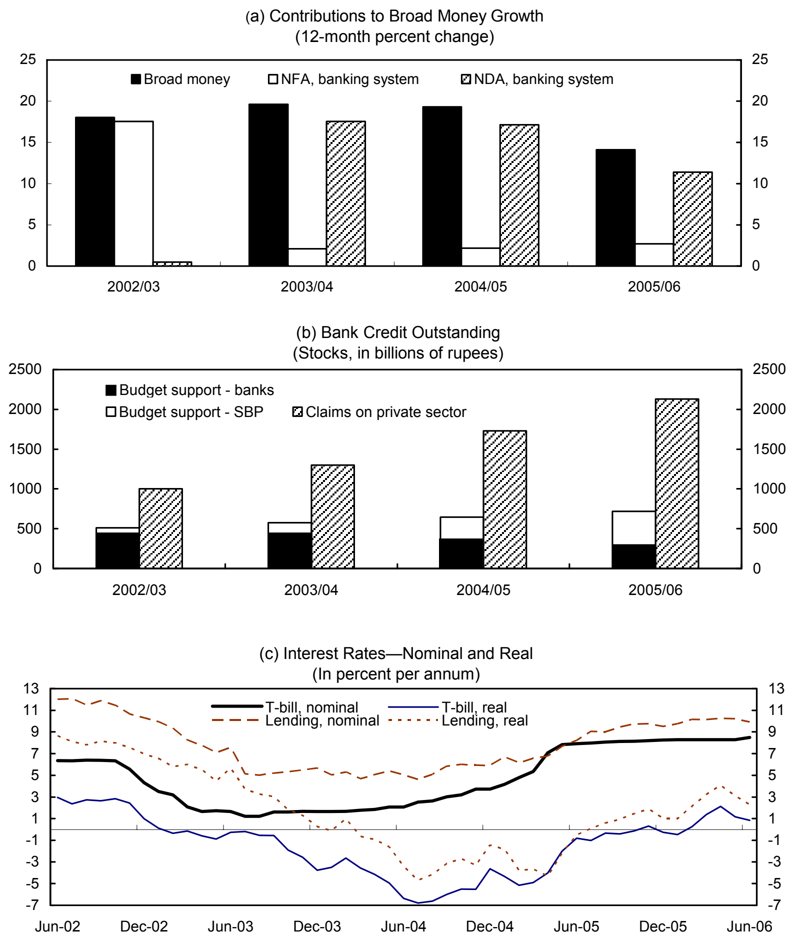
Source: Fund staff estimates.
1/ Banking profitability is defined as the percentage return on assets after tax.

Banks' FSIs have improved, though this could be partly due to continued rapid credit growth. The expansion in bank credit to the private sector slowed to 23 percent in 2005/06 (from an average of 31 percent in the previous two years) but remained on the high side. The slowdown in credit during 2005/06 was broad-based, affecting all types of borrowers—including households. The growing deposit base remained the primary source for credit expansion; banks' foreign borrowing, other than for trade credit, remained negligible.

Concentration of the banking system remains high. As of March 2006, Pakistan's five largest banks held 53 percent of the system's assets and 51 percent of its loans—somewhat less than at end-2004. Public banks still account for about 20 percent of total assets of the banking system (excluding the SBP). Mergers and acquisitions are on the rise, partly as a result of mandated increases in minimum required capital (from PRs 1.5 billion at end-2004, to PRs 3 billion at end-2006, and further to PRs 6 billion in 2009). Foreign banks' interest in Pakistani banks is also on the rise, partly in response to the government's plans to divest most of its shares in several domestic banks.

Monetary policy was tightened in July 2006; reserve requirements on bank deposits were raised for the first time since end-2000 and, two weeks later, the discount rate was increased to 9.5 percent.[2]

Money Growth and Interest Rates



Sources: Pakistani authorities; and Fund staff estimates.

8. **Foreign investors' interest in Pakistan increased significantly in 2005/06**. The sale of the Karachi Electric Supply Company (KESC) and the partial sale and transfer of management control of Pakistan Telecommunication Company Limited (PTCL) generated large foreign exchange inflows and revitalized the privatization process.[3] Foreign direct investment inflows, excluding privatization, rose by 70 percent. The successful March 2006

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[2] Cash reserve requirements on demand deposits (CRR) were raised from 5 to 7 percent, and the Statutory Liquidity Requirement on demand and time deposits (excluding CRR) was raised from 15 to 18 percent.

[3] In mid-June, the Supreme Court annulled the March 2006 sale of Pakistan Steel Mills (for US$362 million) to a group of foreign investors due to procedural irregularities.

placement of US$800 million of 10-year and 30-year government bonds at very favorable terms was also indicative of strong foreign demand for Pakistani paper.

9. **Progress on structural reforms was mixed**. Reforms to broaden the income tax base and reduce rates continued, and the legal framework for investor protection was strengthened. However, reform of the power sector has stalled, and the schedule of higher regional electricity tariffs has not yet been implemented. Progress on trade liberalization slowed.

III. Report on the Discussions

10. **Discussions on the near-term macroeconomic outlook focused on steps to strengthen the balance of payments and lower inflation, and on policy responses to possible adverse external shocks**. On structural reforms, discussions focused on key areas to sustain high growth and reduce poverty over the medium term.

A. Economic Outlook and Key Challenges

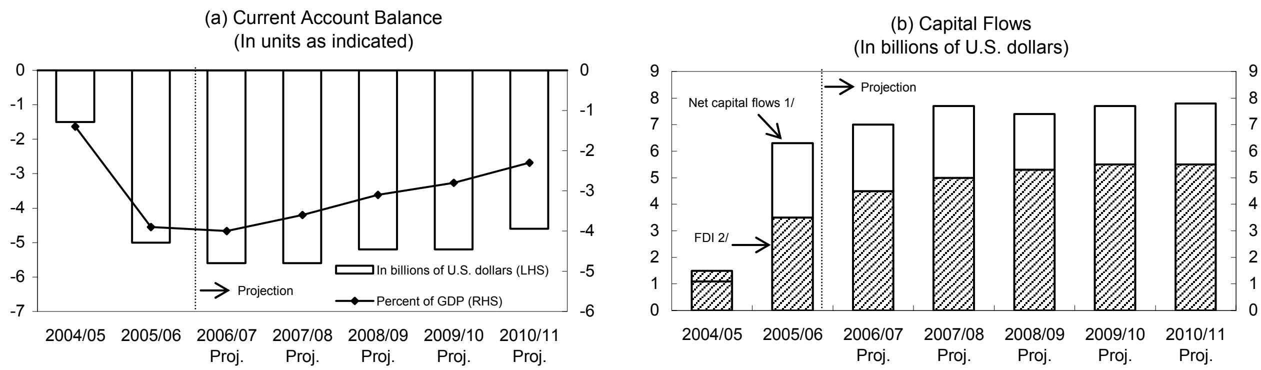
11. **The outlook for sustained growth is favorable, provided inflation falls further**. In addition, there is a need to strengthen the balance of payments to reduce external vulnerabilities by:

a. containing the external current account deficit;
b. obtaining foreign financing consistent with external debt sustainability; and
c. achieving a higher stock of international reserves.

Discussions on these issues were illustrated by quantitative scenarios. The focus was mainly on: (i) the level and trajectory of the external current account deficit; (ii) the prospects for external financing (particularly for non-debt-creating capital flows); and (iii) the role of macroeconomic policies in reducing external risks.

12. **The authorities and staff had broadly similar views on the medium-term path for the external current account deficit, the prospects for external financing, and the targets for international reserves**. The external current account deficit has reached relatively high levels—by both historical and cross-country standards—and a further widening could, at some point, compromise external sustainability. However, Pakistan's increased attractiveness to foreign investors (including from oil-exporting countries in the Gulf region) has led to a notable rise in the supply of non-debt-creating capital flows (in search of both profitable new projects and purchase of entities slated for privatization). At the same time, the country's ability to borrow from international and regional capital markets at relatively low spreads and long maturities has also improved. With this change in the supply of capital flows, external financing prospects can remain favorable for several years. During this period, Pakistan could sustain external current account deficits in the range of US$5-6 billion (consistent with a steady decline in the current account deficit-to-GDP ratio), and strengthen gradually its international reserves position (chart).

Medium-Term Balance of Payments



Source: See Table 3.

1/ Defined as the overall balance minus the current account balance. Net capital flows in 2004/05 were lower than FDI flows.

2/ Foreign direct investment, including privatization.

13. **There were, however, differences of views on the policies needed to achieve those outcomes**. **In the authorities' view, the macroeconomic policy stance envisaged for 2006/07 will keep the external current account deficit at levels broadly similar to last year's outturn, and reduce headline CPI inflation to about 6½ percent**. The current policy stance was also seen by the authorities as consistent with the government's target of real GDP growth of at least 7 percent in 2006/07. The authorities expected import growth to decelerate sharply during the year as the effects of transitory, nonrecurrent factors that pushed up imports in 2005/06 (e.g., oil price spike, unforeseen imports of sugar) unwind. They were also confident that the July 2006 tightening of monetary conditions, supported by continued exchange rate stability, would accelerate the pace of disinflation. The authorities thought that the recent tightening of monetary policy would not have adverse effects on bank lending to the private sector.[4] Moreover, they indicated that they were prepared to tighten monetary policy further if inflation continued above the government's 6½ percent target. On the fiscal side, the authorities saw some scope for overperforming on their budget deficit target for 2006/07, including by saving higher-than-projected revenue.

14. **The authorities' policy stance for 2006/07 may not suffice, however, to contain domestic demand growth and stabilize the external current account deficit**. In particular, a further tightening of monetary policy, including by allowing higher cutoff rates at treasury bill auctions (to increase commercial banks' demand for government paper and reduce SBP's direct lending to the government), would help slow the growth of private sector credit and non-oil imports, and avoid an increase in the external current account deficit-to-GDP ratio. To be effective, this tightening would have to be supported by greater exchange rate

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[4] At the time of the discussions the SBP had not finalized revising its monetary projections for 2006/07. However, staff was informed that the revised projections would include an increase in bank lending to the private sector of about 18 percent (year-on-year) during 2006/07.

flexibility and by fiscal restraint to keep the underlying budget deficit (the overall deficit excluding grants and earthquake-related expenditures) at the level of 2005/06—i.e., some 0.3 percent of GDP lower than the outcome envisaged in the budget.

15. **During the discussions, staff prepared a macroeconomic scenario encompassing monetary and fiscal tightening (Tables 2–6)**. In the staff's scenario, higher real interest rates starting in 2006/07 are assumed to rein in domestic demand growth, significantly reduce non-oil imports growth, and lower inflation to 6½ percent. Over the medium term, fiscal consolidation bringing the overall fiscal deficit (excluding grants) below 2½ percent of GDP, a stable real exchange rate, and the maintenance of real interest rates at positive levels would help keep domestic demand growth in check and narrow the aggregate saving-investment imbalance. Under these policy assumptions, output growth would remain in the 6½–7 percent range (compared to growth in the 7–8 percent range expected by the government), headline and core inflation would fall further to 5 percent, and the reserve import coverage would rise moderately. The downward trend in public debt and external debt ratios would continue, even under less favorable assumptions for growth and interest rates (Tables 7–8, Figures 1–2). By 2010/11, the external current account deficit as a share of GDP (2.3 percent) would be close to Pakistan's current account "norm" (Box 3).

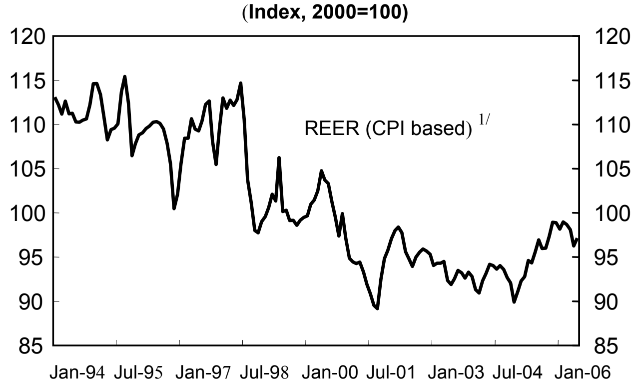
16. **The authorities were in broad agreement with the inflation and international reserves objectives contained in the staff's scenario, as well as with the balance of payments outlook, but took the view that achieving those objectives did not require major changes in the policies currently in place. They also believe that growth would be somewhat higher than assumed by staff**. The authorities anticipate that higher growth would result from rapid increases in investment as a result of the large inflows of foreign direct investment, continued support from credit policy, and higher capital expenditure—especially in infrastructure. In addition, they envisage that growth in national savings would outpace the increase in domestic investment, driven by a gradual rise of real interest rates (as a result of the lower inflation), a decline in the fiscal deficit below 3 percent of GDP over the medium term, growth-induced increases in personal disposable income, and favorable demographic trends.

17. **The authorities viewed the current level of the real exchange rate as broadly appropriate**. They indicated that the real exchange rate was significantly more depreciated than its level during the 1990s, and that export growth had not been affected by the recent, small, real appreciation. Staff noted that while domestic demand pressures, rather than losses in external competitiveness, had been a major factor behind the increase in the trade and current account deficits since 2003/04, future policies should be consistent with avoiding a steady appreciation of the real exchange rate over the medium term. The authorities recognized that a continued strengthening of the rupee would be inconsistent with the required decline in the current account deficit-to-GDP ratio.

Box 3. Pakistan's Real Exchange Rate

Pakistan: Real Effective Exchange Rate, 1994–2006

(Index, 2000=100)



Source: IMF, International Financial Statistics.

1/ Increase denotes real appreciation.

Relative to its trading partners, the (CPI-based) real value of the rupee rose by almost 10 percent from December 2004 to June 2006, a period when strong domestic demand put pressure on prices and the external current account, and the external terms-of-trade deteriorated. As of mid-2006, Pakistan's real effective exchange rate (REER) was at about the same level as in early 2002, but well below its average during the 1990s.

Estimates based on two methodologies to evaluate misalignment suggest that the rupee may be slightly overvalued as of mid-2006.[1/] Estimates from the *equilibrium real exchange rate approach* suggest that the rupee is 10 percent more appreciated than the (equilibrium) level that results from applying to Pakistani data the coefficients obtained from a cross-country panel regression of "fundamental" REER determinants. Estimates from the *external sustainability approach* also suggest the need for a real depreciation of a broadly similar magnitude in order for the current account deficit to decline to the level that stabilizes Pakistan's net foreign assets-to-GDP ratio at its 2004 level.

In contrast, estimates from a third methodology, *the macroeconomic balance approach (MBA)*, do not point to an overvaluation of the rupee. According to this methodology, the macroeconomic policies in the staff's scenario (see paragraph 15) would be consistent with a five-year ahead current account deficit-to-GDP ratio (2.3 percent) that is broadly in line with the equilibrium current account ("current account norm") implied by the medium-term levels of the "fundamentals" that determine Pakistan's saving and investment**.** If the five year-ahead current account deficit-to-GDP ratio were higher than in the projections in Table 3, however, the MBA would also find evidence of overvaluation.

1/ For details on the methodologies see "Methodology for CGER Exchange Rate Assessments" IMF Research Department, November 2006 (http://www.imf.org/external/pp/longres.aspx?id=3957).

B. Risks to the Outlook and Policy Responses

18. **The favorable outlook for capital flows and the balance of payments is subject to downside risks**. Even if the external current account-to-GDP ratio is placed on a downward trajectory, macroeconomic stability throughout the projection period will be dependent on the timely receipt of large flows of foreign direct investment (FDI). FDI flows typically consist of a few "lumpy" transactions that are subject to delays of uncertain duration, and are intrinsically difficult to predict. It is thus possible that in some periods (which may last weeks, or even months) the external financing available to Pakistan could fall short of the

amounts assumed in the scenario.[5] If policies remain unchanged, official international reserves during those periods would fall below the (rising) path shown in Tables 2–3. Shocks to the current account are also possible. Higher oil prices or lower private transfers could cause deviations from the path for the external current account deficit shown in Tables 2–3, which would also call for a policy response.[6]

19. **The authorities indicated that their response to adverse balance of payments developments would take into account the nature and severity of the shock**. They believed that temporary shocks involving external financing shortfalls could be accommodated by using international reserves or increasing foreign borrowing. In cases where the shortfalls were sizable, or more permanent, however, the authorities noted that their response would take into consideration the full range of policy instruments.

20. **Using international reserves to cover external financing shortfalls stemming from balance of payments shocks would carry some risks**. This would especially be the case for shortfalls caused by the postponement of new FDI projects (or large-scale privatizations). The time required to recover the reserves used to finance shortfalls caused by this type of shock is uncertain, and often beyond the authorities' control. Until the flows from that particular FDI transaction materialize, the balance of payments position would be weaker, and external vulnerabilities higher than in the baseline scenario. Continued reliance on this policy response may result in significantly lower levels of reserves which, if sustained for a prolonged period, could reduce Pakistan's attractiveness for foreign investors, and jeopardize external sustainability.

21. **Monetary policy should respond quickly to shortfalls of external financing**. Because foreign borrowing may not be readily available to cover all external financing shortfalls,[7] the task of preventing significant losses of international reserves following shocks to the current or financial account has to fall primarily on monetary policy. In cases where external shocks are very large, fiscal measures conducive to higher fiscal savings also should be part of the policy response. In this regard, discussions centered on the authorities' preparedness to tighten monetary policy in a timely manner in response to balance of payments shocks. To this effect, staff recommended to pay close attention to the level of

[5] Net flows of FDI (including privatization receipts) average US$5.2 billion per annum in the baseline "policy" scenario of Tables 2–6. This implies that delays in finalizing one large transaction (either a new project or a privatization) representing, for example, 20–25 percent of the inflows expected for any given year would create an ex-ante shortfall of financing, relative to the baseline projections, of over US$1 billion.

[6] Figure 2 (second row, second column) illustrates the effect of a negative shock to the non-interest current account balance on the external-debt-to-GDP ratio. In this exercise, the new foreign borrowing (which is assumed to be fully available in the same year of the shock) represents the "policy response" to the higher current account deficit.

[7] Figure 2 (second row, first column) shows the effects on the external-debt-to-GDP ratio of a shock to the level of FDI flows that is fully offset, within the same year, by additional foreign borrowing.

official reserves when formulating interest rate and exchange rate policy, and to signal to market participants tolerance for greater flexibility in the nominal exchange rate.

C. Key Structural Reforms

22. **Structural reforms will be essential for sustaining high growth and poverty reduction through higher rates of saving and investment**. Discussions focused on four areas critical to attain this goal.

23. **Deepening domestic financial markets**. Efficient financial intermediation is a key element in the strategy to maintain Pakistan on a high-growth trajectory. The authorities pointed to the ongoing modernization of the National Savings Schemes (NSS), recent initiatives to foster microfinance, and the phased reform of the system of broker-financing of stock trading ("Badla") as evidence of their continued efforts to develop domestic financial markets. Discussions centered on the need to subject the NSS to market discipline so as to integrate it more fully with local financial markets, and on the advisability of moving speedily with plans to replace Badla with the regular margin financing used in modern stock exchanges. The staff stressed that new issues of long-term government securities—e.g., Pakistani Investment Bonds (PIBs)—were essential for the development of a local bond market, and encouraged the authorities to substantially increase reliance on this means of deficit financing during 2006/07.[8] Although banking system soundness indicators have continued to improve, and recent stress tests by the SBP do not reveal vulnerabilities, the authorities agreed with staff that it was prudent to remain vigilant of banking system developments in light of the rapid credit expansion of the last three years.

24. **Increasing government revenues**. The authorities concur that raising the tax revenue-to-GDP ratio will be necessary to realize their fiscal strategy and create space for pro-poor spending. Key measures to broaden the tax base (such as expanding taxation of the agricultural and service sectors and eliminating nonstandard exemptions) could have large revenue potential, but the authorities indicated that there was not enough political support for undertaking them at present. Efforts to increase the efficiency of tax collection by streamlining of income tax rates, however, have continued. On tax administration, there has been recent progress on rolling out large- and medium-taxpayer offices, and discussions covered reform priorities going forward—including improvement of audit strategies, and advancing the functional integration of income and sales tax administration.

[8] In May 2006, the authorities raised PRs 10 billion through the placement of 10-year PIBs that carried an average yield of 9.8 percent. This was the first placement of PIBs since May 2004 and represented less than 15 percent of net domestic government borrowing in 2005/06. On September 30, the authorities re-allowed nonbank institutional investors to access the NSS. The scope for large issuances of PIBs in 2006/07 is likely to be substantially smaller as a result of this decision.

25. **Improving public service delivery**. Steps are being taken to improve the efficiency and composition of government spending and strengthen public financial management, including through technical assistance from FAD. Work conducive to the doubling of spending on education and health as a share of GDP within 10 years (as mandated by the 2005 Fiscal Responsibility Law) is underway, including through the rolling out of medium-term budget frameworks in several key ministries and the preparation of a new Poverty Reduction Strategy Paper. Discussions highlighted the importance of reallocating spending from untargeted subsidies to pro-poor and pro-growth spending in order to reduce inefficiencies and facilitate faster progress towards the attainment of the Millennium Development Goals.

26. **Trade liberalization**. Pakistan remains committed to a liberal trade regime, but the authorities indicated that progress in trade liberalization has been affected by the inconclusive Doha round. Pakistan's textile exports performed reasonably well following the January 2005 expiration of the Multi-Fiber Agreement (Box 4). The authorities noted, however, that they had since felt compelled to adopt schemes to support Pakistani exporters in order to offset the increased subsidies provided by other textile-exporting countries. They also argued that Pakistan's increased efforts to sign preferential trade agreements with several countries was part of a global trend. Staff stressed the advantages of persevering with trade liberalization despite difficulties in the global trading environment.

D. Other Issues

27. **Statistics**. Pakistan's data are broadly adequate for effective surveillance, but further improvements in the availability and timeliness of key economic statistics would help policy analysis and formulation (Appendix III). On fiscal data, the authorities plan to make interim arrangements (pending full implementation of system upgrades under a World Bank-supported project) for economic classification reporting, and to work on avoiding the recurrence of the large statistical discrepancies between above- and below-the-line fiscal outturns of the last two years. Staff encouraged the authorities to expedite the process of subscribing to the Special Data Dissemination Standard, including by compiling quarterly national accounts and wage data and appointing a national coordinator.

28. **AML/CFT framework**. Pakistan continues to strengthen its anti-money laundering/ combating the financing of terrorism (AML/CFT) framework. In July 2006, the SBP issued prudential regulations recommended by the Financial Action Task Force. In addition, a bill creating a national executive committee on AML is under parliamentary consideration.

Box 4. Textile and Clothing Exports Following the Expiration of the Multi-Fiber Agreement (MFA)

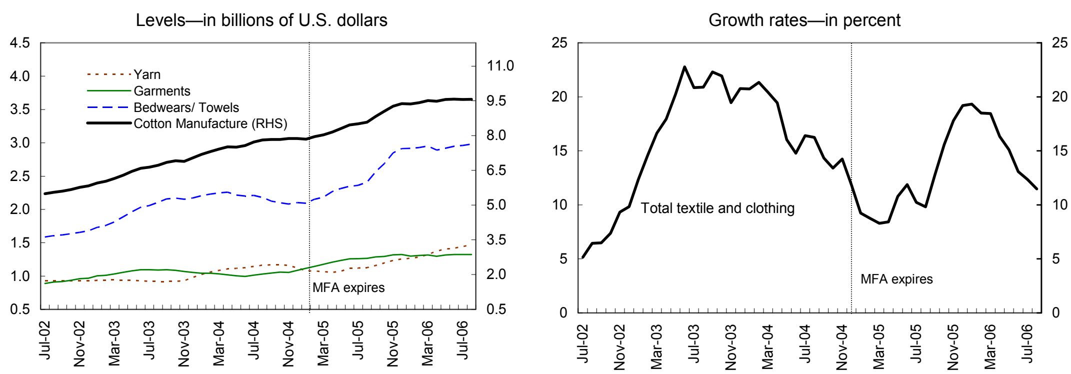
Textile and Clothing (T&C) is Pakistan's main export industry. Its share in total exports has been around 60 percent for the last 10 years, up from 50 percent in the early 1990s. Only Bangladesh and Cambodia have a larger share of T&C in total exports.

Pakistan performed relatively well in the wake of the removal (in January 2005) of the quotas restricting T&C exports to developed countries under the MFA. T&C export growth started to rise in 2002 (up to a sample-peak of 23 percent in mid-2003) reflecting both expanding production capacity and an improving trade regime. T&C export growth fell below 10 percent in the first quarter of 2005, but ratcheted up to nearly 20 percent by the end of the year.

The scope for sustained market share gains in a post-MFA environment has become more uncertain. Pakistan's T&C export base is relatively concentrated in low value-added products: yarn and bedwear/towels account for 45 percent of T&C exports, while exports of ready-made garments account for only 15 percent. Increases in input costs (i.e., minimum wages, interest rates and energy) during 2005/06 may have reduced Pakistan's T&C competitiveness. Pakistani exporters argue that their foreign competitors benefit from export subsidies and protection from similar cost increases. To allay these concerns, the government has recently granted T&C exporters a research and development subsidy of 5 percent as well as loan-refinancing schemes at below market terms.

Prospects for strong growth in Pakistan's T&C exports remain favorable if productivity gains are sustained and the value-added content of export increases. Pakistan's textile industry has up-to-date technology, and easy access to homegrown premium-quality cotton. Policies should help enhance the industry's responsiveness to market signals through improvements in the overall business climate, increases in the efficiency of the production process and enhancements in product quality. Across-the-board export subsidy schemes run counter to this objective, as they tend to delay the allocation of resources toward the most competitive sub-sectors in the T&C industry.

Pakistan: Textile and Clothing Exports
(July 2002–August 2006; 12-month rolling windows)



Sources: Pakistani authorities and Fund staff estimates.

IV. Staff Appraisal

29. **Economic performance during 2005/06 was strong**. The economy withstood well the impact of large negative shocks, including the tragic earthquake of October 2005, a large rise in international oil prices, and unfavorable weather conditions. Growth remained buoyant, inflation started to decline, and debt ratios fell further.

30. **Pakistan continued to attract large inflows of foreign investment**. The surplus in the financial account of the balance of payments in 2005/06 reached a historical peak, reflecting a marked rise in FDI flows—destined to both new projects and entities slated for privatization. Strong foreign demand for Pakistani assets (including from oil-exporting countries in the Gulf region) was also reflected in the favorable terms for new bond placements in international capital markets. Global and regional conditions, together with Pakistan's strong record on the macroeconomic and structural reform fronts in recent years, bodes well for continued sizable FDI flows.

31. **Domestic demand pressures, however, have not subsided**. The trade and current account deficits have increased, driven by rapid import growth, and the pace of disinflation remains slow. Credit growth continued at a strong pace in 2005/06, the fiscal deficit (excluding earthquake-related expenditures) increased slightly, and policy interest rates and the exchange rate remained stable. Monetary conditions were tightened somewhat in July 2006, but the authorities do not envisage that further changes in the stance of macroeconomic policies will be necessary in the remainder of 2006/07.

32. **Macroeconomic policies in 2006/07 should be more effectively geared at slowing domestic demand growth in order to contain the external current account deficit and accelerate the pace of disinflation**. A further tightening of monetary policy resulting in higher cutoff rates at treasury bill auctions and significantly lower central bank lending to the government would help reduce credit and import growth, stabilize the external current account deficit, and attain the government's 6½ percent inflation target. To be effective, the monetary tightening should be supported by greater exchange rate flexibility and fiscal restraint to keep the underlying budget deficit (the overall deficit excluding grants and earthquake-related expenditures) at the level of 2005/06.

33. **Beyond 2006/07, macroeconomic policies should ensure that the current account deficit-to-GDP ratio remains on a declining path**. Fiscal consolidation that brings the overall fiscal deficit (excluding grants) to about 2½ percent of GDP over the medium term, a tight monetary policy stance that keeps real interest rates at positive levels (and credit growth more closely aligned with nominal GDP growth), and the continuation of a policy allowing for greater exchange rate flexibility are necessary to keep domestic demand growth in check, avoid a sustained real appreciation of the currency and gradually bring the external current account deficit to a more sustainable level—in the range of 2–2½ percent of GDP.

34. **The favorable prospects for foreign direct investment bode well for future gains in productivity, but large non-debt-creating capital inflows also present challenges for macroeconomic policy**. Continued reliance on inflows of foreign direct investment of uncertain size and timing to finance large current account deficits would require a high degree of flexibility in economic policymaking. In this regard, an improved capacity to generate timely policy responses to shortfalls of external financing arising from negative balance of payments shocks would help safeguard macroeconomic stability in the years ahead. When designing those policy responses, staff recommends that priority be given to a significant strengthening of the international reserves position. The option of resorting to official international reserves to cover shortfalls of external financing carries risks, and should be used sparingly.

35. **Structural reforms conducive to sustained increases in saving and investment need to be prioritized.** Completing the reform of the regulatory and tariff framework for the power sector will improve productivity, increase public sector savings, and enhance the prospects for privatization of power companies. Creating space for increases in public investment and pro-poor spending, and for faster fiscal consolidation, requires stepped-up efforts to garner the political support required for broadening the tax base and further curtailing nonstandard exemptions. Improvements in the debt management strategy to shift the sources of fiscal deficit financing away from short-term treasury bills and NSS funds into long-term government securities (PIBs) are essential to jump-start the local bond market. Initiatives underway to modernize the NSS and reform the system of broker-financing of stock trading are welcome, but should be followed quickly with measures that enable the integration of the NSS with local financial markets and with the adoption of the regular margin financing used in modern stock exchanges. Ongoing efforts to improve the investment climate are also important for sustaining rapid growth and reducing poverty.

36. **Staff welcomes Pakistan's commitment to maintaining a liberal trade regime, and its determination to contribute to the success of the Doha round of trade talks**. To further raise the economy's outward-orientation, staff advises the authorities to resist pressures to reinstate ad-hoc tariff and nontariff measures, and to adopt special support schemes for some exports. It is also important to evaluate carefully the administrative costs and trade diversion effects of the preferential trade agreements currently under consideration.

37. **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. Staff is not proposing approval given the lack of a timetable for lifting this restriction.

38. It is proposed that the next Article IV consultation take place within the standard 12 month cycle.

Table 1. Pakistan: Selected Economic Indicators, 2001/02–2006/07 1/

(Population: 151 million (2004))
(Per capita GDP: US$724 (2005))
(Poverty rate: 23.9 percent (2004/05))

	2001/02	2002/03	2003/04	2004/05	Est. 2005/06	Proj. 2/ 2006/07
			(Annual changes; in percent)			
Output and prices						
Real GDP at factor cost	3.1	4.7	7.5	8.6	6.6	6.5
Partner country demand (WEO definition)	2.4	3.6	4.5	4.6	4.6	4.4
Consumer prices (period average)	2.5	3.1	4.6	9.3	7.9	6.5
Consumer prices (end of period)	3.4	1.9	8.5	8.7	7.6	6.2
Pakistani rupees per U.S. dollar (period average)	5.2	-4.7	-1.5	3.1	0.8	…
			(In percent of GDP)			
Saving and investment						
Gross national saving	20.7	21.9	18.4	16.7	16.1	16.5
Government	-0.8	1.3	1.1	0.5	1.1	1.6
Nongovernment (including public sector enterprises)	21.5	20.5	17.3	16.3	15.1	14.9
Gross capital formation 3/	16.8	16.9	16.6	18.1	20.0	20.5
Government	2.9	2.7	2.8	3.5	4.7	5.2
Nongovernment (including public sector enterprises)	13.9	14.2	13.7	14.7	15.3	15.3
Public finances						
Revenue (including grants)	16.1	17.4	14.6	14.0	14.5	14.6
Expenditure (including statistical discrepancy)	19.7	18.7	16.4	17.0	18.2	18.1
Budget balance (excluding grants)	-5.5	-3.8	-2.3	-3.3	-4.2	-3.9
Budget balance (including grants)	-3.6	-1.4	-1.8	-3.0	-3.6	-3.5
Primary balance (including grants)	2.0	2.9	1.7	0.2	-0.6	-0.4
Total government debt	81.4	75.3	67.8	61.8	56.1	53.0
External government debt	41.0	36.0	32.1	29.0	26.2	24.9
Domestic government debt	40.4	39.3	35.7	32.8	29.9	28.1
Implicit interest rate on government debt (in percent) 4/	6.9	5.8	5.4	5.5	5.8	6.4
	(Annual changes in percent of initial stock of broad money; unless otherwise indicated)					
Monetary sector						
Net foreign assets	13.4	17.5	2.1	2.2	1.7	3.9
Net domestic assets	2.0	0.5	17.5	17.1	13.4	8.6
Broad money	15.4	18.0	19.6	19.3	15.2	12.5
Private credit (annual change; in percent)	4.8	18.9	29.8	33.2	23.2	10.4
Six-month treasury bill rate (period average; in percent)	8.2	4.1	1.7	4.7	8.2	…
External sector						
Merchandise exports, U.S. dollars (growth rate; in percent)	2.3	20.1	13.5	16.2	14.0	13.0
Merchandise imports, U.S. dollars (growth rate; in percent)	-7.5	20.1	21.2	38.3	31.3	10.1
Current account including official current transfers (in percent of GDP)	3.9	4.9	1.8	-1.4	-3.9	-4.0
	(In percent of exports of goods and nonfactor services; unless otherwise indicated)					
External public and publicly guaranteed debt	282.0	229.0	209.5	183.7	168.3	156.9
Debt service	35.8	26.6	17.3	16.1	14.1	12.8
Implicit interest rate (in percent) 4/	4.3	3.4	2.8	2.5	2.4	2.6
Gross reserves (in millions of U.S. dollars) 5/	4,337	9,529	10,564	9,805	10,760	12,060
In months of next year's imports of goods and services	3.7	6.5	5.0	3.6	3.6	3.6
Memorandum items:						
Real effective exchange rate (annual average; percentage change) 6/	-2.6	-0.1	-1.8	0.3	5.3	…
Terms of trade (percentage change)	-0.5	-0.9	1.8	-8.3	-4.4	0.5
Real per-capita GDP (percentage change)	1.1	2.2	5.4	6.5	4.6	4.6
GDP at market prices (in billions of Pakistani rupees)	4,402	4,823	5,641	6,581	7,713	8,748
GDP at market prices (in billions of U.S. dollars)	71.9	82.6	98.1	111.0	129.0	141.4

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

1/ Fiscal year ends June 30.
2/ Staff projections; assume monetary and fiscal tightening during 2006/07.
3/ Including changes in inventories. Investment data recorded by the Federal Bureau of Statistics are said to underreport true activity.
4/ Calculated as interest payments in percent of the end-of-period debt stock of the previous year.
5/ Excluding gold, foreign deposits held with the State Bank of Pakistan, and net of outstanding short-term foreign currency swap and forward contracts.
6/ An increase is a real appreciation.

Table 2. Pakistan: Medium-Term Macroeconomic Framework, 2003/04–2010/11

	2003/04	2004/05	Est. 2005/06	Proj. 2006/07	Proj. 2007/08	Proj. 2008/09	Proj. 2009/10	Proj. 2010/11
				(in percent of GDP)				
Saving and investment								
Current account balance	1.8	-1.4	-3.9	-4.0	-3.6	-3.1	-2.8	-2.3
Gross national saving	18.4	16.7	16.1	16.5	17.4	18.4	19.1	20.2
Gross capital formation	16.6	18.1	20.0	20.5	21.0	21.5	22.0	22.5
				(In billions of U.S. dollars, unless otherwise indicated)				
Balance of Payments								
Current account balance	1.8	-1.5	-5.0	-5.6	-5.6	-5.2	-5.2	-4.6
Net capital flows 1/	-1.0	1.1	6.3	7.0	7.7	7.4	7.7	7.8
of which : Foreign direct investment 2/	1.0	1.5	3.5	4.5	5.0	5.3	5.5	5.5
Gross official reserves	10.6	9.8	10.8	12.1	14.0	15.9	18.1	21.0
In months of imports 3/	5.0	3.6	3.6	3.6	3.8	3.9	3.9	4.1
External debt (in percent of GDP)	34.0	30.7	27.7	26.0	24.8	23.4	22.0	20.7
				(In percent of GDP)				
Public Finances								
Primary balance 4/	1.7	0.2	-0.6	-0.4	0.2	0.4	0.4	0.5
Overall fiscal balance 4/	-1.8	-3.0	-3.6	-3.5	-3.1	-2.7	-2.5	-2.2
Underlying fiscal balance 5/	-2.3	-3.3	-3.4	-3.4	-3.2	-2.9	-2.6	-2.4
Total government debt	67.8	61.8	56.1	53.0	50.4	47.9	45.4	43.1
				(Annual changes in percent)				
Output and prices								
Real GDP at factor cost	7.5	8.6	6.6	6.5	6.5	6.5	7.0	7.0
Consumer prices (period average)	4.6	9.3	7.9	6.5	6.0	5.5	5.0	5.0

Sources: Pakistani authorities and IMF staff estimates for historical data. Projections based on a staff scenario of monetary and fiscal tightening.

1/ Difference between the overall balance and the current account balance.

2/ Including privatization.

3/ Ratio of gross official reserves to next year's imports of goods and services (divided by twelve).

4/ Including grants and earthquake-related expenditures.

5/ Excluding grants and earthquake-related expenditures.

Table 3. Pakistan: Balance of Payments, 2001/02–2010/11

					Est.	Projections 1/				
	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11
	(In millions of U.S. dollars; unless otherwise indicated)									
Current account	2,833	4,061	1,811	-1,534	-4,996	-5,617	-5,608	-5,195	-5,225	-4,602
Balance on goods	-294	-359	-1,279	-4,514	-8,442	-8,819	-8,713	-8,599	-8,220	-7,460
Exports, f.o.b.	9,140	10,974	12,459	14,482	16,506	18,648	21,445	24,876	29,105	34,344
Imports, f.o.b.	-9,434	-11,333	-13,738	-18,996	-24,948	-27,467	-30,158	-33,476	-37,326	-41,805
Services (net)	-298	-11	-1,316	-3,293	-4,402	-4,990	-5,577	-5,637	-6,135	-6,549
Services: credit	1,916	2,703	2,644	3,319	3,748	3,724	4,395	5,239	5,969	7,105
Services: debit	-2,214	-2,714	-3,960	-6,612	-8,150	-8,715	-9,973	-10,876	-12,104	-13,654
Income (net)	-2,319	-2,211	-2,207	-2,386	-2,676	-2,804	-3,144	-3,409	-3,684	-3,903
Income: credit	111	170	187	437	761	825	841	894	928	974
Income: debit, *of which:*	-2,430	-2,381	-2,394	-2,823	-3,437	-3,628	-3,985	-4,303	-4,612	-4,877
interest payments	-1,584	-1,277	-1,056	-1,036	-1,232	-1,355	-1,485	-1,553	-1,598	-1,588
income on direct investment	-851	-990	-1,228	-1,640	-2,115	-2,273	-2,499	-2,749	-3,014	-3,289
Current transfers (net)	5,744	6,642	6,613	8,659	10,524	10,995	11,826	12,450	12,814	13,309
Current transfers: credit, *of which:*	5,789	6,714	6,713	8,768	10,632	11,075	11,930	12,555	12,920	13,417
official	1,500	918	549	266	714	447	464	390	292	295
workers' remittances	2,390	4,237	3,871	4,168	4,600	5,000	5,500	5,900	5,925	5,950
other private transfers	1,899	1,559	2,293	4,334	5,310	5,629	5,966	6,265	6,703	7,172
Current transfers: debit	-45	-72	-100	-109	-108	-80	-104	-105	-106	-108
Capital account	0	1,133	82	685	183	158	422	261	366	273
Capital transfers: credit	0	1,133	85	693	192	169	434	275	381	288
Of which: official capital grants 2/	0	1,133	70	657	144	118	384	225	202	179
Capital transfers: debit	0	0	-3	-8	-9	-11	-12	-14	-15	-15
Financial account	-1,107	-1,137	-1,334	446	5,897	6,887	7,251	7,130	7,381	7,577
Direct investment abroad	-2	-27	-45	-66	-70	-90	-99	-109	-120	-132
Direct investment in Pakistan	485	798	951	1,525	3,521	4,517	5,000	5,300	5,500	5,500
Of which: privatization receipts	117	186	199	363	1,540	1,517	1,500	1,500	1,500	1,500
Portfolio investment (net), *of which:*	-491	-239	314	620	985	1,765	1,405	912	818	1,423
Eurobond/GDR	0	0	500	600	800	1,500	1,000	1,000	1,000	1,000
amortization	-483	-261	-163	-142	-187	-165	-25	-523	-622	-22
Other investment assets	236	-216	-669	-1,352	196	-445	-115	-110	-215	-140
General government	127	-18	3	-2	3	0	0	0	0	0
Banks	-53	-25	-220	-986	380	-195	100	100	100	100
Other sectors	162	-173	-452	-364	-187	-250	-215	-210	-315	-240
Other investment liabilities	-1,335	-1,453	-1,885	-281	1,265	1,140	1,060	1,138	1,397	926
Monetary authorities	-155	-51	2	-5	-1	0	0	0	0	0
General government, *of which:*	-452	-1,419	-1,792	574	761	808	794	768	1,033	590
disbursements (medium and long term)	1,416	1,202	970	1,892	2,036	1,888	1,853	1,855	2,101	1,993
amortization (medium and long term) 3/	-1,513	-2,421	-2,419	-1,434	-1,059	-1,044	-1,109	-1,137	-1,118	-1,093
Banks	-90	36	75	-55	15	87	87	87	87	87
Other sectors	-638	-19	-170	-795	490	244	180	282	278	248
Net errors and omissions	927	534	221	-7	244	0	0	0	0	0
Reserves and related items	-2,653	-4,591	-781	410	-1,328	-1,427	-2,066	-2,197	-2,522	-3,247
Reserve assets, *of which:*	-3,081	-5,261	-299	610	-1,130	-1,400	-2,000	-2,000	-2,300	-3,000
foreign exchange (State Bank of Pakistan)	-2,713	-5,678	-442	493	-774	-1,300	-1,900	-1,900	-2,200	-2,900
foreign exchange (deposit money banks)	-365	650	123	117	-356	-100	-100	-100	-100	-100
Use of Fund credit and loans	290	50	-427	-145	-143	-127	-166	-197	-222	-247
Exceptional financing	138	620	-55	-55	-55	100	100	0	0	0
Memorandum items:										
Current account (in percent of GDP; including official transfers)	3.9	4.9	1.8	-1.4	-3.9	-4.0	-3.6	-3.1	-2.8	-2.3
Exports f.o.b. (growth rate; in percent)	2.3	20.1	13.5	16.2	14.0	13.0	15.0	16.0	17.0	18.0
Imports f.o.b. (growth rate; in percent)	-7.5	20.1	21.2	38.3	31.3	10.1	9.8	11.0	11.5	12.0
Terms of trade (growth rate; in percent)	-0.5	-0.9	1.8	-8.3	-4.4	0.5	0.3	0.5	0.5	0.4
Workers' remittances and other private transfers (growth rate; in percent)	38.6	35.1	6.3	37.9	16.6	7.3	7.9	6.1	3.8	3.9
External debt (in millions of U.S. dollars) 4/	33,400	33,352	33,307	34,037	35,679	36,784	38,405	39,299	40,381	41,616
Gross financing needs (in millions of U.S. dollars) 5/	-837	-1,379	771	3,110	6,242	6,825	6,742	6,855	6,965	5,717
End-period gross official reserves (millions of U.S. dollars) 6/	4,337	9,529	10,564	9,805	10,760	12,060	13,960	15,860	18,060	20,960
(In months of next year's imports of goods and services)	3.7	6.5	5.0	3.6	3.6	3.6	3.8	3.9	3.9	4.1

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

1/ Projections are based on a staff scenario of monetary and fiscal tightening.
2/ Includes U.S. capital grants to finance accelerated repayment of U.S. debt in 2002/03 ($1 billion) and in 2004/05 ($495 million).
3/ Includes accelerated repayments to the U.S. ($1 billion in 2002/03 and $495 million in 2004/05) and to the AsDB ($1.1 billion in 2003/04).
4/ Including IMF, military debt, commercial loans, and short-term debt.
5/ Defined as current account balance plus amortization of medium- and long-term debt.
6/ Excluding foreign currency deposits held with the State Bank of Pakistan (cash reserve requirements), gold, and net of outstanding short-term swap and forward contracts.

Table 4. Pakistan: Monetary Survey and Analytical Balance Sheet of the State Bank of Pakistan, 2001/02–2006/07

	2001/02	2002/03	2003/04	2004/05	Est. 2005/06	Proj. 2006/07 1/
	(In billions of Pakistani rupees)					
Monetary survey						
Net foreign assets (NFA)	230.8	539.6	583.2	636.9	688.4	822.5
Net domestic assets (NDA)	1,530.5	1,539.1	1,903.4	2,329.4	2,728.1	3,021.0
Net claims on government, *of which:*	639.4	561.0	619.1	714.9	805.6	873.7
budget support	567.2	511.2	574.9	646.7	717.6	779.1
commodity operations	100.6	74.0	65.9	87.8	107.8	119.8
Credit to nongovernment	921.6	1,069.0	1,364.2	1,782.4	2,190.8	2,415.7
Private sector	840.9	999.9	1,298.0	1,728.9	2,129.6	2,351.5
Public sector enterprises	80.7	69.1	66.2	53.5	61.2	64.2
Privatization account	-2.9	-2.9	-2.9	-2.9	-2.9	-2.9
Other items, net	-27.5	-88.0	-77.0	-164.9	-265.4	-265.4
Broad money	1,761.4	2,078.7	2,486.6	2,966.4	3,416.5	3,843.6
Currency	433.8	494.6	578.1	665.9	740.4	814.1
Rupee deposits	1,170.1	1,458.0	1,762.7	2,120.2	2,480.6	2,818.7
Foreign currency deposits	157.5	126.1	145.7	180.3	195.5	210.7
State Bank of Pakistan (SBP)						
Net foreign assets (NFA)	133.5	461.6	512.2	503.7	565.4	680.9
Net domestic assets (NDA)	451.1	207.9	260.7	405.4	435.9	420.9
Net claims on government	273.7	28.7	91.2	248.8	383.8	358.8
Of which: budget support	302.6	52.9	112.9	268.5	403.6	378.6
Claims on nongovernment	22.7	11.5	1.3	-6.8	-7.3	-7.3
Claims on scheduled banks	195.8	180.6	196.0	210.4	218.4	228.4
Privatization account	-2.9	-2.9	-2.9	-2.9	-2.9	-2.9
Other items, net	-38.2	-9.9	-24.9	-44.1	-156.0	-156.0
Reserve money, *of which*:	584.6	669.5	772.9	909.0	1,001.3	1,101.8
banks' reserves	110.5	141.0	156.2	196.3	207.6	228.9
currency	460.2	525.0	614.5	709.4	788.8	868.0
	(12-month changes; in percent)					
Broad money	15.4	18.0	19.6	19.3	15.2	12.5
NFA, banking system (in percent of broad money) 2/	13.4	17.5	2.1	2.2	1.7	3.9
NDA, banking system (in percent of broad money) 2/	2.0	0.5	17.5	17.1	13.4	8.6
Budgetary support (in percent of broad money) 2/	4.4	-3.2	3.1	2.9	2.4	1.8
NDA, banking system	2.1	0.6	23.7	22.4	17.1	10.7
Budgetary support	13.5	-9.9	12.5	12.5	11.0	8.6
Private credit	4.8	18.9	29.8	33.2	23.2	10.4
Currency	15.5	14.0	16.9	15.2	11.2	10.0
Reserve money	9.6	14.5	15.4	17.6	10.2	10.0
NFA, SBP (in percent of reserve money) 2/	28.6	56.1	7.6	-1.1	6.8	11.5
NDA, SBP (in percent of reserve money) 2/	-19.0	-41.6	7.9	18.7	3.4	-1.5
Net claims on government (in percent of reserve money) 2/	-10.6	-41.9	9.3	20.4	14.8	-2.5
	(In units as indicated)					
Memorandum items:						
Velocity	2.5	2.3	2.2	2.2	2.3	2.3
Money multiplier	3.0	3.1	3.2	3.3	3.4	3.5
Reserves to deposit ratio (percent)	8.3	8.9	8.2	8.5	7.8	7.6
Budget bank financing (billions of Pakistani rupees), *of which:*	67.3	-56.0	63.7	71.8	71.0	61.5
by commercial banks	125.9	193.6	3.7	-83.8	-64.1	86.5
by SBP	-58.5	-249.6	60.0	155.6	135.1	-25.0
NFA of commercial banks (billions of Pakistani rupees)	97.3	78.0	71.0	133.3	123.0	141.7
NDA of commercial banks (billions of Pakistani rupees)	1,079.5	1,331.3	1,642.7	1,924.1	2,292.2	2,600.1
Excess reserves in percent of broad money	0.6	0.9	0.8	1.1	0.3	...

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

1/ Staff projections; assume monetary and fiscal tightening during 2006/07.
2/ Denominator is the stock of broad (reserve) money at the end of the previous year.

Table 5a. Pakistan: Consolidated Government Budget, 2001/02–2006/07

(In billions of Pakistani rupees)

	2001/02	2002/03	2003/04	2004/05	Est. 2005/06	Proj. 1/ 2006/07
Revenue and grants	707	838	825	919	1,121	1,274
Revenue	624	719	794	900	1,077	1,239
Tax revenue	478	554	611	659	804	938
Federal	459	532	583	624	767	896
CBR revenue	404	460	522	595	713	837
Direct taxes	143	152	164	184	225	269
Federal excise duty	47	44	46	59	55	66
Sales tax	166	195	221	236	295	345
Customs duties	48	69	91	117	138	158
Oil and gas surcharges and other	55	72	62	29	54	59
Provincial	19	22	28	35	37	42
Nontax revenue	146	165	183	241	273	302
Grants	83	119	31	19	44	35
Expenditure 2/	826	891	956	1,196	1,422	1,631
Current expenditure 2/	700	802	775	943	1,093	1,233
Federal 2/	525	608	557	689	760	854
Interest	245	207	196	210	237	278
Other 2/	279	401	360	478	523	576
Provincial	176	194	218	254	333	379
Development expenditure and net lending 2/	126	88	181	252	329	398
Public Sector Development Program 2/	126	130	161	228	327	403
Federal 2/	98	91	102	135	186	238
Provincial	28	39	58	92	141	165
Net lending	0	-42	20	25	2	-5
Statistical discrepancy (“+” = additional expenditure) 3/	-12	13	-32	-79	-86	-98
Underlying budget balance (excluding grants and earthquake)	-190	-185	-129	-217	-259	-294
One-off expenditure (earthquake-related spending in 2005–07)	52	...	...	...	66	50
Budget balance (excluding grants)	-242	-185	-129	-217	-325	-344
Budget balance (including grants)	-159	-66	-99	-198	-281	-309
Financing	159	66	99	198	281	309
External	52	-24	-37	113	202	219
Of which: privatization receipts	...	8	0	12	97	156
Domestic	108	89	136	85	79	91
Bank	67	-56	64	72	71	62
Nonbank	32	142	61	-4	8	29
Privatization receipts	8	4	11	16	0	0
Memorandum items:						
Expenditure 4/	867	904	924	1,117	1,402	1,584
Primary balance (excluding grants)	3	23	67	-7	-88	-66
Primary balance (including grants)	86	142	97	13	-44	-31
Social and poverty-related expenditure 5/	167	209	254	300	372	440
Defense spending	149	160	180	212	242	...
Total government debt 6/	3,581	3,633	3,822	4,069	4,325	4,634
Domestic debt	1,777	1,896	2,012	2,159	2,308	2,455
External debt 6/	1,804	1,737	1,810	1,910	2,017	2,179
Nominal GDP (market prices)	4,402	4,823	5,641	6,581	7,713	8,748

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

1/ Staff projections based on the budget for 2006/07 plus additional monetary and fiscal tightening.
2/ Excludes spending related to the 2005 earthquake.
3/ The statistical discrepancy is believed to arise mainly from double-counting of spending at the provincial level.
4/ Includes statistical discrepancy and spending related to the 2005 earthquake.
5/ Social- and poverty-related expenditure as defined in the government's Poverty Reduction Strategy Paper (2003).
6/ Excludes military debt, commercial loans, and short-term debt.

Table 5b. Pakistan: Consolidated Government Budget, 2001/02–2006/07
(In percent of GDP; unless otherwise indicated)

	2001/02	2002/03	2003/04	2004/05	Est. 2005/06	Proj. 1/ 2006/07
Revenue and grants	16.1	17.4	14.6	14.0	14.5	14.6
Revenue	14.2	14.9	14.1	13.7	14.0	14.2
Tax revenue	10.9	11.5	10.8	10.0	10.4	10.7
Federal	10.4	11.0	10.3	9.5	9.9	10.2
CBR revenue	9.2	9.5	9.3	9.0	9.2	9.6
Direct taxes	3.2	3.2	2.9	2.8	2.9	3.1
Federal excise duty	1.1	0.9	0.8	0.9	0.7	0.8
Sales tax	3.8	4.0	3.9	3.6	3.8	3.9
Customs duties	1.1	1.4	1.6	1.8	1.8	1.8
Oil and gas surcharges and other	1.3	1.5	1.1	0.4	0.7	0.7
Provincial	0.4	0.5	0.5	0.5	0.5	0.5
Nontax revenue	3.3	3.4	3.2	3.7	3.5	3.4
Grants	1.9	2.5	0.5	0.3	0.6	0.4
Expenditure 2/	18.8	18.5	16.9	18.2	18.4	18.6
Current expenditure 2/	15.9	16.6	13.7	14.3	14.2	14.1
Federal 2/	11.9	12.6	9.9	10.5	9.9	9.8
Interest	5.6	4.3	3.5	3.2	3.1	3.2
Other 2/	6.3	8.3	6.4	7.3	6.8	6.6
Provincial	4.0	4.0	3.9	3.9	4.3	4.3
Development expenditure and net lending 2/	2.9	1.8	3.2	3.8	4.3	4.6
Public Sector Development Program 2/	2.9	2.7	2.8	3.5	4.2	4.6
Federal 2/	2.2	1.9	1.8	2.1	2.4	2.7
Provincial	0.6	0.8	1.0	1.4	1.8	1.9
Net lending	0.0	-0.9	0.4	0.4	0.0	-0.1
Statistical discrepancy (“+” = additional expenditure) 3/	-0.3	0.3	-0.6	-1.2	-1.1	-1.1
Underlying budget balance (excluding grants and earthquake)	-4.3	-3.8	-2.3	-3.3	-3.4	-3.4
One-off expenditure (earthquake-related spending in 2005–07)	1.2	...	...	...	0.9	0.6
Budget balance (excluding grants)	-5.5	-3.8	-2.3	-3.3	-4.2	-3.9
Budget balance (including grants)	-3.6	-1.4	-1.8	-3.0	-3.6	-3.5
Financing	3.6	1.4	1.8	3.0	3.6	3.5
External	1.2	-0.5	-0.7	1.7	2.6	2.5
Of which: privatization receipts	...	0.2	0.0	0.2	1.3	1.8
Domestic	2.4	1.9	2.4	1.3	1.0	1.0
Bank	1.5	-1.2	1.1	1.1	0.9	0.7
Nonbank	0.7	2.9	1.1	-0.1	0.1	0.3
Privatization receipts	0.2	0.1	0.2	0.2	0.0	0.0
Memorandum items:						
Expenditure 4/	19.7	18.7	16.4	17.0	18.2	18.1
Primary balance (excluding grants)	0.1	0.5	1.2	-0.1	-1.1	-0.8
Primary balance (including grants)	2.0	2.9	1.7	0.2	-0.6	-0.4
Social and poverty-related expenditure 5/	3.8	4.3	4.5	4.6	4.8	5.0
Defense spending	3.4	3.3	3.2	3.2	3.1	...
Total government debt 6/	81.4	75.3	67.8	61.8	56.1	53.0
Domestic debt	40.4	39.3	35.7	32.8	29.9	28.1
External debt 6/	41.0	36.0	32.1	29.0	26.2	24.9
Nominal GDP (market prices; in billions of Pakistani rupees)	4,402	4,823	5,641	6,581	7,713	8,748

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

1/ Staff projections based on the budget for 2006/07 plus additional monetary and fiscal tightening.
2/ Excludes spending related to the 2005 earthquake.
3/ The statistical discrepancy is believed to arise mainly from double-counting of spending at the provincial level.
4/ Includes statistical discrepancy and spending related to the 2005 earthquake.
5/ Social- and poverty-related expenditure as defined in the government's Poverty Reduction Strategy Paper (2003).
6/ Excludes military debt, commercial loans, and short-term debt.

Table 6. Pakistan: Medium-Term Fiscal Framework, 2001/02–2010/11 1/

(In percent of GDP; unless otherwise indicated)

					Est.	Proj.	Proj.	Proj.	Proj.	Proj.
	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11
Revenue and grants	16.1	17.4	14.6	14.0	14.5	14.6	15.1	15.1	15.2	15.3
Tax revenue	10.9	11.5	10.8	10.0	10.4	10.7	11.1	11.5	11.9	12.2
Of which: Central Board of Revenue	9.2	9.5	9.3	9.0	9.2	9.6	9.9	10.2	10.5	10.9
Nontax revenue	3.3	3.4	3.2	3.7	3.5	3.4	3.4	3.2	3.0	2.9
Grants	1.9	2.5	0.5	0.3	0.6	0.4	0.5	0.4	0.3	0.2
Expenditure 2/	20.0	18.5	16.9	18.2	18.4	18.6	18.8	18.7	18.6	18.6
Current expenditure 2/	15.9	16.6	13.7	14.3	14.2	14.1	14.0	13.7	13.3	13.0
Interest	5.6	4.3	3.5	3.2	3.1	3.2	3.3	3.1	2.9	2.7
Other federal 2/	6.3	8.3	6.4	7.3	6.8	6.6	6.4	6.2	6.0	5.9
Provincial	4.0	4.0	3.9	3.9	4.3	4.3	4.4	4.4	4.4	4.4
Development expenditure 2/	2.9	2.7	2.8	3.5	4.2	4.6	4.8	5.0	5.3	5.6
Net lending	0.0	-0.9	0.4	0.4	0.0	-0.1	0.0	0.0	0.0	0.0
Statistical discrepancy	-0.3	0.3	-0.6	-1.2	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1
Overall balance										
Underlying (excluding grants and earthquake)	-4.3	-3.8	-2.3	-3.3	-3.4	-3.4	-3.2	-2.9	-2.6	-2.4
One-off expenditure 3/	1.2	...	...	...	0.9	0.6	0.5	0.2	0.1	0.0
Excluding grants	-5.5	-3.8	-2.3	-3.3	-4.2	-3.9	-3.7	-3.1	-2.7	-2.4
Including grants	-3.6	-1.4	-1.8	-3.0	-3.6	-3.5	-3.1	-2.7	-2.5	-2.2
Financing	3.6	1.4	1.8	3.0	3.6	3.5	3.1	2.7	2.5	2.2
External	1.2	-0.5	-0.7	1.7	2.6	2.5	2.0	1.5	1.5	1.4
Of which : privatization receipts	0.0	0.2	0.0	0.2	1.3	1.8	1.0	0.9	0.8	0.7
Domestic	2.4	1.9	2.4	1.3	1.0	1.0	1.1	1.2	1.0	0.8
Bank	1.5	-1.2	1.1	1.1	0.9	0.7	0.7	0.7	0.5	0.4
Nonbank	0.7	2.9	1.1	-0.1	0.1	0.3	0.4	0.5	0.5	0.4
Privatization	0.2	0.1	0.2	0.2	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:										
Primary balance										
Excluding grants	0.1	0.5	1.2	-0.1	-1.1	-0.8	-0.4	0.0	0.2	0.3
Including grants	2.0	2.9	1.7	0.2	-0.6	-0.4	0.2	0.4	0.4	0.5
Interest payments/revenue (ratio)	39.3	28.8	24.7	23.4	22.0	22.4	22.6	21.2	19.3	17.6
PRSP expenditure 4/	3.8	4.3	4.5	4.6	4.8	5.0	5.2	5.3	5.4	5.4
Total government debt 5/	81.4	75.3	67.8	61.8	56.1	53.0	50.4	47.9	45.4	43.1
Domestic	40.4	39.3	35.7	32.8	29.9	28.1	26.6	25.4	24.2	22.9
External 5/	41.0	36.0	32.1	29.0	26.2	24.9	23.8	22.5	21.2	20.2
Implicit interest rate (in percent) 6/	6.9	5.8	5.4	5.5	5.8	6.4	7.0	6.9	6.7	6.6
External	3.4	2.3	2.4	2.2	2.2	2.4	2.7	2.7	2.7	2.7
Domestic	10.3	9.4	8.2	8.5	9.0	10.0	10.9	10.8	10.3	10.0
Nominal GDP, market prices (in billions of PRs)	4,402	4,823	5,641	6,581	7,713	8,748	9,876	11,096	12,467	14,007

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

1/ Fiscal year runs from July 1–June 30. Projections are based on a staff scenario of monetary and fiscal tightening.
2/ Excludes spending related to the 2005 earthquake.
3/ Earthquake-related spending in 2005–09.
4/ Social- and poverty-related expenditure as defined in the government's Poverty Reduction Strategy Paper (2003).
5/ Excludes military debt, commercial loans, and short-term debt.
6/ Calculated by dividing interest expenditure by the outstanding debt stock at the end of the previous period.

Table 7. Pakistan: Public Sector Debt Sustainability Framework, 2001/02–2010/11

(In percent of GDP, unless otherwise indicated)

	Actual				Est.	Projections					
	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	Debt-stabilizing primary balance 9/
1 **Baseline: Public sector debt 1/**	81.4	75.3	67.8	61.8	**56.1**	**53.0**	**50.4**	**47.9**	**45.4**	**43.1**	**-1.9**
Of which: foreign-currency denominated	42.3	36.9	32.7	29.4	26.3	25.0	23.9	22.5	21.2	20.2	
2 Change in public sector debt	-4.4	-6.0	-7.6	-5.9	-5.7	-3.1	-2.6	-2.5	-2.5	-2.3	
3 Identified debt-creating flows (4+7+12)	-3.2	-6.1	-9.0	-5.1	-5.1	-4.2	-3.3	-3.1	-3.1	-3.0	
4 Primary deficit	-2.0	-2.8	-1.7	-0.2	0.6	0.4	-0.2	-0.4	-0.4	-0.5	
5 Revenue and grants	16.1	17.4	14.6	14.0	14.5	14.6	15.1	15.1	15.2	15.3	
6 Primary (noninterest) expenditure	14.1	14.6	12.9	13.8	15.1	14.9	14.9	14.7	14.7	14.8	
7 Automatic debt dynamics 2/	-1.8	-4.2	-7.2	-5.7	-5.8	-3.5	-2.8	-2.4	-2.4	-2.3	
8 Contribution from interest rate/growth differential, *of which:* 3/	0.9	-2.8	-7.4	-6.5	-6.0	-3.5	-2.8	-2.4	-2.4	-2.3	
9 contribution from real interest rate	3.5	0.8	-2.7	-1.8	-2.7	-0.2	0.3	0.5	0.6	0.5	
10 contribution from real GDP growth	-2.6	-3.6	-4.7	-4.6	-3.3	-3.2	-3.0	-2.9	-3.0	-2.8	
11 Contribution from exchange rate depreciation 4/	-2.7	-1.4	0.2	0.7	0.2	...	...	...	...	...	
12 Other identified debt-creating flows	0.5	0.9	0.0	0.9	0.1	-1.1	-0.4	-0.3	-0.2	-0.2	
13 Privatization receipts (negative)	-0.2	-0.2	-0.2	-0.4	-1.3	-1.8	-1.0	-0.9	-0.8	-0.8	
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	
15 Build-up of bank deposits	0.7	1.2	0.2	1.3	1.4	0.6	0.6	0.6	0.6	0.6	
16 Residual, including other asset changes (2–3) 5/	-1.2	0.0	1.4	-0.9	-0.6	1.1	0.7	0.7	0.5	0.7	
Public sector debt-to-revenue ratio 1/	506.4	433.4	463.5	442.5	385.9	363.6	334.1	318.6	299.6	281.2	
Gross financing need 6/	29.9	22.0	20.4	18.8	20.5	20.5	19.2	18.4	17.3	15.7	
in billions of U.S. dollars	21.5	18.2	20.0	20.8	26.4	29.0	29.6	30.9	31.8	31.7	
Scenario with key variables at their historical averages 7/					**56.1**	**53.0**	**50.4**	**47.9**	**45.5**	**43.3**	**-1.3**
Scenario with no policy change (constant primary balance) in 2005/06–2010/11					**56.1**	**52.9**	**51.1**	**49.6**	**48.0**	**46.6**	**-2.0**
Key Macroeconomic and Fiscal Assumptions Underlying Baseline											
Real GDP growth at market prices (in percent)	3.2	4.9	7.4	8.0	6.2	6.5	6.5	6.5	7.0	7.0	
Average nominal interest rate on public debt (in percent) 8/	6.9	5.8	5.4	5.5	5.8	6.4	7.0	6.9	6.7	6.6	
Average real interest rate (nominal rate minus change in GDP deflator; in percent)	4.4	1.3	-3.5	-2.5	-4.6	-0.1	1.0	1.4	1.7	1.6	
Nominal appreciation (increase in U.S. dollar value of local currency; in percent)	6.7	3.8	-0.6	-2.5	-0.9	...	...	...	...	...	
Inflation rate (GDP deflator; in percent)	2.4	4.5	8.9	8.0	10.4	6.5	6.0	5.5	5.0	5.0	
Growth of real primary spending (deflated by GDP deflator; in percent)	21.7	8.5	-5.2	15.4	16.4	5.3	6.6	4.7	7.4	7.7	
Primary deficit	-2.0	-2.8	-1.7	-0.2	0.6	0.4	-0.2	-0.4	-0.4	-0.5	

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

1/ General government gross debt; excludes external military debt, external commercial debt, and external short-term debt.

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/ For projections, this line includes exchange rate changes.

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

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

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

9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Table 8. Pakistan: External Debt Sustainability Framework, 2001/02–2010/11
(In percent of GDP, unless otherwise indicated)

	Actual				Est.	Projections					
	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	**Debt-stabilizing noninterest current account 7/**
Baseline: External debt	46.5	40.4	34.0	30.7	**27.7**	**26.0**	**24.8**	**23.4**	**22.0**	**20.7**	**-4.0**
Change in external debt	1.5	-6.1	-6.4	-3.3	-3.0	-1.6	-1.2	-1.5	-1.4	-1.3	
Identified external debt-creating flows (4+8+9)	-4.9	-12.0	-9.2	-4.1	-0.8	-1.9	-1.4	-1.8	-1.9	-2.1	
Current account deficit, excluding interest payments	-6.1	-6.5	-2.9	0.4	2.9	3.0	2.7	2.2	2.0	1.5	
Deficit in balance of goods and services	0.8	0.4	2.6	7.0	10.0	9.8	9.2	8.5	7.8	7.0	
Exports	15.4	16.6	15.4	16.0	15.7	15.8	16.7	17.9	19.1	20.6	
Imports	16.2	17.0	18.0	23.1	25.7	25.6	25.9	26.4	26.9	27.6	
Net non-debt-creating capital inflows (negative)	-0.7	-1.0	-0.9	-1.5	-3.0	-4.2	-3.5	-3.4	-3.2	-3.0	
Automatic debt dynamics 1/	2.0	-4.5	-5.3	-3.0	-0.7	-0.7	-0.6	-0.6	-0.6	-0.6	
Contribution from nominal interest rate	2.2	1.5	1.1	0.9	1.0	1.0	1.0	0.9	0.9	0.8	
Contribution from real GDP growth	-1.4	-2.0	-2.5	-2.4	-1.6	-1.6	-1.5	-1.5	-1.5	-1.4	
Contribution from price and exchange rate changes 2/	1.2	-4.1	-3.9	-1.5	...	...	...	...	...	...	
Residual, including change in gross foreign assets (2–3) 3/	6.4	5.9	2.7	0.8	-2.2	0.2	0.2	0.3	0.5	0.8	
External debt-to-exports ratio (in percent)	302.1	243.9	220.5	191.2	176.2	164.4	148.6	130.5	115.1	100.4	
Gross external financing need (in billions of U.S. dollars) 4/	0.9	0.3	1.6	4.0	6.6	7.4	7.5	7.0	7.1	6.4	
In percent of GDP	1.2	0.3	1.6	3.6	5.1	5.2	4.9	4.2	3.8	3.2	
Scenario with key variables at their historical averages 5/					**27.7**	**26.5**	**25.2**	**23.9**	**22.8**	**22.2**	**-1.0**
Key Macroeconomic Assumptions Underlying Baseline											
Real GDP growth (in percent)	3.2	4.9	7.4	8.0	6.2	6.5	6.5	6.5	7.0	7.0	
GDP deflator in U.S. dollars (change in percent)	-2.6	9.6	10.6	4.7	9.5	2.9	2.7	2.1	2.1	2.3	
Nominal external interest rate (in percent)	4.9	3.8	3.2	3.1	3.6	3.8	4.0	4.0	4.1	3.9	
Growth of exports (U.S. dollar terms; in percent) 6/	7.5	23.7	10.4	17.9	13.8	10.5	15.5	16.5	16.5	18.2	
Growth of imports (U.S. dollar terms; in percent) 6/	-7.1	20.6	26.0	44.7	29.2	9.3	10.9	10.5	11.4	12.2	
Current account balance, excluding interest payments	6.1	6.5	2.9	-0.4	-2.9	-3.0	-2.7	-2.2	-2.0	-1.5	
Net non-debt-creating capital inflows	0.7	1.0	0.9	1.5	3.0	4.2	3.5	3.4	3.2	3.0	

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 U.S. dollar terms, g = real GDP growth rate, ε = nominal appreciation (increase in dollar value of domestic currency), and α = 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/ For projections, this line includes the impact of price and exchange rate changes.

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

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both noninterest current account and nondebt inflows in percent of GDP.

6/ Exports and imports of goods and services.

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

Table 9. Pakistan: Selected Vulnerability Indicators, 2001/02–2005/06

	2001/02	2002/03	2003/04	2004/05	Est. 2005/06
Key Economic and Market Indicators					
Real GDP growth (market prices; in percent)	3.2	4.9	7.4	8.0	6.2
CPI inflation (period average; in percent)	2.5	3.1	4.6	9.3	7.9
Short-term (ST) interest rate (in percent)	8.2	4.1	1.7	4.7	8.2
EMBI secondary market spread (bps; end of period)	686	...	313	229	251
Nominal exchange rate (Pakistani rupees per U.S. dollar; end of period)	59.9	57.7	58.1	59.6	60.1
External Sector					
Exchange rate regime	De facto currency peg since December 2004				
Current account balance (in percent of GDP)	3.9	4.9	1.8	-1.4	-3.9
Net FDI inflows (in percent of GDP)	0.7	0.9	0.9	1.3	2.7
Exports (percentage change of U.S. dollar value; GNFS)	7.5	23.7	10.4	17.9	13.8
Real effective exchange rate (2000=100; annual average)	93.1	93.0	91.3	91.5	96.4
Gross international reserves (GIR) in billions of U.S. dollars	4.3	9.5	10.6	9.8	10.8
GIR in percent of ST debt at remaining maturity (RM) 1/	229.6	338.0	348.5	492.2	678.9
GIR in percent of ST debt at RM and banks' FX deposits 1/	96.0	190.4	190.7	195.4	222.5
Total gross external debt (ED) (in percent of GDP), *of which:*	46.5	40.4	34.0	30.7	27.7
ST external debt (original maturity, in percent of total ED)	0.5	0.6	0.1	0.8	0.5
ED of domestic private sector (in percent of total ED)	6.7	6.1	5.0	3.9	4.4
ED to foreign official sector (in percent of total ED)	93.3	93.9	95.0	96.1	95.6
Total gross external debt in percent of exports of GNFS	302.1	243.9	220.5	191.2	176.2
Gross external financing requirement (in billions of U.S. dollars) 2/	-0.8	-1.4	0.8	3.1	6.2
Public Sector (PS) 3/					
Overall balance (in percent of GDP)	-3.6	-1.4	-1.8	-3.0	-3.6
Primary balance (in percent of GDP)	2.0	2.9	1.7	0.2	-0.6
Debt-stabilizing primary balance (in percent of GDP) 4/	-1.9	-4.3	-7.3	-5.8	-5.9
Gross PS financing requirement (in percent of GDP) 5/	29.9	22.0	20.4	18.8	20.5
Public sector gross debt (PSGD; in percent of GDP)	81.4	75.3	67.8	61.8	56.1
Public sector net debt (in percent of GDP) 6/	77.7	70.8	63.7	57.0	50.6
Financial Sector (FS) 7/					
Capital adequacy ratio (in percent) 8/	8.8	8.8	8.5	10.5	11.9
NPLs in percent of total loans 8/	23.4	21.8	17.0	11.6	8.0
Provisions in percent of NPLs 8/	54.7	60.6	63.9	70.4	75.3
Return on average assets (in percent) 8/	-0.5	0.1	1.0	1.2	2.1
Return on equity (in percent) 8/	-12.6	3.2	20.0	20.3	26.5
FX deposits held by residents (in percent of total deposits)	11.9	8.0	7.6	7.8	7.3
Government debt held by FS (in percent of total FS assets)	36.3	27.0	24.9	24.1	23.6
Credit to private sector (percent change)	4.8	18.9	29.8	33.2	23.2
Memorandum item:					
Nominal GDP (in billions of U.S. dollars)	71.9	82.6	98.1	111.0	129.0

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

1/ Debt at remaining maturity is defined as maturing short-, medium-, and long-term external public debt.
2/ Current account balance plus amortization of medium- and long-term debt.
3/ Public sector covers the general (consolidated) government.
4/ Based on the end of period debt stock in year t-1, and the baseline assumptions for the relevant variables (i.e., growth, interest rates, inflation, exchange rates) in year t.
5/ Overall balance plus amortization of medium- and long-term public sector debt, plus short-term domestic public debt at end of year t-1.
6/ Net debt is defined as gross debt minus government deposits with the banking system.
7/ Financial sector includes all commercial and specialized banks; for government debt also includes nonbanks, but excludes debt held by the State Bank of Pakistan.
8/ For columns 2001/02 to 2004/05 data are on a calendar year basis (e.g., the value for 2002/03 corresponds to the indicator as of end-December 2002). Data in the 2005/06 column correspond to values as of end-June 2006.

Table 10. Pakistan: Financial Soundness Indicators for the Banking System, 2001–2006

	2001 Dec.	2002 Dec.	2003 Dec.	2004 Dec.	2005 Dec.	2006 Jun.
Capital adequacy						
Regulatory capital to risk-weighted assets	8.8	8.8	8.5	10.5	11.3	11.9
Tier I capital to risk-weighted assets	7.3	6.2	6.5	7.6	8.3	8.9
Capital to total assets	3.8	4.8	5.5	6.7	7.9	8.1
Asset composition and quality						
Nonperforming loans (NPLs) to gross loans	23.4	21.8	17.0	11.6	8.3	8.0
Provisions to NPLs	54.7	60.6	63.9	70.4	76.7	75.3
NPLs net of provisions to capital	150.5	85.5	54.4	29.2	14.3	13.9
Earnings and profitability						
Return on assets (after tax)	-0.5	0.1	1.0	1.2	1.9	2.1
Return on equity (after tax)	-12.6	3.2	20.0	20.3	25.8	26.5
Net interest income to gross income	70.4	67.1	59.2	62.8	72.0	73.2
Noninterest expenses to gross income	62.4	59.1	50.5	52.0	41.5	41.8
Liquidity						
Liquid assets to total assets	38.5	46.7	45.1	36.6	33.7	34.1
Liquid assets to total deposits	50.7	61.8	58.5	46.5	43.5	44.5

Sources: Pakistani authorities.

Table 11. Pakistan: Millennium Development Goals, 1990–2004 1/

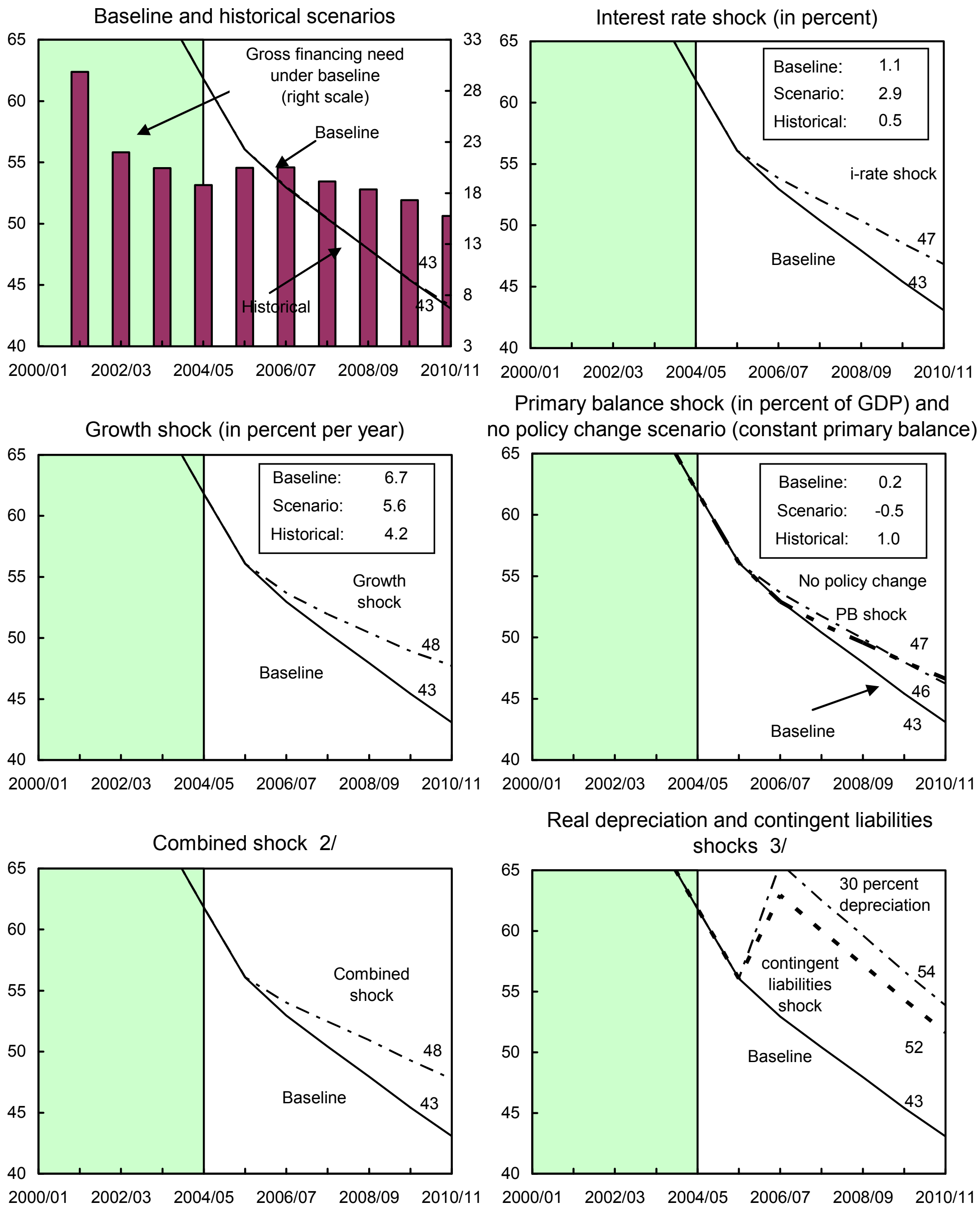
	1990	1995	2001	2004
Goal 1: Eradicate extreme poverty and hunger				
Percentage share of income or consumption held by poorest 20 percent	...	...	9.3	...
Population below $1 a day (in percent)	47.8	...	17.0	...
Population below minimum level of dietary energy consumption (in percent)	25.0	...	30.0	...
Poverty gap ratio at $1 a day (incidence x depth of poverty)	14.6	...	3.1	...
Poverty headcount, national (in percent of population)	26.1	29.8	34.5	23.9
Prevalence of underweight in children (under five years of age)	40.2	38.2	35.0	...
Goal 2: Achieve universal primary education				
Net primary enrollment ratio (in percent of relevant age group)	...	...	...	66.2
Primary completion rate, total (in percent of relevant age group)	...	...	...	...
Proportion of pupils starting grade 1 who reach grade 5	...	...	...	...
Youth literacy rate (in percent ages 15–24)	47.4	...	...	65.5
Goal 3: Promote gender equality and empower women				
Proportion of seats held by women in national parliament (in percent)	10.0	...	...	22.0
Ratio of girls to boys in primary and secondary education (in percent)	...	...	...	72.9
Ratio of young literate females to males (in percent ages 15–24)	49.0	...	...	72.2
Share of women employed in the nonagricultural sector (in percent)	8.7	...	8.9	10.0
Goal 4: Reduce child mortality				
Immunization, measles (in percent of children ages 12–23 months)	50.0	47.0	57.0	67.0
Infant mortality rate (per 1,000 live births)	100.0	93.0	...	80.2
Under 5 mortality rate (per 1,000)	130.0	118.0	...	100.8
Goal 5: Improve maternal health				
Births attended by skilled health staff (in percent of total)	18.8	...	23.0	...
Maternal mortality ratio (modeled estimate, per 100,000 live births)	550.0	...	350.0	400.0
Goal 6: Combat HIV/AIDS, malaria, and other diseases				
Contraceptive prevalence rate (in percent of women ages 15–49)	14.0	23.9	28.0	...
Incidence of tuberculosis (per 100,000 people)	181.3	...	...	181.3
Number of children orphaned by HIV/AIDS	...	...	...	...
Prevalence of HIV, total (in percent of population aged 15–49)	...	...	0.1	...
Tuberculosis cases detected under DOTS (in percent)	...	1.0	5.3	26.8
Goal 7: Ensure environmental sustainability				
Access to an improved water source (in percent of population)	83.0	...	90.0	...
Access to improved sanitation (in percent of population)	38.0	...	54.0	...
Access to secure tenure (in percent of population)	...	...	...	...
CO2 emissions (metric tons per capita)	0.6	0.7	0.8	...
Forest area (in percent of total land area)	3.3	...	...	...
GDP per unit of energy use (2000 PPP $ per kg oil equivalent)	3.9	4.0	4.2	...
Nationally protected areas (in percent of total land area)	9.1	...	11.3	11.3
Goal 8: Develop a global partnership for development				
Aid per capita (current U.S. $)	10.5	6.7	13.8	9.3
Debt service (in percent of exports)	21.3	26.5	24.6	21.2
Fixed line and mobile phone subscribers (per 1,000 people)	7.8	17.7	28.2	62.6
Internet users (per 1,000 people)	0.0	0.0	3.5	13.2
Personal computers (per 1,000 people)	1.4	3.7	4.2	...
Unemployment, youth female (in percent of female labor force ages 15–24)	1.3	18.1	20.6	...
Unemployment, youth male (in percent of male labor force ages 15–24)	5.7	7.6	12.0	...
Unemployment, youth total (in percent of total labor force ages 15–24)	5.1	8.9	13.4	...
Other				
Fertility rate, total (births per woman)	5.8	5.2	4.5	4.3
GNI per capita, Atlas method (current U.S. $)	420	490	480	600
GNI, Atlas method (current U.S. $, billions)	45.5	59.8	68.4	90.7
Gross capital formation (in percent of GDP)	18.9	18.5	17.2	17.3
Life expectancy at birth, total (years)	59.1	60.9	63.8	64.9
Literacy rate, adult total (in percent of people ages 15 and above)	35.4	...	...	49.9
Population, total (millions)	108.0	122.4	141.5	152.1
Trade (in percent of GDP)	32.6	30.8	31.9	33.4

Sources: Pakistani authorities; Pakistan Millennium Development Goals Report (2005); World Development Indicators database (2006); and Fund staff estimates.

1/ When data for a particular year is missing, the value reported corresponds to the following year where data for that indicator is available.

Figure 1. Pakistan: Public Debt Sustainability: Bound Tests 1/

(Public debt in percent of GDP)



Sources: International Monetary Fund; historical data from Pakistani authorities; and Fund staff estimates and projections.

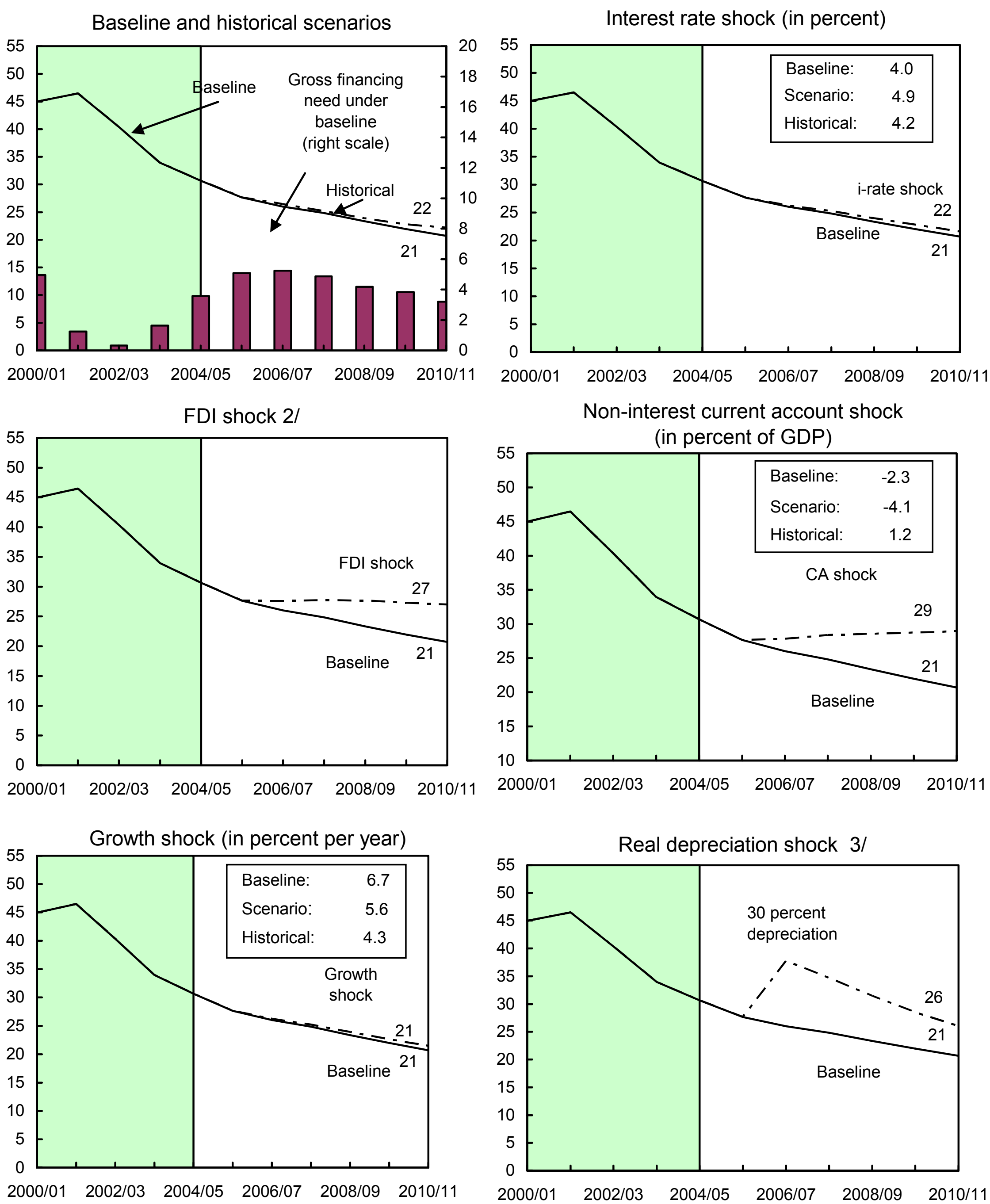
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

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 2006/07, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Figure 2. Pakistan: External Debt Sustainability: Bound Tests 1/

(External debt in percent of GDP)



Sources: International Monetary Fund; historical data from Pakistani authorities; and Fund staff estimates and projections.

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/ Net flows of foreign direct investment are 50 percent lower than in the baseline scenario.

3/ One-time real depreciation of 30 percent occurs in 2006/07.

APPENDIX I: PAKISTAN—RELATIONS WITH THE FUND

As of September 30, 2006

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	1,074.66	103.96
Reserve position in Fund	0.12	0.01

III. **SDR Department**:	SDR Million	% Allocation
Net cumulative allocation	169.99	100.00
Holdings	146.45	86.15

IV. **Outstanding Purchases and Loans**:	SDR Million	% Quota
Extended arrangements	41.07	3.97
PRGF arrangements	959.99	92.87

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):

	Forthcoming				
	2006	2007	2008	2009	2010
Principal	29.06	97.88	116.16	146.36	172.28
Charges/Interest	3.17	6.96	5.61	4.50	3.56
Total	32.24	104.84	121.77	150.86	175.84

[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's exchange rate system consisted of a fixed exchange rate with periodic step devaluations 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. In their formal notification, the authorities classify Pakistan's exchange rate regime as managed floating with no predetermined path for the exchange rate. The nominal exchange rate has remained in the range of 59.0 to 60.5 rupees per U.S. dollar since late December 2004. As a result, Pakistan is classified as having a de facto conventional peg to the U.S. dollar. As of September 29, 2006, the FIBR was PRs 60.48 per $1. Pakistan has accepted the obligations of Article VIII, but maintains an 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 and ex post assessment of longer-term program engagement staff reports (IMF Country Report No. 05/409) were discussed by the Executive Board on November 2, 2005.

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. FSAP Participation and ROSCs

Fiscal Transparency Module	Available at: http://www.imf.org/external/np/rosc/pak/fiscal.htm
Fiscal Transparency Module—Update	IMF Country Report No. 04/416
Financial System Stability Assessment Financial Sector Assessment Program	IMF Country Report No. 04/215
Data Module and Detailed Assessment Using the Data Quality Assessment Framework	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.

APPENDIX II: PAKISTAN—RELATIONS WITH THE WORLD BANK GROUP

Thomas Buckley, Senior Country Officer, Telephone: (202) 473-0075

1. Pakistan is among the largest recipients of World Bank financial assistance. In FY2006 World Bank support to Pakistan totaled US$1.5 billion, making it the fourth largest borrower in the world. The World Bank Group program in Pakistan consists of an integrated package of financial support, including IBRD lending, concessional IDA credits and IFC investments along with complementary analytical and advisory services.

2. The Bank Group's Board of Directors endorsed a new Country Assistance Strategy (CAS) for Pakistan on June 1, 2006, covering fiscal years 2006 through 2009. The CAS outlines the Bank's strategic approach to helping Pakistan achieve its development goals over the coming four years. Despite recent good economic performance, Pakistan's development challenges remain formidable. The strategy addresses the key challenge of sustaining rapid growth in order to further reduce poverty. This will require accelerating human development so that the poor can participate in and benefit from growth. Sustained growth will also require sound macroeconomic management along with improvements in the investment climate, including regulatory reform and significant investment in infrastructure.

3. The CAS is designed around three main pillars:

- **Sustained Growth and Improved Competitiveness:** The principal focus of this pillar will be to support investments and reforms needed to improve the business environment for trade and investment and sustain rapid, private sector-led growth. The Bank will provide support to key sectors such as agriculture and infrastructure, and help the government strengthen macroeconomic management through improving public expenditures and supporting ongoing tax reforms.

- **Strengthened Governance and Service Delivery:** Priorities in this area will be to support further reforms and investment to increase efficiency, transparency, and accountability in the use of public resources while supporting cross-cutting reforms needed to improve service delivery at all levels of government—with particular attention to health, education, water and sanitation, safety nets, and municipal services.

- **Improved Lives and Protection of the Vulnerable:** The Bank will focus on increased investment in the education and health sectors to help build the skilled, healthy work force needed to sustain strong growth. This area of the CAS also features targeted interventions to help the poor including strengthening safety nets and targeted interventions and community-based approaches in rural areas.

4. In line with Pakistan's recent performance and the government's request for increased Bank Group support, the CAS outlines a substantial increase in the volume of lending to Pakistan during the next four years. The expansion in lending will take place primarily in infrastructure (mainly in energy, water, and transport) and human development. An immediate priority will be to assist in addressing the impact of the October 2005 earthquake—up to US$1 billion will be used to support reconstruction and recovery. Overall, a flexible lending program of up to US$6.5 billion is set forth in the CAS. About half of this amount (US$3.1 billion) will take the form of IDA credits. Policy-based lending will account for up to half of planned financial support.

5. The IFC strategy in Pakistan, as expressed in the CAS, seeks to increase investments with a target range of US$500–600 million during the FY2006–09 period. IFC activity will focus on three main sectors: financial, SME and infrastructure. IFC has also initiated a substantial TA program in Pakistan to build capacity and address constraints of the SME, infrastructure and financial sectors.

IBRD/IDA financial operations since FY2001 are summarized below:

Pakistan: World Bank Group Financial Operations
(In millions of U.S. dollars)

	FY2001	FY2002	FY2003	FY2004	FY2005	FY2006
Commitments						
IBRD	--	--	--	50	347	315
IDA	374	800	297	731	500	1,161
Disbursements						
IBRD	143	38	40	13	203	149
IDA	503	830	316	291	781	1,063
Repayments						
IBRD	225	238	252	288	320	297
IDA	65	71	83	96	111	117
Debt Disbursed and Outstanding						
IBRD	3,043	2,943	2,813	2,601	2,464	2,247
IDA	4,123	5,097	5,604	6,020	6,651	7,627

APPENDIX III: PAKISTAN—STATISTICAL ISSUES

1. Data are broadly adequate for effective surveillance; however, the December 2004 data ROSC report identified shortcomings in some statistical practices that could detract from accurate and timely analysis of economic and financial developments and the formulation of appropriate policies.[1] Follow-up STA technical assistance missions have assisted the authorities in implementing some of the key recommendations made in the report to address the shortcomings.

2. The authorities are committed to adhering to internationally accepted standards and good practices, as demonstrated by 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) the quarterly employment and unemployment data with a timeliness of one quarter; (c) monthly transaction data on central government operations with a timeliness of one month; (d) quarterly data on the national accounts, wages/earnings, and external debt, all with a timeliness of one quarter; (e) more detailed breakdown of data on central government debt and external debt; and (f) update and expand the metadata on compilation and dissemination practices.

3. In 2004, the Federal Bureau of Statistics (FBS) completed a revision of the national accounts statistics to bring them in line with the concepts and definitions of the *1993 System of National Accounts (1993 SNA)*. As noted by the December 2004 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. An IMF mission visited Pakistan in April–June 2005 to assist the FBS in the development of quarterly national accounts (QNA) and to advise on the dwelling rent component of the consumer price index (CPI). The compilation methods for the 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 the QNA, a number of deficiencies in the annual compilation methods were discovered. With respect to labor market statistics, the FBS has recently started to compile quarterly employment/unemployment data (although not with the frequency required for subscription to the SDDS) and is investigating the feasibility of disseminating data on wages/salaries.

[1] IMF Country Report No. 04/398.

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. Plans have been made to introduce the classification of individual consumption by purpose (COICOP) and to complete the work to develop a Producer Price Index (PPI), with base year 1999/2000; an IMF mission also provided some advice in this regard.

5. 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 central government data is further limited because it does not cover the activity of extra-budgetary funds. Classification and sectorization systems follow *GFSM 1986* standards to a limited extent. 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 identified according to economic classification. The basis of recording GFS is on, or close to, a cash basis. 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). The authorities have indicated their intent to adopt the methodology of *Government Finance Statistics Manual 2001* over the medium to long term. Budgetary central government operations data are regularly reported for inclusion in the *GFS Yearbook*, and use the *GFSM 2001* framework. However, no data are reported on transactions in nonfinancial and financial assets and liabilities. The authorities do not report higher frequency data for inclusion in the *IFS*.

6. The ROSC mission found that 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 has indicated its intention 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. A follow-up mission to prepare a substantive update to the monetary statistics section of the ROSC report is scheduled for November 1–15, 2006. This mission will also finalize the review of the data in the Standardized Report Form framework.

7. The balance of payments statistics are compiled broadly in accordance with the concepts and definitions of the *Balance of Payments Manual, Fifth Edition (BPM5).* The presentation of the balance of payments in the publications and the website of the SBP is based both on the *BPM4* and *BPM5*. 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 and published on the SBP website. Regarding the external sector, the SBP plans to: (a) continue the implementation of the *BPM5*; and (b) continue disseminating data on the SBP website following the format of the template on International Reserves and Foreign Currency Liquidity. Finally, the differences between the two sources of trade data (FBS and SBP) for imports have been widening. Most of the differences can be reconciled ex-post (see SBP's *Second Quarterly Report for FY2006*), and the authorities are working to narrow these differences before the publication of the data.

PAKISTAN: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE
AS OF OCTOBER 18, 2006

	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]	Memo Items: Data Quality – Accuracy and reliability[8]
Exchange Rates	real time	real time	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]							
Reserve/Base Money	August 2006	October 2006	M	M	M	LO, O, LNO, LO	LNO, LO, O, O, O
Broad Money	August 2006	October 2006	M	M	M		
Central Bank Balance Sheet	August 2006	October 2006	M	M	M		
Consolidated Balance Sheet of the Banking System	August 2006	October 2006					
Interest Rates[2]	September 2006	October 2006	M	M	M		
Consumer Price Index	August 2006	September 2006	M	M	M	O, LO, LO, O	O, LO, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	June 2006	August 2006	Q	Q	Q	LO, LO, LNO, LO	O, O, LO, LO, LO
Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government	June 2006	August 2006	Q	Q	Q		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	June 2006	August 2006	Q	Q	Q		
External Current Account Balance	June 2006	August 2006	M	M	M	LO, LO, LO, O	O, O, O, O, LNO
Exports and Imports of Goods and Services	August 2006	September 2006	M	M	M		
GDP/GNP	2005/06	June 2006	A	A	A	LO, LNO, LO, LO	LNO, LNO, O, LNO, O
Gross External Debt	June 2006	August 2006	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
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 06/139
FOR IMMEDIATE RELEASE
December 7, 2006

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2006 Article IV Consultation with Pakistan

On November 22, 2006, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Pakistan.[1]

Background

Pakistan's recent economic performance has been impressive. Growth has accelerated, improvements in public spending and wide-ranging structural reforms have reduced the debt burden and increased efficiency, and pro-poor policies have helped lower poverty rates. The devastating earthquake of October 2005 left a heavy toll in terms of human lives and physical and social infrastructure, but had relatively minor effects on macroeconomic indicators (except for an increase in government spending) owing mainly to the small share of the affected areas in the overall economy.

Economic developments during the fiscal year ending in June 2006 were favorable, with buoyant real GDP growth and inflation declining to 7.6 percent. The external current account deficit, however, increased to US$5 billion (3.9 percent of GDP), from US$1.5 billion (1.4 percent of GDP) a year earlier. Record-high net capital flows (mainly from foreign direct investment—including privatization) more than covered the larger deficit and allowed for a build up of nearly US$1 billion in official international reserves. The interbank market exchange rate was broadly unchanged from end-June 2005.

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[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.

The fiscal deficit exceeded the original budget target for 2005/06 owing to earthquake-related spending. Excluding the latter, revenues and expenditures rose by roughly the same amounts compared to the outturn in the previous fiscal year. The government debt-to-GDP ratio fell to 56 percent by the end of June, below the 60 percent ceiling stipulated in the 2005 Fiscal Responsibility Law. The budget for 2006/07 targets a deficit of 4.2 percent of GDP (excluding grants), unchanged from the estimated outturn for 2005/06.

The growth of broad money and bank credit to the private sector decelerated in 2005/06, but private sector credit continued to expand at a relatively strong pace. Bank lending rates became increasingly positive in real terms as inflation declined; the real return on bank deposits remained negative. The State Bank of Pakistan's (SBP) claims on the government rose by more than total government borrowing from the banking system, as the SBP absorbed treasury bills that commercial banks did not roll over upon redemption. In July 2006, the SBP tightened monetary conditions by raising reserve and liquidity requirements on bank deposits and the discount rate.

Foreign investors' interest in Pakistan increased significantly in 2005/06. Foreign direct investment inflows, excluding privatization, rose by 70 percent, and foreign demand for Pakistani bonds was strong. Government divestiture from electricity and telecommunications entities generated large foreign exchange inflows and revitalized the privatization process.

Progress on structural reforms, other than privatization, was mixed. Reforms to broaden the income tax base and streamline rates continued, and the legal framework for investor protection was strengthened. However, implementation of the schedule of higher regional electricity tariffs, a key step for continued reform of the power sector, remains pending, and progress on trade liberalization slowed.

Executive Board Assessment

Executive Directors commended Pakistan's impressive macroeconomic performance since 2001. They welcomed in particular the acceleration in output growth, the steady decline in debt ratios, and the fall in poverty rates. Directors noted that Pakistan's strong track record on the macroeconomic and structural reform fronts had made the country increasingly attractive to foreign investors, as shown by the record-high inflows of foreign direct investment (FDI) during 2005/06 and the favorable terms obtained on recent sovereign bond placements in the international capital markets.

Directors noted that during 2005/06 the Pakistani economy had withstood well the impact of large negative shocks, including the tragic earthquake of October 2005, a sharp rise in international oil prices, and unfavorable weather conditions. Although these shocks had limited the scope for fiscal maneuver, growth had remained buoyant, inflation had declined slightly and the import coverage of reserves had remained stable.

Directors nonetheless noted the risks to the outlook, including the continued strength of domestic demand, and its adverse effects on the trade and current account deficits as well as on the pace of disinflation during 2005/06. They noted also the authorities' view that macroeconomic imbalances would decline without the need for further changes in the stance of policies envisaged for the current fiscal year, and welcomed the government's commitment to tighten monetary policy, if warranted. However, most Directors felt that macroeconomic policies during 2006/07 should be more effectively geared at reducing domestic demand and strengthening the balance of payments position. To this effect, many considered that a further tightening of monetary policy (including by allowing higher cutoff rates at treasury bill auctions) should not be delayed to help strengthen the external position and allow the government to meet its inflation target. Most Directors considered that to be effective, monetary policy should be supported by exchange rate flexibility and a fiscal policy that keeps this year's budget deficit (excluding grants and earthquake-related expenditures) at least at the level of 2005/06.

Directors stressed that, beyond 2006/07, Pakistan's macroeconomic policies should aim at ensuring that the external current account deficit-to-GDP ratio remains on a declining path with a steady build up of reserves. In this regard, they encouraged the authorities to adopt a policy stance that maintains real interest rates at positive levels accompanied by a close monitoring of credit growth, and a fiscal consolidation program that lowers the overall fiscal deficit to a sustainable level over the medium term.

Directors viewed the favorable prospects for sizable FDI inflows as important for future gains in productivity and investment, but also as presenting challenges for macroeconomic policy in the years ahead. They highlighted that continued reliance on FDI inflows of uncertain size and timing would require a large degree of flexibility in economic policymaking. In this connection, Directors stressed the need to improve the government's capacity to generate timely policy responses to shortfalls of external financing arising from negative balance of payments shocks. Directors were of the view that those shocks should generally require monetary policy and exchange rate responses, but also envisaged a role for fiscal tightening in cases where the shocks are large, or more permanent in nature. Directors cautioned that the option of resorting to the use of international reserves to cover shortfalls of external financing (especially those stemming from delays in FDI-related flows) ought to be used sparingly.

Directors viewed structural reforms conducive to higher saving and investment, an improved business climate, and well-targeted poverty-related spending as critical for sustaining growth and poverty reduction over the medium term. They encouraged the authorities to quickly complete the reform of the regulatory and tariff framework for the power sector, and step up efforts to broaden the tax base and further curtail tax exemptions. Directors also saw scope for improving the government's debt management strategy, including by increasing the issuance of long-term marketable securities and reducing its reliance on treasury bills and the National Savings Schemes (NSS) to finance the fiscal deficit. Directors welcomed the initiatives underway to modernize the

NSS and reform the system of broker-financing of stock trading, but noted that these should be followed quickly with measures that enable the integration of the NSS with local financial markets.

Directors welcomed the authorities' commitment to maintaining a liberal trade regime and their determination to contribute to the success of the Doha round of trade talks. They called on the authorities to resist pressures to reinstate ad-hoc tariff and nontariff measures and broaden export subsidy schemes.

Directors encouraged the authorities to further improve the quality and timeliness of data, including by reporting fiscal data on an economic classification. They also urged the authorities to expedite the process of subscribing to the Special Data Dissemination Standard.

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. The Staff Report for the 2006 Article IV Consultation with Pakistan is also available.

Pakistan: Selected Economic Indicators, 2001/02–2005/06 1/

(In percent of GDP, unless otherwise noted)

	2001/02	2002/03	2003/04	2004/05	Est. 2005/06
Output and prices					
Real GDP at factor cost (percentage change)	3.1	4.7	7.5	8.6	6.6
Consumer prices (period average; percentage change)	2.5	3.1	4.6	9.3	7.9
Consumer prices (end of period; percentage change)	3.4	1.9	8.5	8.7	7.6
Gross national saving	20.7	21.9	18.4	16.7	16.1
Gross capital formation 2/	16.8	16.9	16.6	18.1	20.0
GDP at market prices (in billions of Pakistani rupees)	4,402	4,823	5,641	6,581	7,713
Public finances					
Revenue (including grants)	16.1	17.4	14.6	14.0	14.5
Expenditure (including statistical discrepancy)	19.7	18.7	16.4	17.0	18.2
Budget balance (excluding grants)	-5.5	-3.8	-2.3	-3.3	-4.2
Budget balance (including grants)	-3.6	-1.4	-1.8	-3.0	-3.6
Primary balance (including grants)	2.0	2.9	1.7	0.2	-0.6
Total government debt	81.4	75.3	67.8	61.8	56.1
Monetary sector					
Net foreign assets (change in percent of broad money)	13.4	17.5	2.1	2.2	1.7
Net domestic assets (change in percent of broad money)	2.0	0.5	17.5	17.1	13.4
Broad money (annual change; in percent)	15.4	18.0	19.6	19.3	15.2
Private credit (annual change; in percent)	4.8	18.9	29.8	33.2	23.2
Six-month treasury bill rate (period average; in percent)	8.2	4.1	1.7	4.7	8.2
External sector					
Merchandise exports, U.S. dollars (growth rate; in percent)	2.3	20.1	13.5	16.2	14.0
Merchandise imports, U.S. dollars (growth rate; in percent)	-7.5	20.1	21.2	38.3	31.3
Current account including official current transfers	3.9	4.9	1.8	-1.4	-3.9
External public and publicly guaranteed debt (in percent of exports of goods and services)	282.0	229.0	209.5	183.7	168.3
Gross official reserves (in millions of U.S. dollars) 3/	4,337	9,529	10,564	9,805	10,760
In months of next year's imports of goods and services	3.7	6.5	5.0	3.6	3.6
Pakistani rupees per U.S. dollar (period average)	61.3	58.4	57.5	59.3	59.8
Real effective exchange rate (annual average; percentage change) 4/	-2.6	-0.1	-1.8	0.3	5.3

Sources: Pakistani authorities; and IMF staff estimates and projections

1/ Fiscal year ends June 30.

2/ Including changes in inventories. Investment data recorded by the Federal Bureau of Statistics are said to underreport true activity.

3/ Excluding gold, foreign deposits held with the State Bank of Pakistan, and net of outstanding short-term foreign currency swap and forward contracts.

4/ An increase is a real appreciation.

Statement by Abbas Mirakhor, Executive Director for Pakistan and Iqbal Zaidi, Advisor to Executive Director November 22, 2006

As noted in the well-written staff report, economic performance during 2005/06 was strong, despite the impact of negative shocks, including the tragic earthquake of October 2005, a sharp rise in international oil prices, and unfavorable weather conditions. Reflecting prudent financial policies and a further broadening of the structural reform efforts, economic growth remained buoyant, inflation declined, and record-high capital inflows more than covered the larger external current account deficit and allowed for an increase of nearly US$1 billion in gross official reserves. The government debt-to-GDP ratio fell to 56 percent by end-June 2006, below the 60 percent ceiling stipulated in the 2005 Fiscal Responsibility Law, while pro-poor policies helped lower poverty rates. The authorities and staff agree that over the medium term, the main challenges to sustaining high output growth are to deepen structural reforms in areas critical for raising saving and investment, and improving external competitiveness. There was also broad agreement with the inflation and international reserves objectives, as well as with the medium-term balance of payments outlook.

Fiscal and monetary policies

Staff have noted that domestic demand pressures have not subsided and that the current account deficit has increased, driven by rapid import growth. However, real domestic demand growth slowed to 8.1 percent during FY06 from 11.5 percent. Despite the increase in the government's consumption due to earthquake related expenditures, total consumption showed a relatively small increase of 7.8 percent compared to 11.9 percent in the previous year. The authorities are firm in their determination to maintain external sustainability and stand ready to implement policy measures if needed. They expect import growth to decelerate sharply during the year as the effects of transitory and nonrecurring factors that pushed up imports in 2005/06 (e.g., oil price spike, unforeseen imports of sugar) unwind. Furthermore, monetary conditions were tightened in July 2006, which together with continued exchange rate stability, gives comfort that the inflation rate will decline further. During FY06, the State Bank of Pakistan (SBP) policy of keeping the overnight money market rate close to its policy lending rate has proved to be very effective in reducing the growth of private sector credit. Yearly average overnight rate in FY06 was 7.9 percent compared to 3.8 percent in FY05. The authorities are determined to follow prudent fiscal and monetary policies, reinforced by a flexible exchange rate. Whereas fiscal discipline is essential to achieve the authorities' objectives, and they have demonstrated fiscal restraint by keeping the underlying budget deficit (the overall deficit excluding grants and earthquake-related expenditures) at the level of 2005/06, the authorities have also noted that monetary policy will be tightened further if inflation remains above the government's 6½ percent target. Over the next couple of years, fiscal policy formulation will take account of

the additional demands on government spending created by the earthquake and reconcile them with macroeconomic stability and poverty-reduction objectives.
The authorities have made progress in their efforts to raise the tax revenue to GDP ratio, and moreover, have been laying the groundwork for additional reforms to broaden the tax base, which, because of their complexity and the need for institutional development, will necessarily take some time. Staff have recognized that efforts to increase the efficiency of tax collection have continued by streamlining income tax rates, but it should also be stressed that revenue collection will be enhanced by the considerable progress in other areas. Recent reforms in improving the documentation of the economy and the move to a greater reliance on self-assessment and risk-based auditing will make the tax machinery more efficient and taxpayer-friendly. The authorities have been focusing on further extending the tax net into the service and agriculture sectors in a meaningful way, and increasing the provinces' contribution to overall revenue collection remains an area of continuing attention.

Structural reforms

In addition to tax reforms aimed at broadening the income tax base and reducing rates, major steps were also taken in other areas such as strengthening the legal framework for investor protection. The authorities' reform agenda has attached importance to the financial sector, including strenuous efforts to improve competition and supervision, which have played a crucial role in improving efficiency and maintaining the soundness of the sector. The banking system continued to strengthen, as banks have not only maintained their ranking among the top half in a group of 44 emerging market countries in terms of indicators of capital adequacy and asset quality, but have moved to near the top of the ranking in terms of profitability from a position near the bottom in 2001. The authorities will focus on encouraging higher return on deposits to promote financial savings. Staff have stressed that new issues of long-term government securities—e.g., Pakistani Investment Bonds (PIBs)—were essential for the development of a local bond market, and have encouraged the authorities to substantially increase reliance on this means of deficit financing during 2006/07. On October 13, 2006, government raised Rs. 15.03 billion through the placement of 3,5,10,15 and 20 year PIBs at weighted average yields of 9.78 percent, 9.93 percent, 10.39 percent, 10.85 percent and 11.17 percent, respectively. The sale of the Karachi Electric Supply Company and the partial sale and transfer of management control of Pakistan Telecommunication Company Limited were instrumental in revitalizing the privatization process.

Exchange rate

The SBP is committed to exchange rate flexibility, and intervention in the foreign exchange market is limited to preventing excess volatility; a flexible exchange rate regime has been in effect since May 19, 1999. The current level of the real exchange rate is broadly appropriate: the real exchange rate was significantly more depreciated than its level during the 1990s. Regarding the staff's classification of Pakistan's exchange rate regime as a conventional peg, the methodology used is essentially centered on the variability of the nominal exchange rate, and gives very little weight to other considerations such as foreign exchange intervention and judgmental elements. The authorities have noted that the movement of the exchange rate within a narrow band, particularly when this is due to effective policy measures, should not be treated at par with the exchange rate regime that has been classified as de jure (announced) peg. In the recent Board meeting on review of exchange rate arrangements, several chairs had stressed that greater exchange rate stability per se is not sufficient evidence of less flexibility in the exchange rate regime, since it may just as well reflect a different pattern of shocks to the foreign exchange market. In particular, a country that experiences a decrease in the intensity and number of shocks (e.g., terms of trade, cost of borrowing, policy induced) could easily see a stable exchange rate over a 12-month period. A country should not be encouraged to have a greater fluctuation in the exchange rate so that it may be categorized as following a de facto floating exchange rate regime. As regards the intervention in the interbank foreign exchange market, especially in providing support to meet lumpy payments for petroleum imports, the authorities have pointed out that a recent study done at the SBP has shown that the effects of intervention on dampening volatility of the exchange rate are more pronounced compared to the effects on the level of the exchange rate.

Payments restriction

Regarding the 50 percent limit on advance payments for some imports, the authorities have pointed out that payments of over 50 percent are not prohibited but require SBP’s approval and that genuine requests receive blanket approval to effect 100 percent advance payment. They note that 50 percent advance payment against some imports is an adjustment in the mode of payment, which is aimed at curbing speculative activity in the market. It has no effect on meeting the genuine needs of businesses and does not impede any bona fide transactions. Also, importers have been given blanket approvals to effect 100 percent advance payment where it was either a supplier’s requirement or global corporate policies, which necessitated such settlements with companies. Staff agree that the regulation states that requests shall be considered for approval by the SBP on the basis of evidence of the bona fide nature of the underlying transaction and a bank guarantee, and all bona fide transactions have been allowed. However, there is an exchange restriction that could be removed by clarifying the regulations. It is a restriction only insofar as the authorities have not yet issued the circular that would clarify that despite the various limits on advance import payments, foreign exchange will be provided without limitations for advance import payments upon verification of the bona fide nature of the underlying transactions. In short, there is no payment restriction in the sense of having any real world effects, that is, affecting current account transactions in a material way that would classify as a payment restriction. This is entirely a legal issue, with no economic effects, and the authorities are looking into the exact wording of the regulation that would lead to the removal of this restriction.

Poverty reduction

Estimates based on the recent Household Integrated Economic Survey (HIES) show that the share of Pakistan's population living below the poverty line (poverty headcount ratio) declined by over 10 percentage points from 2000/01 to 2004/05. Two other key measures of poverty incidence (the poverty gap and severity of poverty) also showed improvement during the last four years. Despite this impressive outturn, the authorities are deeply concerned that nearly one quarter of Pakistan's population lives below the poverty line. They have reiterated their commitment to make further inroads in this top priority item, and are determined to increase spending in health and education because that is a sine qua non for achieving the Millennium Development Goals.

Investment climate, anti-money laundering, and trade policy

The overall business climate and governance in key macroeconomic institutions have clearly improved, as attested by the data on fiscal transparency and Doing Business survey of the World Bank. Notwithstanding this progress, the authorities have stressed that they are determined to create an environment conducive to investment and improving governance in all public institutions. Priorities in this area will be to bolster reforms to increase efficiency, transparency, and accountability in the use of public resources. The anti-money laundering/combating the financing of terrorism (AML/CFT) framework has been strengthened. In July 2006, the SBP issued prudential regulations recommended by the Financial Action Task Force. In addition, an AML/CFT unit has been established in the SBP under the direct supervision of the Governor. On trade policy, the authorities would like to give the assurance that the progress in bilateral and regional trade agreements has not compromised Pakistan's commitment to maintaining a liberal trade regime and to contribute to multilateral trade negotiations, including their support for a successful Doha round of trade talks.

Medium-term outlook

The authorities and staff are in broad agreement on the medium-term path for the external current account deficit, the prospects for external financing, and the targets for international reserves. Staff have noted that the external current account deficit has reached relatively high levels and a further widening could compromise external sustainability. The authorities recognize that the medium-term outlook is subject to various risks, but they note the country's increased attractiveness to foreign investors has led to a notable rise in the supply of non-debt-creating capital flows, as well as relatively low spreads and long maturities in the recent borrowings from international and regional capital markets. The authorities anticipate that growth would be somewhat higher than assumed by staff, mainly due to the rapid increases in foreign direct investment and domestic private investment. The growth in national savings would outpace the increase in domestic investment, both on account of a gradual rise of real return to financial savings (as a result of the lower inflation), as well as a decline in the fiscal deficit below 3 percent of GDP over the medium term. The Fiscal Responsibility Law will serve as a key anchor for sound macroeconomic policies, and the authorities are resolute in their focus on fiscal and external sustainability, including an ambitious program to increase domestic revenue.

The authorities value highly their close relationship with the Fund, gratefully acknowledge the support they have received over the years from the Board, management, and staff and look forward to the Board discussion.