January 2008
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Pakistan: 2007 Article IV Consultation—Staff Report; Staff Statement; 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 Article IV consultation with Pakistan, the following documents have been released and are included in this package:

- the staff report for the 2007 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on September 20, 2007, 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 8, 2007. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff statement of December 17, 2007 updating information on recent developments.

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its December 17, 2007 discussion of the staff report that concluded the Article IV consultation.

- 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 2007 Article IV Consultation

Prepared by the Staff Representatives for the 2007 Consultation with Pakistan

Approved by Amor Tahari and Adnan Mazarei

November 8, 2007

- Discussions for the 2007 Article IV consultation were held in Islamabad and Karachi during September 7–20, and continued in Washington D.C. during October 19–20. The team comprised Messrs. Di Tata (head), Bartsch, Bonato and Ms. George (all MCD), and Mr. Sun (PDR). The mission was assisted by Mr. Lorie (Senior Resident Representative). Mr. Khan (MCD) 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 Waqar, 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/2007/pr07205.htm).

- The last Article IV consultation was concluded on November 22, 2006. Directors' comments may be found at http://www.imf.org/external/np/sec/pn/2006/pn06139.htm.

- Pakistan has accepted the obligations of Article VIII. The exchange rate regime has been classified as a de facto conventional peg since 2005. Pakistan has participated in the GDDS since 2003. At end-September 2007, total Fund credit and loans outstanding to Pakistan amounted to SDR 922.0 million (89.2 percent of quota).

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Executive Summary

Economic developments in Pakistan in fiscal year 2006/07 were generally good, but the external current account deficit widened. Real GDP growth increased to 7 percent, the debt-to-GDP ratio continued to decline, and gross international reserves rose to US$14.3 billion (4½ months of imports). Average inflation, however, remained relatively high at close to 8 percent. Notwithstanding a significant decline in import growth, the current account deficit widened to 4.9 percent of GDP, owing mainly to significantly slower export growth. The deficit was more than covered, however, by record-high capital inflows, including foreign direct investment. Political uncertainties continue in light of the government's recent declaration of a state of emergency and questions about the timing of parliamentary elections. The authorities were of the view that the reforms and institutional changes introduced in recent years would be maintained by the government that will be elected by the new parliament, regardless of its political orientation.

The discussions focused on the prospects for 2007/08 and the policies needed to reduce the current account deficit to a more sustainable level over the medium term. The authorities' economic program for the current fiscal year envisages a reduction in the fiscal deficit to 4 percent of GDP, from 4.3 percent in 2006/07. A recent tightening of monetary conditions is expected to lead to slower broad money growth, with average inflation targeted to decline to 6½ percent.

Although the outlook for 2007/08 remains favorable, the authorities' policies may not be sufficient to achieve their inflation target and reduce the external current account deficit significantly. Real GDP growth is projected by the staff at 6½–7 percent in 2007/08. Capital inflows would more than cover the current account deficit, but there are risks that some inflows could be delayed. Against this background, the staff recommended a stronger fiscal adjustment effort accompanied by a somewhat tighter monetary stance and greater exchange rate flexibility. The authorities considered it very difficult to implement a greater fiscal effort given the political calendar, and thought that exchange rate stability was important at this juncture to maintain confidence. Although they saw no need to increase interest rates in the immediate future, they said that rates would be kept under review to ensure that their objective of reducing net central bank credit to the government was met.

Looking beyond 2007/08, the authorities agreed with the staff on the need to reduce the external current account deficit gradually to about 3½ percent of GDP over the medium term. There were some differences of view, however, with respect to the fiscal effort necessary to achieve this objective. Although the authorities recognized the importance of strengthening revenue mobilization, they envisaged a less ambitious effort than the staff.

Discussions on structural issues focused on reforms to deepen domestic financial markets, public financial management and fiscal reporting, and trade issues.

I. Introduction

1. **Pakistan has experienced a remarkable turnaround in its economic performance since 2001/02.** Sound macroeconomic management and wide-ranging structural reforms have contributed to high real GDP growth, a reduction in the debt burden, and an improved business climate, while implementation of pro-poor policies has helped lower poverty rates. Increasingly, foreign direct investment (FDI) and portfolio flows have become an important source of external financing. Looking ahead, the key challenge is to maintain the growth momentum, while addressing external vulnerabilities and further reducing inflation.

2. **Political uncertainties are likely to continue until after the upcoming parliamentary elections.** On October 6, 2007, President Musharraf was elected for a second five-year term by parliamentary majority. On November 3, he declared a state of emergency. Parliamentary elections were expected to take place in January 2008, but there are uncertainties about their timing. A caretaker government will be put in place two months before the elections, and a new government will be formed from the members of the new parliament. After increasing in July 2007 owing to political factors and turmoil in the international financial markets, the EMBIG spread for Pakistani debt fell to 370 basis points by end-October, before rising again in early November following the declaration of the state of emergency. The Karachi stock market reached new all-time highs in October, but fell significantly in early November. The exchange rate and foreign reserves have remained stable.

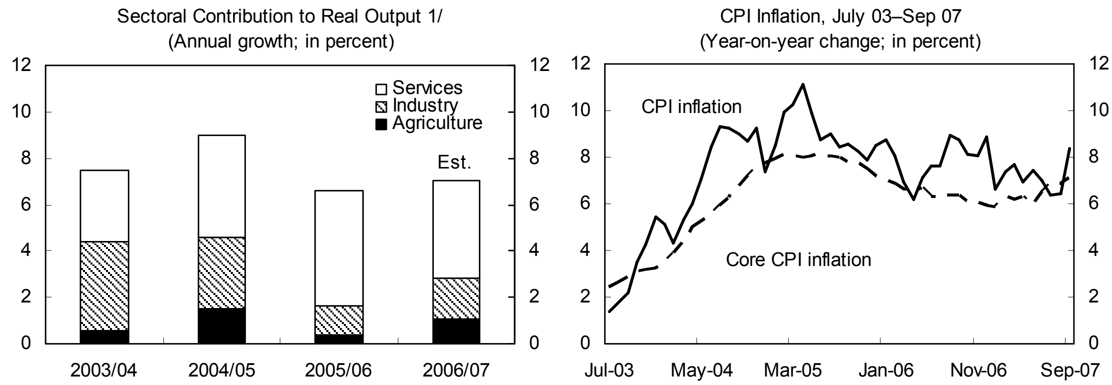
3. **The implementation of recent Fund advice on macroeconomic policies and structural reforms has been mixed.** The macroeconomic policy stance in recent years has generally been more expansionary than recommended by staff. As a result, the current account deficit has widened and progress in reducing inflation has been limited. At the same time, high foreign exchange inflows have allowed the central bank to greatly improve the import coverage of reserves. In addition, in line with staff recommendations, the State Bank of Pakistan (SBP) ceased lending to the government in 2006/07. Tax revenues have risen owing to the buoyant economic activity and improvements in tax administration, but little progress has been made in broadening the tax base. While direct privatizations stalled in 2006/07, the government has been able to sell part of its shares in some entities through the issuance of Global Depository Receipts (GDRs).

II. Recent Economic Developments

4. **Economic conditions in 2006/07 (fiscal year ends June 30) remained favorable.**

- Real GDP growth accelerated to 7 percent, from 6½ percent in 2005/06, with a recovery in agriculture and a strong performance of large-scale manufacturing and services.

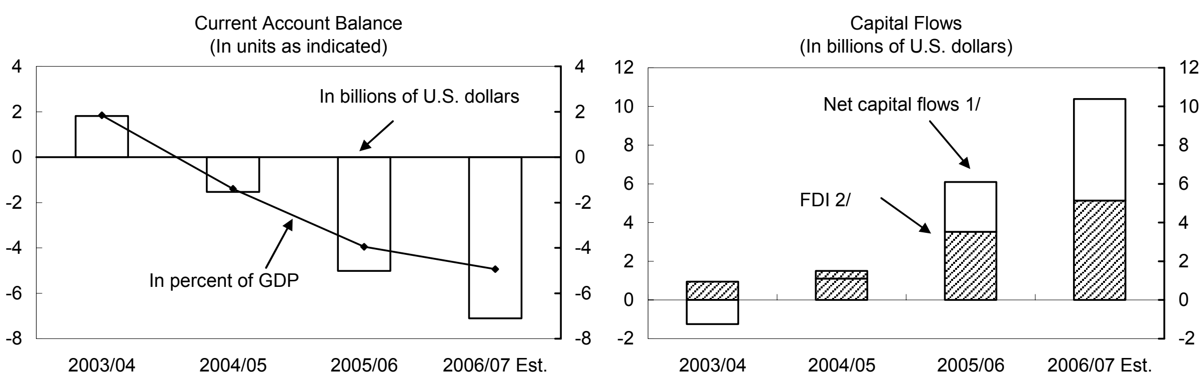
- The disinflation process slowed, however, with average inflation persisting near 8 percent and core inflation at 6¼ percent, both largely unchanged from the previous year (Table 1). Average inflation was 7.1 percent in the first quarter of 2007/08.



Sources: Pakistani authorities; and Fund staff estimates.
1/ At factor cost.

5. **Strong capital inflows led to a surplus in the overall balance of payments, but the current account deficit widened for the third consecutive year.**

- The growth of exports and private transfers slowed in 2006/07, offsetting a significant decline in import growth in response to a deceleration in credit to the private sector. As a result, the current account deficit reached 4.9 percent of GDP (US$7 billion), one percentage point higher than in 2005/06.

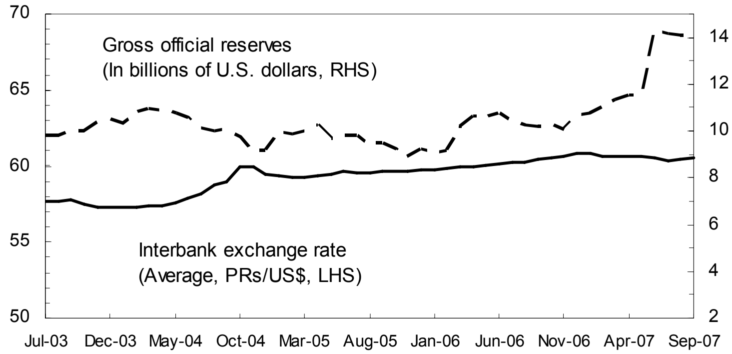


Sources: Pakistani authorities; and Fund staff estimates.
1/ Defined as the overall balance minus the current account balance. Total net capital flows in 2003/04 and 2004/05 were lower than foreign direct investment (FDI) flows.
2/ Includes privatization.

- A surge in FDI flows (excluding privatization proceeds) and portfolio inflows resulted in a record-high surplus in the financial account. The government raised US$2 billion at favorable terms from Eurobonds and from GDRs against its holdings in the Oil and Gas Development Corporation (OGDC) and United Bank (Box 1).

- Overall, gross official reserves increased by US$3.5 billion to US$14.3 billion by end-June 2007,[1] with the import cover ratio improving to 4½ months of next year's imports of goods and services (Table 2).
- The rupee continued to fluctuate within a narrow band against the U.S. dollar, and the real effective exchange rate remained broadly stable.

Exchange Rate and Gross Official Reserves, July 03–September 07
(In units as indicated)

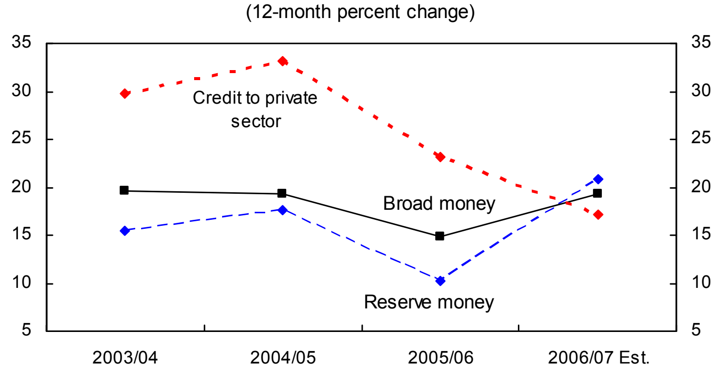


Sources: Pakistani authorities; and Fund staff estimates.

6. **Monetary growth increased in 2006/07, but central bank's net lending to the government ceased.**

- Reserve money growth doubled to 21 percent, driven by the accumulation of net international reserves and lending to commercial banks for subsidized credit to the textile industry.

Growth in Monetary Aggregates
(12-month percent change)



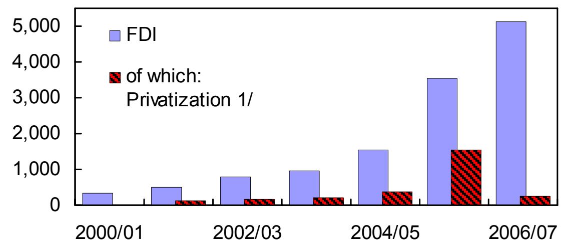
Sources: Pakistani authorities; and Fund staff estimates.

[1] This amount includes US$970 million contained in a sinking fund established in May 2007.

Box 1. The Boom in Foreign Direct Investment

Pakistan has experienced a surge in FDI inflows, which have increased more than tenfold in the last six years, reaching well above US$5 billion in 2006/07 (Figure 1). This development reflects improved macroeconomic stability as well as significant progress in liberalization and investor protection.

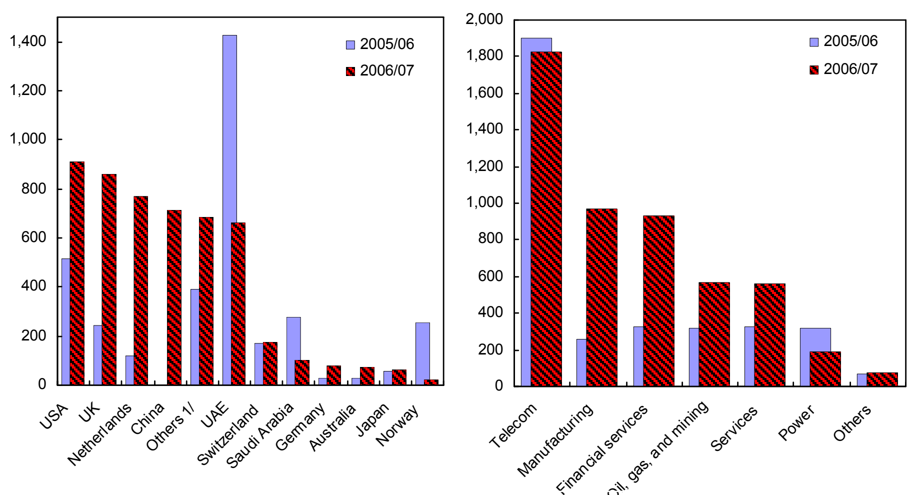
Figure 1. FDI Inflows to Pakistan, 2000/01–2006/07
(In millions of U.S. dollars)



Source: Pakistani authorities.
1/ Data for 2006/07 do not include the proceeds from the sale of shares in OGDC and UBL (about US$1,300 million), effected through placements of Global Depository Receipts.

Part of the FDI inflows are related to the privatization of key state-owned companies, which have attracted interest from strategic investors. Greenfield investment, however, is by far the most important component. The geographic origin of the FDI inflows reflects a broad interest, with countries like the U.S., the U.K., the Netherlands, China, and the U.A.E. playing an important role (Figure 2). In the last two years, most of the FDI has been directed to the telecom sector, manufacturing, and financial services.

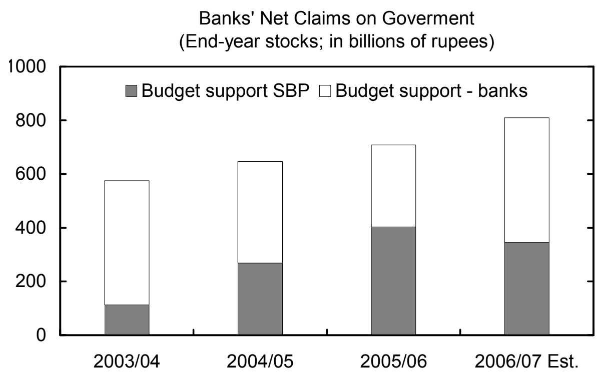
Figure 2. Pakistan, FDI by Country and by Sector, 2005/06–2006/07
(In millions of U.S. dollars)

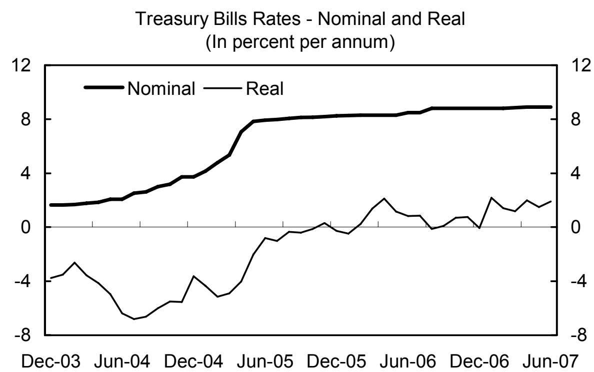


Source: Pakistani authorities.
1/ Includes Hong Kong, Luxembourg, Singapore, Canada, France, Korea, and others.

Progress in structural reforms has been instrumental in these developments. Regulatory impediments have been relaxed significantly. With the recent amendments to the Foreign Private Investment Promotion and Protection Act, the possibility of acquiring full ownership and repatriate profits has been extended to foreign investors in all economic sectors, with some exceptions remaining for agriculture and services. Administrative procedures and red tape have been streamlined and more flexibility has been introduced in working hours, improving the business climate.

- Broad money growth picked up to 19 percent, from 15 percent in 2005/06, and interest rates remained broadly unchanged.
- The SBP was able to offload some of its holdings of treasury bills to the commercial banks for the first time in four years, without raising the cutoff rates for government paper at the biweekly auctions. The corresponding pickup in the commercial banks' credit to government offset a deceleration in credit to the private sector to 17 percent, from 23 percent a year earlier (Table 3).

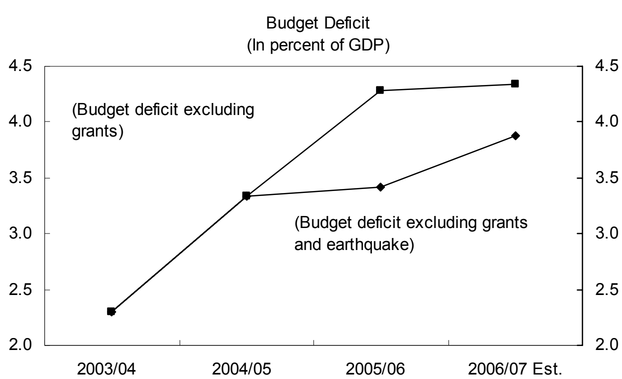


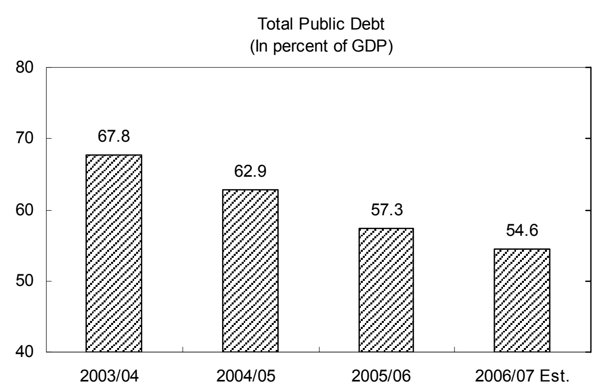


Sources: Pakistani authorities; and Fund staff estimates.

7. **The fiscal stance was kept broadly unchanged.**

- The fiscal deficit (excluding grants) is estimated to have remained unchanged at 4.3 percent of GDP in 2006/07, broadly in line with the budget target.
- Current expenditure overruns—the largest stemming from a bullet interest payment on a maturing obligation that had not been foreseen in the budget—were fully offset by a strong performance of revenues (especially nontax) and underspending on investment projects.





Sources: Pakistani authorities; and Fund staff estimates.

- The deficit was financed in roughly equal shares from external and domestic sources; lower-than-envisaged external financing led to a pickup in domestic borrowing—mainly from commercial banks—relative to 2005/06 (Tables 4a and 4b).
- The public debt ratio declined by almost 3 percentage points to 54.6 percent of GDP, reflecting favorable debt dynamics.

8. **Progress on privatization and other structural reforms was mixed.**

- Privatization stalled after the Supreme Court annulled the sale of Pakistan Steel Mills in June 2006 owing to procedural problems, but placements of GDRs went ahead as planned.
- Electricity tariffs were adjusted by 10 percent in February 2007 for the first time in almost two years, unlocking World Bank loans and preparing the ground for greater private participation in electricity generation.
- In the financial sector, the regulations regarding the broker financing of share trades were strengthened, but the main features of the "Badla" system of stock trade financing remain in place.[2]
- In September 2007, the central bank issued a circular removing a remaining exchange restriction in the form of a 50 percent limit on advance payments for some imports.
- The authorities have been working on their second PRSP, which is expected to be completed by the spring of 2008.

III. The Government's Economic Program for 2007/08

9. **The authorities' economic program for 2007/08** envisages an increase in real GDP growth to 7.2 percent; and an average annual inflation target of 6.5 percent. A Private Sector Development Strategy is being prepared focusing on productivity, innovation and growth. As part of this strategy, the government plans to emphasize public-private partnerships in order to increase investment in key sectors.

10. **The budget deficit target (excluding grants) for 2007/08 has been set at 4 percent of GDP, slightly below last year's outcome.** Buoyancy of tax revenue, together with tight control of current expenditure, is expected to create room for raising capital expenditure to above 5 percent of GDP in 2007/08.

11. **Monetary policy has been tightened.** The authorities target a decline in broad money growth to 13.7 percent in 2007/08, with credit growth to the private sector remaining

[2] "Badla" is a modality for financing share purchases extended by brokerages and banks, which allows buyers to obtain highly leveraged positions in the market.

at about 17 percent. In its Monetary Policy Statement (MPS) for the period July–December 2007, released in late July, the SBP announced a package of measures that, overall, supports a tightening of the monetary stance. The package includes:

- An increase in the discount rate from 9½ percent to 10 percent.
- A reduction in the stock of subsidized SBP credit to the textile industry and exporters, together with the requirement that commercial banks contribute 30 percent of their own funds to any new loans to those sectors.
- The opening of a new facility for long-term financing of industrial development projects.
- The recommendation that during 2007/08 the government retire PRs 62 billion of its holdings of treasury bills currently in the SBP's balance sheet (PRs 250 billion), adopt quarterly ceilings on new borrowing, and issue more long-term debt.[3]

IV. Report on the Discussions

12. **The consultation discussions focused on the policy adjustments needed to lower the external current account deficit and reduce the associated vulnerabilities,** particularly in light of the uncertainties associated with the domestic political transition and current conditions in global financial markets. On the structural front, the focus was on key reforms to sustain high growth and employment creation, and continue reducing poverty over the medium term. As a general point, the authorities were of the view that the important reforms and institutional changes introduced in recent years would be maintained by the new government, regardless of its political orientation.

13. **The authorities recognized the need to lower the external current account deficit gradually over the medium term,** but indicated that the room to further tighten macroeconomic policies in 2007/08 was very limited, in light of the political calendar. There were also some differences of view with respect to the required medium-term fiscal adjustment, with the authorities envisaging a less ambitious revenue effort than the staff.

A. Economic Outlook and Policies for 2007/08

14. **Real GDP growth should remain strong in 2007/08, and the authorities are confident that external flows, including FDI, will continue at relatively high levels.** In response to slower aggregate demand growth, staff believes that output growth will be in the range of 6½–7 percent. The surplus in the financial account of the balance of payments would remain high at about US$10 billion, as a decline in FDI flows relative to the previous

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[3] Other measures announced in the MPS include: lowering (from 3 percent to 0 percent) the reserve requirements on time deposits, and allowing Islamic banks to use cash and deposits with the National Bank of Pakistan to meet liquidity requirements.

year would be largely offset by higher disbursements of multilateral and bilateral assistance and larger proceeds from GDRs, including from the sale of shares in OGDC and the National Bank of Pakistan.

15. **However, the authorities' policy stance, if not strengthened, may fall short of achieving a significant reduction in the external current account deficit and inflation.** The recent tightening of monetary policy and the projected reduction in the fiscal deficit to 4 percent of GDP may not rein in aggregate demand sufficiently to significantly reduce the external current account deficit and achieve the authorities' inflation target of 6½ percent. The external current account deficit is projected to decline slightly to 4.8 percent of GDP in 2007/08. Following the slowdown in 2006/07, export growth is expected to register a moderate recovery, while import growth could slow to about 7 percent. With the high projected surplus in the financial account, the gross international reserves of the SBP are projected to increase further by US$1.9 billion, to near US$16.2 billion (4.8 months of next year's imports of goods and services) by year's end.

16. **There are, however, significant risks that some capital inflows could be delayed until the second half of the year or the following fiscal year.** The overall external financing envelope for 2007/08 could turn out lower than expected if the current global market conditions and domestic political uncertainties persist. Moreover, a large portion of the proceeds from GDRs and a possible placement in the Eurobond market are likely to take place in the second half of the fiscal year, which could force the government to resort to significant domestic financing in the coming months. Even assuming that the external financing envisaged for 2007/08 as a whole materializes, the government's domestic borrowing requirement would be in the order of PRs 150 billion (1½ percent of GDP) in 2007/08, only slightly lower than last year.

17. **Against this background, the staff called for an additional fiscal effort of at least 0.3 percent of GDP in 2007/08, but the authorities considered it very difficult to implement a tighter fiscal policy.** The authorities indicated, however, that some factors could lead to an overperformance on the budget deficit target. In particular, they cited capacity constraints to implement the budgeted increase in capital spending, and pointed out that the transition government would not be able to disburse funds for new projects during the period preceding the parliamentary elections. Given that the sources of external financing are likely to be limited in the first half of the fiscal year, the authorities agreed on the need to restrain expenditures in the coming months and indicated that they would seek to accelerate disbursements of multilateral assistance. They also intend to increase reliance on long-term instruments (Pakistan Investment Bonds (PIBs)) to cover the government's domestic borrowing requirement in 2007/08, which would help lengthen the maturity of government debt and deepen the securities market.

18. **In light of prevailing uncertainties about money demand, a somewhat lower money growth target, supported by further fiscal adjustment, would enhance the**

possibility of lowering average inflation toward the target of 6½ percent.[4] The authorities recognized that it would be difficult to achieve the targeted reduction in average inflation, particularly in view of significant recent pressures on food prices (including wheat) driven by global market developments. They were of the view, however, that reducing the broad money growth target below 13.7 percent could have a negative impact on growth. At the same time, the authorities agreed with the staff that the decision to reduce SBP's net credit to the government required that interest rates on treasury bills and other government paper be sufficiently flexible to ensure that the government's domestic borrowing requirement is covered entirely by commercial bank or nonbank sources. In this regard, although they saw no need for a further increase in the cut-off rates at treasury bill auctions in the immediate future, they indicated that interest rates would be kept under constant review during the year.

19. **Pakistan's de facto exchange system has remained a conventional peg.** Staff called for greater exchange rate flexibility to enhance the effectiveness of monetary policy and facilitate the policy response in case of shocks. The authorities argued that exchange rate stability was important at this juncture to promote confidence and encourage capital inflows. They noted, however, that they would continue reducing the SBP's direct provision of foreign exchange to oil importers by shifting it gradually to the interbank market, in order to enhance the determination of the exchange rate by market forces.

20. **The authorities considered the level of the real exchange rate as broadly appropriate; this view is confirmed by the staff's exchange rate assessment (Box 2).** The authorities pointed to the recent stability of the real effective exchange rate owing to the depreciation of the U.S. dollar vis-à-vis major currencies and the appreciation of the currencies of some of Pakistan's main competitors, such as India and China. They were confident that the implementation of reforms aimed at enhancing the economy's productivity (including through the development of infrastructure and human capital), the establishment of export processing zones and industrial zones, and continued high levels of FDI would contribute to strengthening Pakistan's export potential in the coming years. In particular, the authorities thought that, following a period of mergers and consolidation and with a more level playing field among regional competitors, the medium-term prospects for the textile industry were favorable. They also indicated that some new export sectors, such as cement, marble and jewelry, were already experiencing very high growth rates, albeit from a relatively low base.

B. The Medium-Term Outlook

21. **Looking beyond 2007/08, the staff prepared a medium-term scenario consistent with reducing the current account deficit to 3½ percent of GDP by 2011/12.** Under the

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[4] Notwithstanding the de facto peg to the U.S. dollar, the limited degree of capital mobility prevailing in Pakistan continues to allow monetary policy to have some effectiveness in influencing domestic demand.

Box 2. External Competitiveness and Exchange Rate Assessment

Pakistan's export performance in recent years compares favorably to most of its competitors. Although growth has moderated recently after a strong performance in the late 1990s, Pakistan's average export value growth since 2000, at around 12 percent a year, is above that of most of its competitors, except China and Sri Lanka. Pakistan's market share in world exports has remained broadly stable. Because of the large capital inflows (mainly FDI), market pressures have been towards a nominal appreciation of the rupee.

Growth in Merchandise Export Value, Regional Comparison
(In percent)

	Average 2000–06 1/
Pakistan	12.0
Bangladesh	11.4
China	18.9
India	6.3
Sri Lanka	19.5
Other Asian competitors 2/	10.8

Sources: World Economic Outlook; and Fund staff calculations.

1/ Annual growth rate up to June 2007 for Pakistan and up to December 2006 for the others.

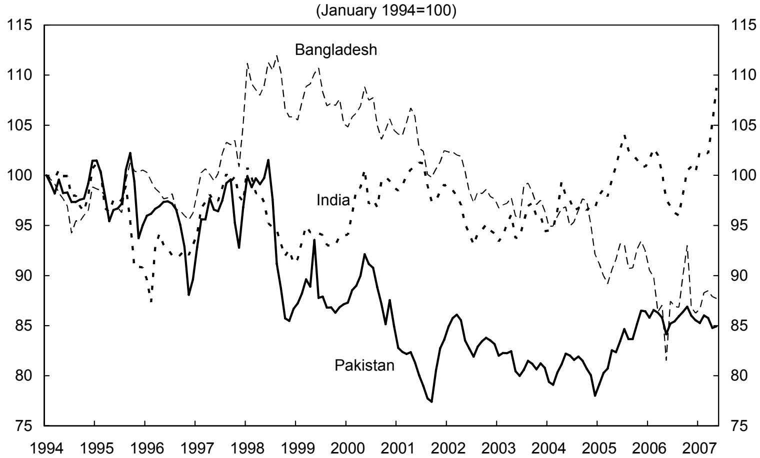
2/ Includes Cambodia, Hong Kong SAR, Indonesia, and Vietnam.

The real effective exchange rate (REER) remained stable in 2006/07. Focusing on the current account of the balance of payments, the staff's REER estimates suggest only a slight overvaluation.[1/] Estimates based on the *equilibrium real exchange rate* approach suggest that the rupee is 6 percent more appreciated than its equilibrium level. The *external sustainability* approach suggests that the real effective exchange rate is 9 percent more appreciated than the value that would be consistent with the current account balance that stabilizes the net foreign liabilities to GDP ratio at its 2006 level.

Estimates obtained from the *macroeconomic balance (MB)* approach, in turn, suggest that the REER is consistent with its equilibrium value in the staff's medium-term scenario (paragraphs 21 and 22). In that scenario, Pakistan's current account deficit would narrow to about 3½ percent of GDP by 2011/12, in line with the equilibrium current account balance ("norm") implied by Pakistan's fundamentals (a deficit of 3.4 percent of GDP). Staff has also prepared estimates under the *MB* approach based on current policies. In this case, the fiscal deficit for 2007/08, stripped of earthquake-related expenditures and a large interest bullet payment, was calculated at below 2½ percent of GDP. Maintaining this fiscal deficit over the medium term is estimated to correspond to an underlying external current account deficit of 3.8 percent of GDP, which would imply an overvaluation of less than 2 percent calculated against a current account "norm" (a deficit of 3.5 percent of GDP) estimated on the basis of current policies. Taking into account the statistical margins of error, the estimates under the three methodologies suggest that Pakistan's real effective exchange rate is broadly in line with its equilibrium level.

[1/] The methodologies are described in "Methodology for CGER Exchange Rate Assessments" (http://www.imf.org/external/np/pp/eng/2006/110806.pdf)

Real Effective Exchange Rates
(January 1994=100)



Source: IMF, Information Notice System.

staff's scenario, real GDP growth is assumed to average 6½–7 percent a year over the medium term, while inflation is projected to decline gradually to 4½ percent by 2011/12, in response to the maintenance of a tight monetary policy supported by fiscal adjustment (text table and Tables 5 and 6). The staff's scenario envisages the implementation of a stronger fiscal effort, starting in 2007/08. As a result, the fiscal deficit (excluding grants) is projected to decline gradually from 3.7 percent of GDP in 2007/08 (compared with 4 percent in the current budget) to about 2 percent in 2011/12, with the primary surplus increasing from 0.3 percent of GDP to 0.6 percent over the same period.[5] Given the need to increase government spending in infrastructure and the social sectors, the scenario incorporates a strong effort to increase the tax-to-GDP ratio by more than 2½ percentage points of GDP during 2007/08–20011/12. To achieve this objective, measures to be considered include fully taxing services under the GST, broadening the income tax to cover commercial agriculture and capital gains, and a vigorous effort to reduce tax exemptions. Debt sustainability analyses (and the associated bound tests) corresponding to the staff's scenario are presented in Tables 7 and 8, and Figures 1 and 2, respectively.

22. **The authorities agreed on the need to reduce the external current account deficit to a more sustainable level of 3½ percent of GDP by 2011/12.** They believe, however, that this objective could be achieved by relying on a less ambitious improvement of the fiscal position, to a deficit of about 3 percent of GDP by 2011/12. The authorities stressed the importance of increasing spending on infrastructure and education, but indicated that it would be very difficult to strengthen tax revenue by more than 1½ percentage points of GDP over the next five years. The staff noted that achieving the same medium-term current account objective by relying on a less ambitious fiscal effort was likely to require higher real interest rates than in the staff's scenario, in order to narrow the gap between private investment and savings. A stronger fiscal effort would also contribute to limiting pressures on the real exchange rate and improving external competitiveness.

23. **In the years ahead, Pakistan will continue to depend heavily on the availability of large capital inflows to finance its current account deficit and further strengthen its international reserves position.** The authorities indicated that they would rely primarily on active demand management policies, particularly monetary policy, to address potential financing shortfalls and protect international reserves.

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[5] Primary balance excluding grants.

Medium-Term Macroeconomic Framework, 2005/06–2011/12

		Est.	Proj.				
	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12
	(In percent of GDP)						
Saving and investment							
Current account balance	-3.9	-4.9	-4.6	-4.4	-4.1	-3.8	-3.5
Gross national saving	17.7	18.0	19.2	20.3	20.8	21.3	21.9
Gross capital formation	21.7	23.0	23.8	24.7	24.9	25.1	25.4
	(In billions of U.S. dollars, unless otherwise indicated)						
Balance of payments							
Current account balance	-5.0	-7.1	-7.4	-7.8	-8.0	-8.0	-8.0
Net capital flows, *of which:* 1/	6.3	10.8	9.6	9.1	9.3	9.4	9.4
Foreign direct investment 2/	3.5	5.1	4.5	5.5	5.5	5.2	5.0
Unidentified financing	0.5	0.9	0.6	0.5	0.3	0.6	1.3
Gross official reserves	10.8	14.3	16.2	17.2	18.2	19.2	20.2
In months of imports 3/	3.7	4.6	4.8	4.7	4.7	4.5	4.2
External debt (in percent of GDP)	28.1	26.1	24.4	23.3	22.4	21.3	20.2
	(In percent of GDP)						
Public finances							
Revenue and grants	14.8	15.2	16.0	16.5	16.8	17.1	17.6
Expenditure 4/	17.6	18.8	19.1	18.8	19.0	19.2	19.4
Overall fiscal balance, including grants 4/	-3.7	-4.0	-3.4	-2.3	-2.2	-2.0	-1.8
Overall fiscal balance, excluding grants 4/	-4.3	-4.3	-3.7	-2.7	-2.4	-2.3	-2.0
Primary balance, excluding grants 4/	-1.2	-0.1	0.3	0.5	0.5	0.5	0.6
	(Annual changes in percent)						
Output and prices							
Real GDP at factor cost	6.6	7.0	6.3	6.7	6.8	6.9	7.0
Consumer prices (period average)	7.9	7.8	6.5	6.0	5.5	5.0	4.5

Sources: Tables 5–8.

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 12).
4/ Including earthquake-related expenditures.

C. Key Structural Reforms

24. **Discussions on structural issues focused on four areas of critical importance to increase savings and investment and sustain growth and poverty reduction:**

25. **Deepening domestic financial markets**

- The authorities pointed to the continued strong profitability and financial soundness of the banking system (Tables 9 and 10). They argued that the system had strengthened further over the last year owing to increases in minimum paid-up capital requirements and FDI. The authorities attributed the high spreads between lending and deposit rates to limited competition among the major banks, but pointed out that competition would increase as new financial institutions seek to increase their market share.

- Progress has been made in modernizing the Central Directorate of Savings (CDNS), and the authorities intend to complete the corporatization and computerization of CDNS operations by the end of the current fiscal year. Looking ahead, it would be important that the new entity to be established (Pakistan Savings) have greater autonomy in managing human resources and determining the interest rates on its instruments, in order to better integrate the National Savings Schemes with domestic financial markets.

26. **Increasing government revenues.** Pakistan's tax revenue-to-GDP ratio, at 11 percent of GDP in 2006/07, is still relatively low, which limits the resources available for infrastructure and poverty alleviation. The Central Bureau of Revenue (CBR) has improved tax administration significantly in recent years, and its imminent transformation into an autonomous body (Federal Bureau of Revenue (FBR)) would contribute to further increasing its efficiency and strengthening tax audits. Notwithstanding this progress, however, substantive tax policy measures are needed to broaden the tax base. The authorities recognized that expanding taxation of the agricultural and service sectors and eliminating nonstandard exemptions could greatly enhance revenue collection, but underscored the need to proceed gradually in this area, taking into account political considerations.

27. **Strengthening financial reporting and public financial management**

- Limited progress has been made in financial reporting, an area of critical importance to enhancing the transparency of the budget and its usefulness as a tool for economic policy making. In particular, a long-standing problem of double-counting of spending at the provincial and local government levels has not yet been resolved. Work is under way to produce a new chart of fiscal accounts with World Bank assistance, which would allow an economic classification of budget line items.
- The authorities indicated their intention to implement a number of recommendations made by a recent FAD technical assistance mission on budget formulation, cash planning, and management.

28. **Trade liberalization.** Pakistan has made substantial progress in reducing import protection in recent years, and its simple average tariff rate is estimated at around 14.3 percent in 2006. The authorities indicated that they plan to rationalize and further reduce tariffs over the medium term. Presently, the government's main efforts are concentrated in expanding market access by concluding bilateral preferential trade agreements with Pakistan's major trading partners, including duty free entry into the United States for products produced in Reconstruction Opportunities Zones and negotiations to facilitate preferential access to the European Union. In addition, an FTA with China to be implemented gradually in two phases came into effect, with the first phase of tariff reductions starting in July 2007. Pakistan is also actively participating in the Doha round of multilateral trade negotiations.

D. Other Issues

29. **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.** The authorities pointed to progress in their efforts to subscribe to the Fund's Special Data Dissemination System (SDDS). In particular, work is ongoing on producing quarterly national accounts, which would be completed with a rebasing of the national accounts to the year 2005/06. In addition, a recent update of the Report on the Observance of Standards and Codes (ROSC) published in February 2007 identified significant improvements in the monetary statistics.

30. **In September 2007, an ordinance was promulgated by President Musharraf enacting regulations for anti-money laundering and financing of terrorism (AML/CFT).** The ordinance reflects substantially the terms of the AML bill, which is currently in parliament. While the promulgation of the ordinance is a positive development, this remains a temporary measure which will lapse after four months, unless it is reissued. The authorities are currently working on making the Financial Monitoring Unit (FMU) established by the SBP in June 2007 fully operational, and clarifying outstanding issues regarding reporting and accountability of the FMU.

31. The authorities indicated that they have continued to work on finding a satisfactory resolution to outstanding debt obligations with Russia.

V. Staff Appraisal

32. **Pakistan's economy continued to perform strongly in 2006/07.** Real GDP growth accelerated, the international reserves position strengthened further, and debt ratios continued to decline. Average inflation, however, remained relatively high. The external current account deficit widened further in 2006/07, but it was more than covered by record-high capital inflows, including FDI and portfolio flows. In particular, the government was successful in accessing the Eurobond market at favorable terms and selling part of its shares in some entities through the issuance of GDRs.

33. **Looking ahead, the key challenge is to maintain the high growth momentum of recent years while reducing the external current account deficit to a more sustainable level and further lowering inflation.** This requires an appropriate policy mix to increase savings and investment while addressing external vulnerabilities. Non-debt-creating capital inflows, including FDI, are expected to remain large over the medium term, but some inflows may not materialize or could be delayed in 2007/08 owing to domestic political uncertainties and tighter conditions in global markets.

34. **The authorities' macroeconomic policies for 2007/08** envisage a limited reduction in the fiscal deficit through further improvements in tax administration and current

expenditure restraint, and a tightening of the monetary stance based on actions announced in the SBP's Monetary Policy Statement of July 2007, including an increase in the discount rate and a reduction in the role of the central bank in financing the government and providing export refinance.

35. **The authorities' policies for 2007/08 are in the right direction, but may not be sufficiently strong to put the external current account deficit on a clear downward path and achieve the inflation target.** In particular, more concrete fiscal measures are needed to both support the current fiscal program and strengthen it to lower the deficit beyond the level envisaged in the budget. This could be achieved through a combination of revenue and expenditure actions, including by eliminating some exemptions and reducing subsidies, in particular energy subsidies. Attention should also be paid to any possible fiscal risks associated with the planned public-private partnerships.

36. **The measures announced recently by the SBP constitute an important step in the direction of slowing monetary growth and increasing the operational independence of the central bank.** However, supporting the tighter monetary policy stance with a stronger fiscal effort would enhance the possibility of achieving a significant reduction in inflation. It is also important that interest rates on treasury bills and other government paper be sufficiently flexible to ensure that the government's domestic borrowing requirement is covered entirely by commercial banks or nonbank sources. At the same time, consideration should be given to allowing greater exchange rate flexibility to enhance the effectiveness of monetary policy. As part of this process, the SBP should move forward with its plan to shift gradually the demand of foreign exchange for oil imports to the interbank market. The authorities are also encouraged to link the interest rate on the new facility for long-term financing of industrial development projects to market levels.

37. **Looking beyond 2007/08, macroeconomic policies should be geared at keeping the current account deficit on a declining path.** A policy mix relying on further fiscal consolidation would contribute significantly to this objective while lessening pressures on real interest rates. The fiscal effort should rely primarily on strengthening revenue mobilization substantially to reduce the deficit, while allowing for increased spending in infrastructure, human capital, and poverty alleviation. Towards this end, the new government should move ahead vigorously with reforms to expand taxation of the agricultural and services sectors and reduce tax exemptions.

38. **Even with the envisaged reduction in the current account deficit over the medium term, Pakistan will continue to depend heavily on the availability of large capital inflows.** Therefore, a high degree of flexibility in economic policymaking would be required to respond quickly to external shocks. In particular, given the need to continue strengthening the international reserves position, the authorities should adhere to their plans to rely primarily on active demand policies in response to external financing shortfalls.

39. **The staff shares the authorities' view that the real effective exchange rate is broadly in line with fundamentals.** Going forward, fiscal adjustment, accompanied by higher levels of investment and a vigorous implementation of structural reforms to increase the economy's productivity, constitute the main avenues to improve external competitiveness. The recent removal of the remaining exchange restriction in the form of a 50 percent limit on advanced payments for some imports is welcome.

40. **In addition to strengthening tax revenues, priority should be given to other structural reforms of critical importance to increase savings and investment.** Pressing ahead vigorously with the reform of the energy sector's regulatory and tariff framework will contribute to increasing productivity, strengthening public sector savings, and enhancing the prospects for privatization of the power companies. There is also a need to complete the ongoing reform of the National Savings Schemes to facilitate their integration with local financial markets; adopt a system of regular margin financing in line with major stock exchanges; and move forward with current plans to shift away from the use of short-term government financing instruments into long-term securities, in order to improve debt management and encourage the development of the local bond market. Strong efforts are also necessary to strengthen public financial management and enhance the role of the budget as a tool for policy making. Furthermore, pressures to reinstate ad hoc import tariff and nontariff barriers should be resisted, and the authorities are encouraged to move ahead with their plans to further reduce tariffs and rationalize them.

41. The recent enactment of AML/CFT ordinance is welcome. Going forward, the focus should be on issuing the AML bill, which remains outstanding in parliament, and on making the FMU fully operational and clarifying reporting and accountability issues.

42. It is proposed that the next Article IV consultation with Pakistan take place on the standard 12-month cycle.

Table 1. Pakistan: Selected Economic Indicators, 2002/03–2007/08 1/

(Population: 158.2 million (2006/07))
(Per capita GDP: US$909 (2006/07))
(Poverty rate: 23.9 percent (2004/05))

	2002/03	2003/04	2004/05	2005/06	Est. 2006/07	Proj. 2/ 2007/08
	(Annual changes in percent)					
Output and prices						
Real GDP at factor cost	4.7	7.5	9.0	6.6	7.0	6.5–7.0
Partner country demand (WEO definition)	4.1	4.7	4.8	4.8	4.5	4.5
Consumer prices (period average)	3.1	4.6	9.3	7.9	7.8	7.0
Consumer prices (end of period)	1.9	8.5	8.7	7.6	7.0	6.5
Pakistani rupees per U.S. dollar (period average)	-4.7	-1.5	3.1	0.8	1.3	…
	(In percent of GDP)					
Saving and investment						
Gross national saving	21.6	18.4	17.7	17.7	18.0	18.7
Government	1.3	1.1	0.5	1.1	1.0	2.3
Nongovernment (including public sector enterprises)	20.3	17.3	17.2	16.6	17.0	16.4
Gross capital formation 3/	16.8	16.6	19.1	21.7	23.0	23.5
Government	2.7	2.8	3.5	4.8	5.0	6.0
Nongovernment (including public sector enterprises)	14.1	13.7	15.6	16.9	18.0	17.5
Public finances						
Revenue and grants	17.2	14.6	14.1	14.8	15.2	15.9
Expenditure (including statistical discrepancy)	18.5	16.4	17.2	18.5	19.2	19.6
Budget balance	-1.3	-1.8	-3.0	-3.7	-4.0	-3.7
Budget balance (excluding grants)	-3.8	-2.3	-3.3	-4.3	-4.3	-4.0
Primary balance (including grants)	2.9	1.7	0.2	-0.6	0.2	0.3
Total government debt	74.5	67.8	62.9	57.3	54.6	51.3
External government debt	35.6	32.1	29.4	26.6	24.6	22.8
Domestic government debt	38.9	35.7	33.5	30.8	29.9	28.4
Implicit interest rate on government debt (in percent) 4/	5.8	5.4	5.5	5.8	8.5	8.3
	(Annual changes in percent of initial stock of broad money, unless otherwise indicated)					
Monetary sector						
Net foreign assets	17.5	2.1	2.2	2.5	8.1	3.8
Net domestic assets	0.5	17.5	17.1	12.4	11.3	9.9
Broad money	18.0	19.6	19.3	14.9	19.3	13.7
Private credit (annual change in percent)	18.9	29.8	33.2	23.2	17.2	17.0
Six-month treasury bill rate (period average, in percent)	4.1	1.7	4.7	8.2	8.8	…
External sector						
Merchandise exports, U.S. dollars (growth rate, in percent)	20.1	13.5	16.2	14.3	3.2	7.0
Merchandise imports, U.S. dollars (growth rate, in percent)	20.1	21.2	38.3	31.7	8.0	7.0
Current account including official current transfers (in percent of GDP)	4.9	1.8	-1.4	-3.9	-4.9	-4.8
	(In percent of exports of goods and nonfactor services; unless otherwise indicated)					
External public and publicly guaranteed debt	229.0	209.5	183.7	167.8	169.2	166.7
Debt service	26.6	17.3	16.0	14.3	13.3	12.5
Implicit interest rate (in percent) 4/	3.4	2.8	2.5	2.5	2.6	3.0
Gross reserves (in millions of U.S. dollars) 5/	9,529	10,564	9,805	10,760	14,287	16,158
In months of next year's imports of goods and services	6.5	5.0	3.5	3.7	4.5	4.8
Memorandum items:						
Real effective exchange rate (annual average, percentage change) 6/	-0.1	-1.8	0.3	5.3	0.5	…
Terms of trade (percentage change)	-0.9	1.8	-8.3	-4.6	-0.2	-0.9
Real per capita GDP (percentage change)	2.2	5.4	6.9	4.6	5.2	4.6
GDP at market prices (in billions of Pakistani rupees)	4,876	5,641	6,500	7,594	8,707	9,918
GDP at market prices (in billions of U.S. dollars)	83.5	98.1	109.6	127.0	143.8	...

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

1/ Fiscal year ends June 30.
2/ Authorities' policies—staff projections.
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: Balance of Payments, 2002/03–2007/08

(In millions of U.S. dollars; unless otherwise indicated)

	2002/03	2003/04	2004/05	2005/06	Est. 2006/07	Proj. 1/ 2007/08
Current account	4,061	1,811	-1,534	-5,015	-7,105	-7,757
Balance on goods	-359	-1,279	-4,514	-8,464	-9,947	-10,643
Exports, f.o.b.	10,974	12,459	14,482	16,553	17,080	18,276
Imports, f.o.b.	-11,333	-13,738	-18,996	-25,017	-27,027	-28,919
Services (net)	-11	-1,316	-3,293	-4,432	-4,149	-4,712
Credit	2,703	2,644	3,319	3,769	4,122	4,324
Debit	-2,714	-3,960	-6,612	-8,201	-8,271	-9,035
Income (net)	-2,211	-2,207	-2,386	-2,667	-3,581	-3,840
Credit	170	187	437	784	922	1,113
Debit	-2,381	-2,394	-2,823	-3,451	-4,503	-4,953
Of which: interest payments	-1,277	-1,056	-1,036	-1,238	-1,400	-1,505
Balance on goods, services, and income	-2,581	-4,802	-10,193	-15,563	-17,677	-19,195
Of which: income on direct investment	-990	-1,228	-1,640	-2,115	-3,103	-3,448
Current transfers (net)	6,642	6,613	8,659	10,548	10,572	11,439
Credit, *of which:*	6,714	6,713	8,768	10,655	10,646	11,544
Official	918	549	266	715	504	500
Workers' remittances	4,237	3,871	4,168	4,600	5,494	5,906
Other private transfers	1,559	2,293	4,334	5,270	4,713	5,138
Debit	-72	-100	-109	-107	-74	-105
Capital account	1,133	82	685	241	254	132
Capital transfers: credit	1,133	85	693	250	259	139
Of which: official capital grants 2/	1,133	70	657	9	203	74
Capital transfers: debit	0	-3	-8	-9	-5	-7
Financial account	-1,137	-1,334	446	5,855	10,133	9,845
Direct investment abroad	-27	-45	-66	-71	-110	-120
Direct investment in Pakistan	798	951	1,525	3,521	5,140	4,485
Of which: privatization receipts	186	199	363	1,540	266	485
Portfolio investment (net), *of which:*	-239	314	620	986	3,281	3,531
Eurobond/GDR	0	500	600	800	2,031	1,871
Other investment assets	-216	-669	-1,352	148	-589	-540
General government	-18	3	-2	1	-2	0
Banks	-25	-220	-986	380	-462	-420
Other sectors	-173	-452	-364	-233	-125	-120
Other investment liabilities	-1,453	-1,885	-281	1,271	2,411	2,489
Monetary authorities	-51	2	-5	0	-1	0
General government, *of which:*	-1,419	-1,792	574	794	1,312	1,568
Disbursements (medium and long term)	1,202	970	1,892	2,069	2,443	2,577
Amortization (medium and long term) 3/	-2,421	-2,419	-1,434	-1,059	-1,026	-1,146
Banks	36	75	-55	-2	153	-2
Other sectors	-19	-170	-795	479	947	923
Net errors and omissions	534	221	-7	253	438	0
Reserves and related items	-4,591	-781	410	-1,334	-3,720	-2,220
Reserve assets, *of which:*	-5,261	-299	610	-1,136	-3,700	-2,054
Foreign exchange (State Bank of Pakistan)	-5,678	-442	493	-779	-3,527	-1,871
Foreign exchange (deposit money banks)	650	123	117	-357	-173	-183
Use of Fund credit and loans	50	-427	-145	-143	-120	-166
Exceptional financing	620	-55	-55	-55	100	0
Memorandum items:						
Current account (in percent of GDP; including official transfers)	4.9	1.8	-1.4	-3.9	-4.9	-4.8
Exports f.o.b. (growth rate, in percent)	20.1	13.5	16.2	14.3	3.2	7.0
Imports f.o.b. (growth rate, in percent)	20.1	21.2	38.3	31.7	8.0	7.0
Terms of trade (growth rate, in percent)	-0.9	1.8	-8.3	-4.6	-0.2	-0.9
Workers' remittances and other private transfers (growth rate, in percent)	35.1	6.3	37.9	16.1	3.4	8.2
External debt (in millions of U.S. dollars) 4/	33,352	33,307	34,037	35,679	37,461	39,593
Gross financing needs (in millions of U.S. dollars) 5/	270	1,608	3,968	7,168	9,131	10,129
End-period gross official reserves (millions of U.S. dollars) 6/	9,529	10,564	9,805	10,760	14,287	16,158
(In months of next year's imports of goods and services)	6.5	5.0	3.5	3.7	4.5	4.8

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

1/ Authorities' policies—staff projections.

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 Asian Development Bank ($1.1 billion in 2003/04).

4/ Including IMF, military debt, commercial loans, and short-term debt.

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

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 3. Pakistan: Monetary Survey and Analytical Balance Sheet of the State Bank of Pakistan, 2002/03–2007/08

	2002/03	2003/04	2004/05	2005/06	Est. 2006/07	Proj. 1/ 2007/08
	(In billions of Pakistani rupees)					
Monetary survey						
Net foreign assets (NFA)	540	583	637	710	985	1,141
Net domestic assets (NDA)	1,539	1,903	2,329	2,697	3,080	3,481
Net claims on government, *of which:*	561	619	715	796	889	939
Budget support	511	575	647	708	810	855
Commodity operations	74	66	88	108	99	99
Credit to nongovernment	1,069	1,364	1,782	2,191	2,576	3,007
Private sector	1,000	1,298	1,729	2,130	2,496	2,921
Public sector enterprises	69	66	54	61	81	86
Privatization account	-3	-3	-3	-3	-3	-3
Other items, net	-88	-77	-165	-287	-382	-462
Broad money	2,079	2,487	2,966	3,407	4,065	4,623
Currency	495	578	666	740	840	926
Rupee deposits	1,458	1,763	2,120	2,471	3,018	3,488
Foreign currency deposits	126	146	180	196	207	208
State Bank of Pakistan (SBP)						
NFA	462	512	504	565	788	907
NDA	208	261	405	436	422	419
Net claims on government	29	91	249	384	325	268
Of which: budget support	53	113	268	404	345	283
Claims on nongovernment	11	1	-7	-7	-7	-7
Claims on scheduled banks	181	196	210	218	272	262
Privatization account	-3	-3	-3	-3	-3	-3
Other items, net	-10	-25	-44	-156	-164	-101
Reserve money, *of which:*	669	773	909	1,001	1,210	1,326
Banks' reserves	141	156	196	208	305	337
Currency	525	615	709	789	898	984
	(12-month changes; in percent)					
Broad money	18.0	19.6	19.3	14.9	19.3	13.7
NFA, banking system (in percent of broad money) 2/	17.5	2.1	2.2	2.5	8.1	3.8
NDA, banking system (in percent of broad money) 2/	0.5	17.5	17.1	12.4	11.3	9.9
Budgetary support (in percent of broad money) 2/	-3.2	3.1	2.9	2.1	3.0	1.1
NFA, banking system	133.8	8.1	9.2	11.5	38.7	15.9
NDA, banking system	0.6	23.7	22.4	15.8	14.2	13.0
Budgetary support	-9.9	12.5	12.5	9.5	14.4	5.6
Private credit	18.9	29.8	33.2	23.2	17.2	17.0
Currency	14.0	16.9	15.2	11.2	13.5	10.2
Reserve money	14.5	15.4	17.6	10.2	20.9	9.5
NFA, SBP (in percent of reserve money) 2/	56.1	7.6	-1.1	6.8	22.2	9.8
NDA, SBP (in percent of reserve money) 2/	-41.6	7.9	18.7	3.4	-1.4	-0.3
Net claims on government (in percent of reserve money) 2/	-41.9	9.3	20.4	14.8	-5.8	-4.7
	(In units as indicated)					
Memorandum items:						
Velocity	2.3	2.2	2.2	2.2	2.1	2.1
Money multiplier	3.1	3.2	3.3	3.4	3.4	3.5
Currency to broad money ratio (percent)	23.8	23.2	22.4	21.7	20.7	20.0
Currency to deposit ratio (percent)	31.2	30.3	28.9	27.8	26.1	25.0
Reserves to deposit ratio (percent)	8.9	8.2	8.5	7.8	9.5	9.1
Budget bank financing (billions of Pakistani rupees), *of which:*	-56	64	72	61	102	45
By commercial banks	194	4	-84	-74	161	107
By SBP	-250	60	156	135	-59	-62
NFA of SBP (change in U.S. dollar billions) 3/	...	1	0	1	4	2
NFA of commercial banks (billions of Pakistani rupees)	78	71	133	145	197	235
NDA of commercial banks (billions of Pakistani rupees)	1,331	1,643	1,924	2,261	2,658	3,062
Excess reserves in percent of broad money	0.9	0.8	1.1	0.3	1.0	...

Sources: Pakistani authorities for historical data; and Fund staff estimates and projections.

1/ Authorities' policies—staff projections.
2/ Denominator is the stock of broad (reserve) money at the end of the previous year.
3/ Includes valuation adjustments.

Table 4a. Pakistan: Consolidated Government Budget, 2002/03–2007/08

(In billions of Pakistani rupees)

	2002/03	2003/04	2004/05	2005/06	Est. 2006/07	Budget 2007/08	Proj. 1/ 2007/08
Revenue and grants	838	825	919	1,121	1,327	1,505	1,579
Revenue	719	794	900	1,077	1,298	1,476	1,550
Tax revenue	554	611	659	804	954	1,143	1,150
Federal	532	583	624	767	917	1,078	1,085
CBR revenue	460	522	595	713	843	1,025	1,025
Direct taxes	152	164	184	225	330	405	405
Federal excise duty	44	46	59	55	72	91	98
Sales tax	195	221	236	295	309	375	382
Customs duties	69	91	117	138	132	154	140
Oil and gas surcharges and other	72	62	29	54	74	53	60
Provincial	22	28	35	37	37	65	65
Nontax revenue	165	183	241	273	344	333	400
Grants	119	31	19	44	29	29	29
Expenditure 2/	891	956	1,196	1,422	1,760	1,890	2,055
Current expenditure 2/ 3/	802	775	943	1,093	1,375	1,378	1,491
Federal 2/ 3/	608	557	689	760	973	962	1,034
Interest	207	196	210	237	369	375	395
Other 2/ 3/	401	360	478	523	604	588	640
Provincial	194	218	254	333	402	416	457
Development expenditure and net lending 2/ 3/	88	181	252	329	385	511	564
Public Sector Development Program 2/ 3/	130	161	228	327	394	508	561
Federal 2/ 3/	91	102	135	186	211	358	358
Provincial	39	58	92	141	183	150	203
Net lending	-42	20	25	2	-9	3	3
Statistical discrepancy (“+” = additional expenditure) 4/	13	-32	-79	-86	-125	-50	-142
Underlying budget balance (excluding grants and earthquake)	-185	-129	-217	-260	-338	-364	-363
One-off expenditure (earthquake-related spending in 2005–08)	...	...	...	66	40	35	35
Budget balance (excluding grants)	-185	-129	-217	-326	-378	-399	-398
Budget balance (including grants)	-66	-99	-198	-281	-348	-370	-369
Financing	66	99	198	281	348	370	369
External	-24	-37	113	202	170	239	222
Of which: privatization receipts	8	0	12	97	53	75	113
Domestic	89	136	85	80	178	131	147
Bank	-56	64	72	61	102	81	45
Nonbank	142	61	-4	18	57	50	102
Privatization receipts	4	11	16	0	19	0	0
Memorandum items:							
Expenditure 5/	904	924	1,117	1,402	1,675	1,875	1,948
Primary balance (excluding grants)	23	67	-7	-89	-9	-24	-4
Primary balance (including grants)	142	97	13	-44	21	5	25
Social and poverty-related expenditure 6/	209	254	316	435	…	...	...
Defense spending	160	180	212	242	250	275	275
Total government debt 7/	3,633	3,822	4,085	4,354	4,750	...	5,087
Domestic debt	1,896	2,012	2,176	2,337	2,607	...	2,822
External debt 7/	1,737	1,810	1,910	2,017	2,144	...	2,265

Sources: Pakistani authorities for historical data; and Fund staff for estimates and projections.

1/ Authorities' policies—staff projections.
2/ Excludes spending related to the 2005 earthquake.
3/ Projection for 2007/08 includes as development expenditure PRs 33 billion corresponding to items classified as current expenditure in earlier years.
4/ The statistical discrepancy is believed to arise mainly from double-counting of spending at the provincial level.
5/ Includes statistical discrepancy and spending related to the 2005 earthquake.
6/ Social- and poverty-related expenditures as defined in the government's Poverty Reduction Strategy Paper (2003).
7/ Excludes military debt, commercial loans, and short-term debt.

Table 4b. Pakistan: Consolidated Government Budget, 2002/03–2007/08

(In percent of GDP; unless otherwise indicated)

	2002/03	2003/04	2004/05	2005/06	Est. 2006/07	Budget 2007/08	Proj. 1/ 2007/08
Revenue and grants	17.2	14.6	14.1	14.8	15.2	15.1	15.9
Revenue	14.8	14.1	13.8	14.2	14.9	14.8	15.6
Tax revenue	11.4	10.8	10.1	10.6	11.0	11.5	11.6
Federal	10.9	10.3	9.6	10.1	10.5	10.8	10.9
CBR revenue	9.4	9.3	9.2	9.4	9.7	10.3	10.3
Direct taxes	3.1	2.9	2.8	3.0	3.8	4.1	4.1
Federal excise duty	0.9	0.8	0.9	0.7	0.8	0.9	1.0
Sales tax	4.0	3.9	3.6	3.9	3.6	3.8	3.9
Customs duties	1.4	1.6	1.8	1.8	1.5	1.5	1.4
Oil and gas surcharges and other	1.5	1.1	0.4	0.7 .	0.8	0.5	0.6
Provincial	0.4	0.5	0.5	0.5	0.4	0.7	0.7
Nontax revenue	3.4	3.2	3.7	3.6	3.9	3.3	4.0
Grants	2.4	0.5	0.3	0.6	0.3	0.3	0.3
Expenditure 2/	18.3	16.9	18.4	18.7	20.2	19.0	20.7
Current expenditure 2/ 3/	16.5	13.7	14.5	14.4	15.8	13.8	15.0
Federal 2/ 3/	12.5	9.9	10.6	10.0	11.2	9.7	10.4
Interest	4.2	3.5	3.2	3.1	4.2	3.8	4.0
Other 2/ 3/	8.2	6.4	7.4	6.9	6.9	5.9	6.5
Provincial	4.0	3.9	3.9	4.4	4.6	4.2	4.6
Development expenditure and net lending 2/ 3/	1.8	3.2	3.9	4.3	4.4	5.1	5.7
Public Sector Development Program 2/ 3/	2.7	2.8	3.5	4.3	4.5	5.1	5.7
Federal 2/ 3/	1.9	1.8	2.1	2.5	2.4	3.6	3.6
Provincial	0.8	1.0	1.4	1.9	2.1	1.5	2.0
Net lending	-0.9	0.4	0.4	0.0	-0.1	0.0	0.0
Statistical discrepancy (“+” = additional expenditure) 4/	0.3	-0.6	-1.2	-1.1	-1.4	-0.5	-1.4
Underlying budget balance (excluding grants and earthquake)	-3.8	-2.3	-3.3	-3.4	-3.9	-3.6	-3.7
One-off expenditure (earthquake-related spending in 2005–08)	...	...	...	0.9	0.5	0.4	0.4
Budget balance (excluding grants)	-3.8	-2.3	-3.3	-4.3	-4.3	-4.0	-4.0
Budget balance (including grants)	-1.3	-1.8	-3.0	-3.7	-4.0	-3.7	-3.7
Financing	1.3	1.8	3.0	3.7	4.0	3.7	3.7
External	-0.5	-0.7	1.7	2.7	2.0	2.4	2.2
Of which: privatization receipts	0.2	0.0	0.2	1.3	0.6	0.8	1.1
Domestic	1.8	2.4	1.3	1.0	2.0	1.3	1.5
Bank	-1.1	1.1	1.1	0.8	1.2	0.8	0.5
Nonbank	2.9	1.1	-0.1	0.2	0.7	0.5	1.0
Privatization receipts	0.1	0.2	0.3	0.0	0.2	0.0	0.0
Memorandum items:							
Expenditure 5/	18.5	16.4	17.2	18.5	19.2	18.8	19.6
Primary balance (excluding grants)	0.5	1.2	-0.1	-1.2	-0.1	-0.2	0.0
Primary balance (including grants)	2.9	1.7	0.2	-0.6	0.2	0.0	0.3
Social and poverty-related expenditure 6/	4.3	4.5	4.9	5.7	...	...	...
Defense spending	3.3	3.2	3.3	3.2	2.9	2.8	2.8
Total government debt 7/	74.5	67.8	62.9	57.3	54.6	...	51.3
Domestic debt	38.9	35.7	33.5	30.8	29.9	...	28.5
External debt 7/	35.6	32.1	29.4	26.6	24.6	...	22.8
Nominal GDP (market prices, billions of Pakistani rupees)	4,876	5,641	6,500	7,594	8,707	9,970	9,918

Sources: Pakistani authorities for historical data; and Fund staff for estimates and projections.

1/ Authorities' policies—staff projections.
2/ Excludes spending related to the 2005 earthquake.
3/ Projection for 2007/08 includes as development expenditure 0.3 percent of GDP corresponding to items classified as current expenditure in earlier years.
4/ The statistical discrepancy is believed to arise mainly from double-counting of spending at the provincial level.
5/ Includes statistical discrepancy and spending related to the 2005 earthquake.
6/ Social- and poverty-related expenditures as defined in the government's Poverty Reduction Strategy Paper (2003).
7/ Excludes military debt, commercial loans, and short-term debt.

Table 5. Pakistan: Medium-Term Fiscal Framework, 2005/06–2011/12 1/

(In percent of GDP; unless otherwise indicated)

		Prel.	Projections				
	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12
Revenue and grants	14.8	15.2	16.0	16.5	16.8	17.1	17.6
Tax revenue	10.6	11.0	11.7	12.1	12.7	13.1	13.7
Of which: Central Board of Revenue	9.4	9.7	10.4	10.9	11.4	11.9	12.4
Nontax revenue	3.6	3.9	4.1	4.0	3.9	3.8	3.7
Grants	0.6	0.3	0.3	0.3	0.3	0.2	0.2
Expenditure	19.6	20.7	20.9	20.2	20.5	20.6	20.8
Current expenditure 2/	14.4	15.8	15.1	14.5	14.4	14.3	14.3
Interest	3.1	4.2	4.0	3.1	2.9	2.7	2.6
Other federal 2/	6.9	6.9	6.5	6.5	6.5	6.4	6.4
Provincial	4.4	4.6	4.6	4.8	5.0	5.2	5.3
Development expenditure 2/	5.2	5.0	5.7	5.8	6.0	6.3	6.5
Of which : one-off outlays 3/	0.9	0.5	0.4	0.2	0.1	0.0	0.0
Net-lending	0.0	-0.1	0.0	0.0	0.0	0.0	0.0
Statistical discrepancy	-1.1	-1.4	-1.4	-1.4	-1.4	-1.4	-1.4
Overall balance							
Underlying (excluding grants and one-off outlays)	-3.4	-3.9	-3.3	-2.5	-2.3	-2.3	-2.0
Excluding grants	-4.3	-4.3	-3.7	-2.7	-2.5	-2.3	-2.0
Including grants	-3.7	-4.0	-3.4	-2.3	-2.2	-2.0	-1.8
Financing	3.7	4.0	3.4	2.3	2.2	2.0	1.8
External	2.7	2.0	2.3	1.5	1.6	1.2	1.1
Of which : privatization receipts	1.3	0.6	1.1	0.6	0.5	0.2	0.2
Domestic	1.0	2.0	1.2	0.8	0.6	0.8	0.8
Memorandum items:							
Primary balance							
Excluding grants	-1.2	-0.1	0.3	0.5	0.5	0.5	0.5
Including grants	-0.6	0.2	0.6	0.8	0.7	0.7	0.7
Interest payments/revenue (ratio)	22.0	28.4	25.5	19.3	17.7	16.1	14.7
PRSP expenditure 4/	5.7	5.9	6.1	6.2	6.5	6.8	7.1
Total government debt 5/	57.3	54.6	51.3	48.8	46.2	44.0	42.2
External	26.6	24.6	23.0	22.3	21.4	20.6	19.9
Domestic	30.8	29.9	28.3	26.5	24.7	23.5	22.4
Nominal GDP (billions of Pakistani rupees)	7,594	8,707	9,848	11,139	12,550	14,087	15,752

Sources: Pakistani authorities for historical data; and Fund staff for estimates and projections.

1/ Projections based on a staff scenario with tighter fiscal and monetary policies.
2/ Projection for 2007/08 includes as development expenditure 0.3 percent of GDP corresponding to items classified as current expenditure in earlier years. Reclassification is maintained in all projection years.
3/ Spending related to the 2005 earthquake.
4/ Social- and poverty-related expenditures as defined in the government's Poverty Reduction Strategy Paper (2003).
5/ Excludes military debt, commercial loans, and short-term debt.

Table 6. Pakistan: Medium-Term Balance of Payments, 2005/06–2011/12
(In millions of U.S. dollars; unless otherwise indicated)

		Est.	Projections 1/				
	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12
Current account	-5,015	-7,105	-7,398	-7,758	-7,986	-8,049	-8,042
Balance on goods	-8,464	-9,947	-10,373	-10,974	-11,593	-12,090	-12,526
Exports, f.o.b.	16,553	17,080	18,276	19,738	21,514	23,665	26,269
Imports, f.o.b.	-25,017	-27,027	-28,649	-30,711	-33,107	-35,755	-38,795
Services (net)	-4,432	-4,149	-4,623	-4,901	-5,141	-5,434	-5,857
Credit	3,769	4,122	4,324	4,642	5,114	5,597	6,212
Debit	-8,201	-8,271	-8,947	-9,544	-10,255	-11,030	-12,069
Income (net)	-2,667	-3,581	-3,840	-4,146	-4,492	-4,939	-5,349
Credit	784	922	1,113	1,191	1,274	1,363	1,459
Debit	-3,451	-4,503	-4,953	-5,337	-5,767	-6,302	-6,808
Of which: interest payments	-1,238	-1,400	-1,505	-1,522	-1,555	-1,566	-1,578
Balance on goods, services, and income	-15,563	-17,677	-18,837	-20,021	-21,226	-22,462	-23,732
Of which: income on direct investment	-2,115	-3,103	-3,448	-3,815	-4,211	-4,736	-5,230
Current transfers (net)	10,548	10,572	11,439	12,263	13,240	14,413	15,690
Credit, *of which:*	10,655	10,646	11,544	12,368	13,346	14,521	15,798
Official	715	504	500	390	292	295	295
Workers' remittances	4,600	5,494	5,906	6,379	6,950	7,573	8,251
Other private transfers	5,270	4,713	5,138	5,600	6,104	6,653	7,252
Debit	-107	-74	-105	-105	-106	-108	-108
Capital account	241	254	132	276	366	273	196
Capital transfers: credit	250	259	139	290	381	288	211
Of which: official capital grants	9	203	74	225	202	179	100
Capital transfers: debit	-9	-5	-7	-14	-15	-15	-15
Financial account	5,855	10,133	9,486	8,779	8,942	9,123	9,180
Direct investment abroad	-71	-110	-120	-100	-80	-50	-10
Direct investment in Pakistan	3,521	5,140	4,485	5,500	5,500	5,200	5,000
Of which: privatization receipts	1,540	266	485	1,000	1,000	500	500
Portfolio investment (net), *of which:*	986	3,281	3,531	2,147	2,048	2,398	2,122
Eurobond/GDR	800	2,031	1,871	1,000	1,000	750	750
Other investment assets	148	-589	-540	-630	-735	-660	-672
General government	1	-2	0	0	0	0	0
Banks	380	-462	-420	-420	-420	-420	-420
Other sectors	-233	-125	-120	-210	-315	-240	-252
Other investment liabilities	1,271	2,411	2,130	1,862	2,209	2,235	2,740
Monetary authorities	0	-1	0	0	0	0	0
General government, *of which:*	794	1,312	1,568	1,339	1,941	1,596	1,473
Disbursements (medium- and long-term)	2,069	2,443	2,577	2,234	2,704	2,383	2,717
Amortization (medium- and long-term)	-1,059	-1,026	-1,146	-1,073	-813	-787	-843
Banks	-2	153	-2	-2	-2	-2	-2
Other sectors/unidentified financing 2/	479	947	564	525	270	641	1,269
Net errors and omissions	253	438	0	0	0	0	0
Reserves and related items	-1,334	-3,720	-2,220	-1,297	-1,322	-1,347	-1,335
Reserve assets, *of which:*	-1,136	-3,700	-2,054	-1,100	-1,100	-1,100	-1,100
Foreign exchange (State Bank of Pakistan)	-779	-3,527	-1,871	-1,000	-1,000	-1,000	-1,000
Foreign exchange (deposit money banks)	-357	-173	-183	-100	-100	-100	-100
Use of Fund credit and loans	-143	-120	-166	-197	-222	-247	-235
Exceptional financing	-55	100	0	0	0	0	0
Memorandum items:							
Current account (in percent of GDP; incl. official transfers)	-3.9	-4.9	-4.6	-4.4	-4.1	-3.8	-3.5
Exports f.o.b. (growth rate, in percent)	14.3	3.2	7.0	8.0	9.0	10.0	11.0
Imports f.o.b. (growth rate, in percent)	31.7	8.0	6.0	7.2	7.8	8.0	8.5
Terms of trade (growth rate, in percent)	-4.6	-0.2	-0.9	0.1	0.4	0.4	0.4
Workers' remittances and other private transfers (growth rate, in percent)	16.1	3.4	8.2	8.5	9.0	9.0	9.0
External debt (in millions of U.S. dollars) 3/	35,679	37,461	39,593	41,200	43,152	44,904	46,571
Gross financing needs (in millions of U.S. dollars) 4/	7,168	9,131	9,770	10,043	10,144	10,161	10,207
End-period gross official reserves (millions of U.S. dollars) 5/	10,760	14,287	16,158	17,158	18,158	19,158	20,158
(In months of next year's imports of goods and services)	3.7	4.6	4.8	4.7	4.7	4.5	4.2

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

1/ Projections based on a staff scenario with tighter fiscal and monetary policies.
2/ Other sectors for 2005/06–2006/07; unidentified financing flows for projection years.
3/ Including IMF, military debt, commercial loans, and short-term debt.
4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.
5/ Excluding foreign currency deposits held with the SBP (cash reserve requirements), gold, and net of outstanding short-term swap and forward contracts.

Table 7. Pakistan: Public Sector Debt Sustainability Framework, 2002/03–2011/12

(In percent of GDP; unless otherwise indicated)

		Actual				Est.	Projections 1/					
		2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	**Debt-stabilizing primary balance 10/**
1	**Baseline: Public sector debt 2/**	74.5	67.8	62.9	57.3	**54.6**	**51.3**	**48.8**	**46.2**	**44.0**	**42.2**	**-1.2**
	Of which: foreign-currency denominated	36.5	32.7	29.8	26.8	24.7	23.1	22.3	21.4	20.6	19.9	
2	Change in public sector debt	-5.9	-6.8	-4.9	-5.5	-2.8	-3.3	-2.5	-2.6	-2.2	-1.8	
3	Identified debt-creating flows (4+7+12)	-6.1	-8.2	-4.3	-4.9	-3.3	-3.4	-3.5	-3.2	-2.6	-2.4	
4	Primary deficit	-2.9	-1.7	-0.2	0.6	-0.2	-0.6	-0.8	-0.7	-0.7	-0.7	
5	Revenue and grants	17.2	14.6	14.1	14.8	15.2	16.0	16.5	16.8	17.1	17.6	
6	Primary (noninterest) expenditure	14.3	12.9	14.0	15.3	15.0	15.4	15.7	16.1	16.5	16.8	
7	Automatic debt dynamics 3/	-4.1	-6.4	-5.0	-5.7	-3.0	-2.3	-2.8	-2.6	-2.3	-2.1	
8	Contribution from interest rate/growth differential, *of which:* 4/	-2.7	-6.6	-5.7	-5.9	-3.1	-2.3	-2.8	-2.6	-2.3	-2.1	
9	Contribution from real interest rate	0.8	-1.9	-1.2	-2.2	0.1	0.7	0.2	0.4	0.5	0.7	
10	Contribution from real GDP growth	-3.6	-4.7	-4.5	-3.7	-3.2	-3.0	-3.0	-2.9	-2.8	-2.8	
11	Contribution from exchange rate depreciation 5/	-1.4	0.2	0.8	0.2	0.1	...	...	...	...	...	
12	Other identified debt-creating flows	0.9	0.0	0.9	0.2	-0.1	-0.5	0.1	0.1	0.4	0.4	
13	Privatization receipts (negative)	-0.2	-0.2	-0.4	-1.3	-0.8	-1.1	-0.6	-0.5	-0.2	-0.2	
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	1.2	0.2	1.3	1.5	0.7	0.7	0.7	0.6	0.6	0.6	
16	Residual, including other asset changes (2-3) 6/	0.2	1.4	-0.6	-0.6	0.5	0.1	1.0	0.6	0.5	0.6	
	Public sector debt-to-revenue ratio 2/	433.4	463.5	444.4	388.4	357.9	319.9	295.7	274.6	256.8	240.5	
	Gross financing need 7/	21.6	20.4	19.0	20.8	21.0	20.4	18.4	17.3	16.1	15.2	
	In billions of U.S. dollars	18.0	20.0	20.8	26.4	30.2	33.0	32.6	33.3	33.9	35.0	
	Scenario with key variables at their historical averages 8/					**54.6**	**50.9**	**48.9**	**46.6**	**44.5**	**42.8**	**-0.9**
	Scenario with no policy change (constant primary balance) in 2006/07–2011/12					**54.6**	**51.8**	**49.5**	**47.4**	**45.7**	**44.3**	**-1.3**
	Key Macroeconomic and Fiscal Assumptions Underlying Baseline											
	Real GDP growth at market prices (in percent)	4.8	7.4	7.7	6.9	6.4	6.3	6.7	6.8	6.9	7.0	
	Average nominal interest rate on public debt (in percent) 9/	5.8	5.4	5.5	5.8	8.5	8.3	6.9	6.8	6.6	6.5	
	Average real interest rate (nominal rate minus change in GDP deflator, in percent)	1.3	-2.3	-1.5	-3.5	0.7	1.9	0.9	1.3	1.6	2.0	
	Nominal appreciation (increase in US dollar value of local currency, in percent)	3.8	-0.6	-2.5	-0.9	-0.5	...	...	...	...	...	
	Inflation rate (GDP deflator, in percent)	4.4	7.7	7.0	9.3	7.8	6.5	6.0	5.5	5.0	4.5	
	Growth of real primary spending (deflated by GDP deflator, in percent)	7.4	-3.1	16.5	17.5	4.1	9.3	8.5	9.5	9.3	9.5	
	Primary deficit (including grants)	-2.9	-1.7	-0.2	0.6	-0.2	-0.6	-0.8	-0.7	-0.7	-0.7	

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

1/ Projections based on a staff scenario with tighter fiscal and monetary policies.
2/ General government gross debt; excludes external military debt, commercial debt, and short-term loans.
3/ Derived as [(r - p(1+g) - g + ae(1+r)]/(1+g+p+gp)) times previous period debt ratio, with r = interest rate; p = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).
4/ The real interest rate contribution is derived from the denominator in footnote 3/ as r - π (1+g) and the real growth contribution as -g.
5/ The exchange rate contribution is derived from the numerator in footnote 3/ as ae(1+r).
6/ For projections, this line includes exchange rate changes.
7/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
8/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.
9/ Derived as nominal interest expenditure divided by previous period debt stock.
10/ 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, 2002/03–2011/12

(In percent of GDP, unless otherwise indicated)

		Actual				Est.	Projections 1/					
		2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	Debt-stabilizing noninterest current account 8/
1	**Baseline: External debt**	39.9	34.0	31.1	28.1	**26.1**	**24.4**	**23.3**	**22.4**	**21.3**	**20.2**	**-3.9**
2	Change in external debt	-6.0	-6.0	-2.9	-3.0	-2.0	-1.6	-1.1	-0.9	-1.1	-1.1	
3	Identified external debt-creating flows (4+8+9)	-11.8	-8.7	-3.7	-3.4	-2.7	-1.5	-1.2	-1.0	-0.9	-0.6	
4	Current account deficit, excluding interest payments	-6.4	-2.9	0.5	3.0	4.0	3.6	3.5	3.3	3.1	2.8	
5	Deficit in balance of goods and services	0.4	2.6	7.1	10.2	9.8	9.3	9.0	8.7	8.3	8.0	
6	Exports	16.4	15.4	16.2	16.0	14.7	14.0	13.8	13.8	13.9	14.1	
7	Imports	16.8	18.0	23.4	26.2	24.6	23.2	22.8	22.5	22.2	22.0	
8	Net non-debt-creating capital inflows (negative)	-1.0	-0.9	-1.5	-3.1	-6.1	-4.6	-4.1	-3.7	-3.3	-2.8	
9	Automatic debt dynamics 2/	-4.4	-4.9	-2.6	-3.3	-0.6	-0.5	-0.6	-0.6	-0.7	-0.7	
10	Contribution from nominal interest rate	1.5	1.1	0.9	1.0	1.0	0.9	0.9	0.8	0.7	0.7	
11	Contribution from real GDP growth	-1.9	-2.5	-2.3	-1.9	-1.6	-1.4	-1.5	-1.5	-1.4	-1.4	
12	Contribution from price and exchange rate changes 3/	-4.0	-3.4	-1.2	-2.4	...	...	...	...	...	...	
13	Residual, incl. change in gross foreign assets (2-3) 4/	5.8	2.7	0.8	0.4	0.7	-0.1	0.0	0.1	-0.2	-0.5	
	External debt-to-exports ratio (in percent)	243.9	220.5	191.2	175.6	176.7	175.2	169.0	162.1	153.5	143.4	
	Gross external financing need (in billions of US dollars) 5/	0.3	1.6	4.0	7.2	9.1	9.8	10.0	10.1	10.2	10.2	
	In percent of GDP	0.3	1.6	3.6	5.6	6.4	6.0	5.7	5.3	4.8	4.4	
	Scenario with key variables at their historical averages 6/					**26.1**	**24.8**	**22.6**	**20.6**	**18.1**	**15.4**	**-1.3**
	Key Macroeconomic Assumptions Underlying Baseline											
	Real GDP growth (in percent)	4.8	7.4	7.7	6.9	6.4	6.3	6.7	6.8	6.9	7.0	
	GDP deflator in US dollars (change in percent)	9.6	9.4	3.8	8.4	6.4	6.0	2.2	2.1	2.3	2.4	
	Nominal external interest rate (in percent)	3.8	3.2	3.1	3.6	3.9	4.0	3.8	3.8	3.6	3.5	
	Growth of exports of goods and services (U.S. dollar terms, in percent) 7/	23.7	10.4	17.9	14.2	4.3	6.6	7.9	9.2	9.9	11.0	
	Growth of imports of goods and services (U.S. dollar terms, in percent) 7/	20.6	26.0	44.7	29.7	6.3	6.5	7.1	7.7	7.9	8.7	
	Current account balance, excluding interest payments	6.4	2.9	-0.5	-3.0	-4.0	-3.6	-3.5	-3.3	-3.1	-2.8	
	Net non-debt-creating capital inflows	1.0	0.9	1.5	3.1	6.1	4.6	4.1	3.7	3.3	2.8	

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

1/ Projections based on a staff scenario with tighter fiscal and monetary policies.

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

3/ The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an appreciating domestic currency (e > 0) and rising inflation (based on GDP deflator).

4/ For projection, line includes the impact of price and exchange rate changes.

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

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

7/ Exports and imports of goods and services

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

Table 9. Pakistan: Selected Vulnerability Indicators, 2002/03–2006/07

	2002/03	2003/04	2004/05	2005/06	Est. 2006/07
Key economic and market indicators					
Real GDP growth (market prices, in percent)	4.8	7.4	7.7	6.9	6.4
CPI inflation (period average, in percent)	3.1	4.6	9.3	7.9	7.8
Short-term (ST) interest rate (in percent)	4.1	1.7	4.7	8.2	8.8
Emerging market bond index (EMBI) secondary market spread (basis points, end of period)	...	313	229	251	214
Exchange rate PRs/US$ (end of period)	57.7	58.1	59.6	60.1	60.4
External sector					
Exchange rate regime	De facto currency peg since December 2004				
Current account balance (percent of GDP)	4.9	1.8	-1.4	-3.9	-4.9
Net FDI inflows (percent of GDP)	0.9	0.9	1.3	2.7	3.5
Exports (percentage change of U.S. dollar value; GNFS)	23.7	10.4	17.9	14.2	4.3
Real effective exchange rate (2000=100, annual average)	90.3	92.6	94.3	96.4	96.7
Gross international reserves (GIR) in billions of U.S. dollars	9.5	10.6	9.8	10.8	14.3
GIR in percent of ST debt at remaining maturity (RM) 1/	338.0	348.5	492.2	686.2	1003.3
GIR in percent of ST debt at RM and banks' foreign exchange (FX) deposits 1/	190.4	190.7	195.4	223.3	294.3
Total gross external debt (ED) in percent of GDP, *of which:*	39.9	34.0	31.1	28.1	26.1
ST external debt (original maturity, in percent of total ED)	0.6	0.1	0.8	0.5	0.3
ED of domestic private sector (in percent of total ED)	6.1	5.0	3.9	4.4	4.2
ED to foreign official sector (in percent of total ED)	93.9	95.0	96.1	95.6	95.8
Total gross external debt in percent of exports	243.9	220.5	191.2	175.6	176.7
Gross external financing requirement (in billions of U.S. dollars) 2/	0.3	1.6	4.0	7.2	9.1
Public sector (PS) 3/					
Overall balance (percent of GDP) 4/	-1.3	-1.8	-3.0	-3.7	-4.0
Primary balance (percent of GDP) 4/	2.9	1.7	0.2	-0.6	0.2
Debt-stabilizing primary balance (percent of GDP) 5/	-4.2	-6.5	-5.1	-5.8	-3.1
Gross PS financing requirement (in percent of GDP) 6/	21.6	20.4	19.0	20.8	21.1
Public sector gross debt (in percent of GDP)	74.5	67.8	62.9	57.3	54.6
Public sector net debt (in percent of GDP) 7/	70.0	63.7	58.0	51.7	48.9
Financial sector (FS) 8/					
Capital adequacy ratio (in percent) 9/	8.8	8.5	10.5	11.3	13.4
Nonperforming loans (NPLs) in percent of total loans 9/	21.8	17.0	11.6	8.3	7.4
Provisions in percent of NPLs 9/	60.6	63.9	70.4	76.8	74.7
Return on average assets (in percent) 9/	0.1	1.0	1.2	1.9	2.0
Return on equity (in percent) 9/	3.2	20.0	20.3	25.8	20.6
FX deposits held by residents (in percent of total deposits)	8.0	7.6	7.8	7.3	6.4
Government debt held by FS (percent of total FS assets)	27.0	24.9	24.1	23.6	21.9
Credit to private sector (percent change)	18.9	29.8	33.2	23.2	17.2
Memorandum item:					
Nominal GDP (in billions of U.S. dollars)	83.5	98.1	109.6	127.0	143.8

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

1/ Debt at remaining maturity is defined as maturing short-, medium-, and long-term external official debt.
2/ Current account deficit plus amortization of external debt.
3/ Public sector covers general (consolidated) government.
4/ Including grants.
5/ Based on the end of period debt stock of the previous year (t-1), and the current year's (year t) value for the relevant variables (i.e., growth, interest rates, inflation, exchange rates).
6/ Overall balance plus debt amortization.
7/ Net debt is defined as gross debt minus government deposits with the banking system.
8/ Financial sector includes all commercial and specialized banks; for government debt also includes non-banks, but excludes State Bank of Pakistan.
9/ For 2002/03 to 2005/06 data are on a calendar year basis (e.g., the value for 2002/03 denotes the observation for end-December 2002). Data for 2006/07 is for March 2007.

Table 10. Pakistan: Financial Soundness Indicators for the Banking System, 2002–07

	Dec. 2002	Dec. 2003	Dec. 2004	Dec. 2005	Dec. 2006	Mar. 2007
Capital adequacy						
Regulatory capital to risk-weighted assets	8.8	8.5	10.5	11.3	12.7	13.4
Tier I capital to risk-weighted assets	6.2	6.5	7.6	8.3	10.0	10.7
Capital to total assets	4.8	5.5	6.7	7.9	9.4	9.7
Asset composition and quality						
Nonperforming loans (NPLs) to gross loans	21.8	17.0	11.6	8.3	6.9	7.4
Provisions to NPLs	60.6	63.9	70.4	76.7	77.8	74.7
NPLs net of provisions to capital	85.5	54.4	29.2	14.3	9.7	10.7
Earnings and profitability						
Return on assets (after tax)	0.1	1.0	1.2	1.9	2.1	2.0
Return on equity (after tax)	3.2	20.0	20.3	25.8	23.8	20.6
Net interest income to gross income	67.1	59.2	62.8	72.0	70.9	74.0
Noninterest expenses to gross income	59.1	50.5	52.0	41.5	40.3	42.7
Liquidity						
Liquid assets to total assets	46.7	45.1	36.6	33.7	31.9	34.0
Liquid assets to total deposits	61.8	58.5	46.5	43.5	42.7	45.0

Source: Pakistani authorities.

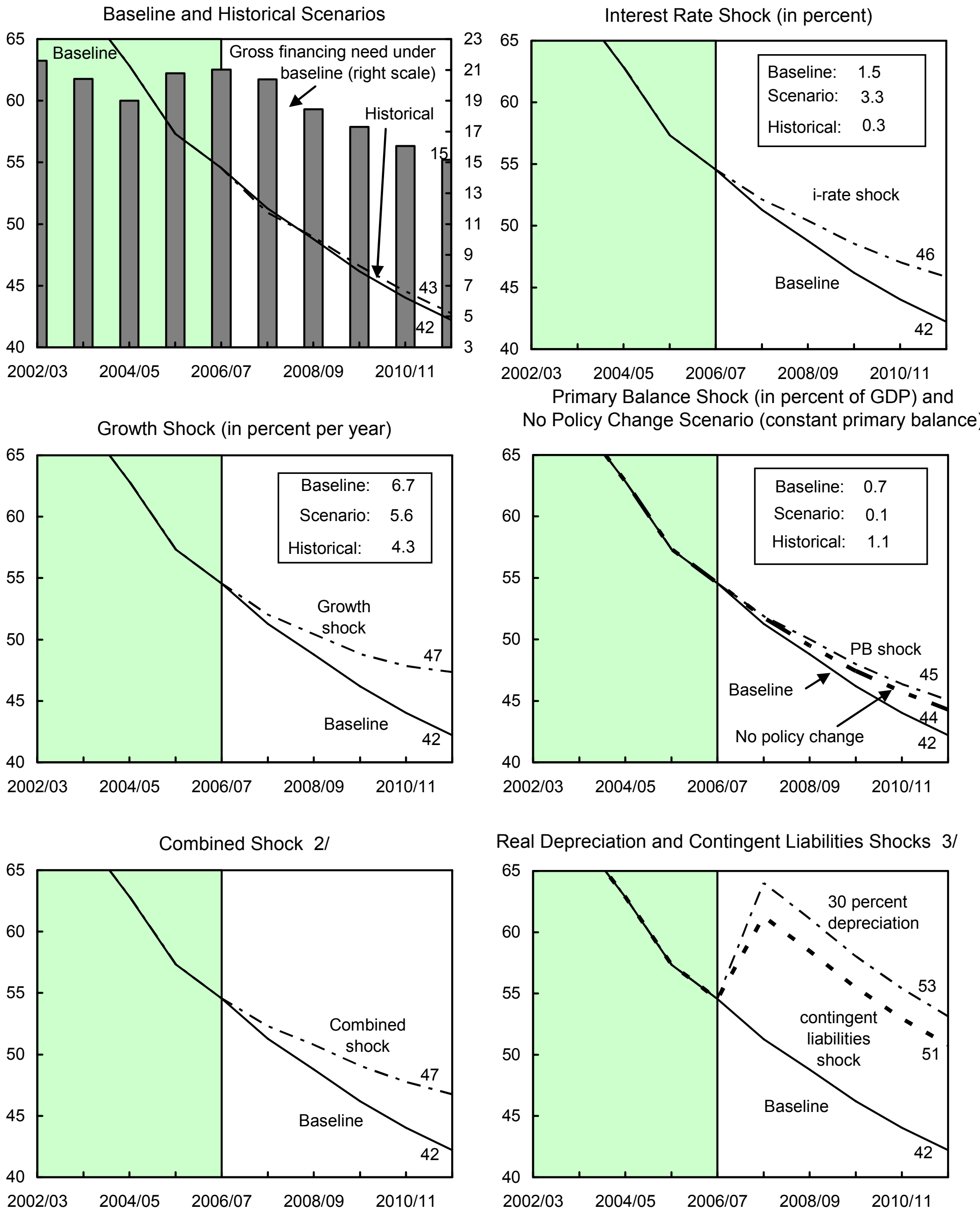
Table 11. Pakistan: Millennium Development Goals, 1990–2005 1/

	1990	1995	2000	2005
Goal 1: Eradicate extreme poverty and hunger				
Percentage share of income or consumption held by poorest 20 percent	...	...	8.8	...
Population below US$1 a day (in percent)	47.8	...	17.0	...
Population below minimum level of dietary energy consumption (in percent)	24.0	19.0	...	24.0
Poverty gap ratio at US$1 a day (incidence x depth of poverty)	14.6	...	3.1	...
Poverty headcount, national (in percent of population)	26.1	28.6	32.6	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)	33.0	...	59.0	68.0
Primary completion rate, total (in percent of relevant age group)	...	...	...	63.0
Proportion of pupils starting grade 1 who reach grade 5	...	...	...	70.0
Youth literacy rate (in percent ages 15–24)	47.4	...	...	65.0
Goal 3: Promote gender equality and empower women				
Proportion of seats held by women in national parliament (in percent)	10.0	...	2.0	21.3
Ratio of girls to boys in primary and secondary education (in percent)	...	...	69.0	75.0
Ratio of young literate females to males (in percent ages 15–24)	49.0	...	...	72.0
Share of women employed in the nonagricultural sector (in percent)	6.6	7.5	7.4	8.6
Goal 4: Reduce child mortality				
Immunization, measles (in percent of children ages 12–23 months)	50.0	47.0	56.0	78.0
Infant mortality rate (per 1,000 live births)	100.0	93.0	85.0	79.0
Under 5 mortality rate (per 1,000)	130.0	118.0	108.0	99.0
Goal 5: Improve maternal health				
Births attended by skilled health staff (in percent of total)	18.8	18.0	23.0	31.0
Maternal mortality ratio (modeled estimate, per 100,000 live births)	550.0	...	500.0	...
Goal 6: Combat HIV/AIDS, malaria, and other diseases				
Contraceptive prevalence rate (in percent of women ages 15–49)	14.0	23.9	27.6	...
Incidence of tuberculosis (per 100,000 people)	181.0	181.0	181.0	181.0
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	2.8	37.0
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	0.8
Forest area (in percent of total land area)	3.3	...	2.7	2.5
GDP per unit of energy use (2000 PPP US$ per kg oil equivalent)	3.9	4.0	4.2	4.2
Nationally protected areas (in percent of total land area)	9.1	...	…	9.5
Goal 8: Develop a global partnership for development				
Aid per capita (current U.S. $)	10.5	6.7	5.1	11.0
Debt service (in percent of exports)	21.3	26.5	25.2	19.7
Fixed line and mobile phone subscribers (per 1,000 people)	7.8	17.7	24.3	116.0
Internet users (per 1,000 people)	0.0	0.0	2.2	67.0
Personal computers (per 1,000 people)	1.4	3.7	4.3	...
Unemployment, youth female (in percent of female labor force ages 15–24)	1.3	18.1	29.2	14.9
Unemployment, youth male (in percent of male labor force ages 15–24)	5.7	7.6	11.1	11.0
Unemployment, youth total (in percent of total labor force ages 15–24)	5.1	8.9	13.3	11.7
Other				
Fertility rate, total (births per woman)	5.8	5.2	4.7	4.1
GNI per capita, Atlas method (current U.S. $)	420	490	480	690
GNI, Atlas method (current U.S. $, billions)	45.5	59.8	66.5	107.3
Gross capital formation (in percent of GDP)	18.9	18.5	17.4	16.8
Life expectancy at birth, total (years)	59.1	60.9	63.0	65.0
Literacy rate, adult total (in percent of people ages 15 and above)	35.4	...	43.0	50.0
Population, total (millions)	108.0	122.4	138.1	155.8
Trade (in percent of GDP)	32.6	30.8	28.4	35.2

Sources: Pakistani authorities; Pakistan Millennium Development Goals Report (2005); World Development Indicators database (2007); and Fund staff estimates.

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

Figure 1. Pakistan: Public Debt Sustainability—Bound Tests 1/
(Public debt in percent of GDP)

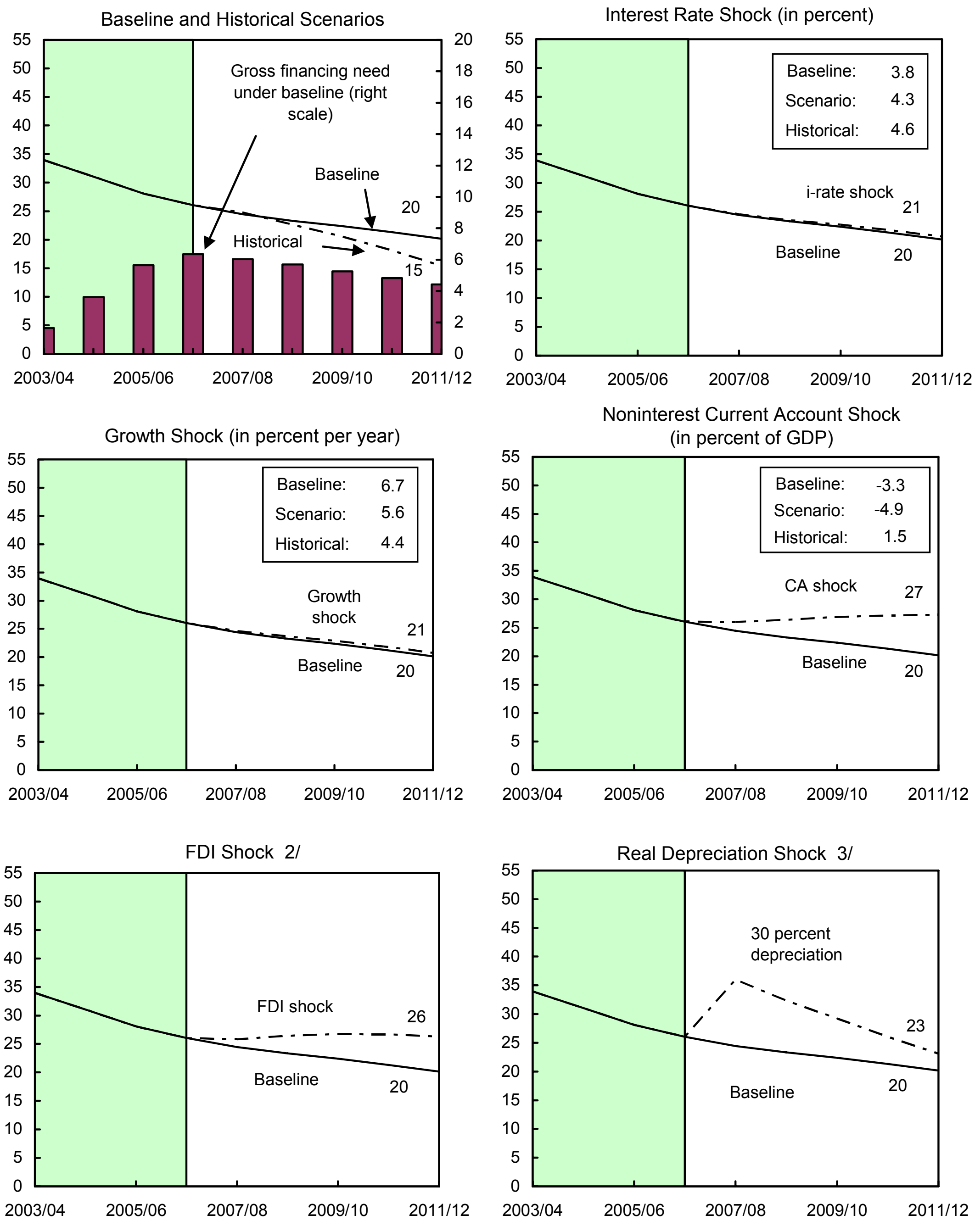


Sources: Historical data from Pakistani authorities; and Fund staff estimates and projections.

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 one-fourth 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 2007/08, 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: 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 2007/08.

INTERNATIONAL MONETARY FUND

PAKISTAN

Staff Report for the 2007 Article IV Consultation

Informational Annex

November 8, 2007

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Annexes

Annex I. Pakistan: Relations with the Fund

As of September 30, 2007

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	1,057.28	102.28
Reserve position in Fund	0.12	0.01

III. **SDR Department**:	SDR Million	% Allocation
Net cumulative allocation	169.99	100.00
Holdings	138.89	81.70

IV. **Outstanding Purchases and Loans**:	SDR Million	% Quota
Extended arrangements	23.70	2.29
PRGF arrangements	898.30	86.90

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				
	2007	2008	2009	2010	2011
Principal	47.87	116.16	146.36	172.28	172.28
Charges/Interest	2.84	5.86	4.76	3.82	2.96
Total	50.72	122.01	151.12	176.11	175.25

[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**

On May 19, 1999, the dual exchange rate system was unified, with all international transactions conducted at the interbank market exchange rate (FIBR). Pakistan is classified as having a de facto conventional peg to the U.S. dollar. Since late December 2004, the nominal exchange rate has remained in the range of 59 to 61 rupees per U.S. dollar and the observed daily changes in that rate have been within a ± 1 percent band. In their formal notification, the authorities classify Pakistan's exchange rate regime as a managed float with no predetermined path for the exchange rate. As of September 28, 2007, the FIBR was PRs 60.69 per US$1. Pakistan has accepted the obligations of Article VIII. The remaining exchange restriction on payments for current international transactions that was subject to Fund approval under Article VIII, Section 2a (which resulted from limitations on advance payments for certain imports) was eliminated in September 2007.

VIII. **Last Article IV Consultation**

The last Article IV consultation (Country Report 06/426) was discussed by the Executive Board on November 22, 2006.

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 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 have been identified under Pakistan's subsequent PRGF Arrangement.

The latest information received at the beginning of 2007 indicates that the SBP continues selective application of International Financial Reporting Standards (IFRS) in combination with the Board-approved accounting policies; that financial statements are audited in conformity with the auditing standards applicable in Pakistan and published on the SBP website; and that a revised organizational structure has enhanced the SBP's internal control systems.

X. FSAP Participation and ROSCs

Fiscal Transparency Module	11/28/2000	(www.imf.org)
Fiscal Transparency Module—Update	11/22/2004	Country Report No. 04/416
Financial System Stability Assessment Financial Sector Assessment Program	6/23/2004	Country Report No. 04/215
Data Module and Detailed Assessment Using Quality Assessment Framework	11/29/2004	Country Report No. 04/398
Data Module, Reassessment of Monetary Statistics and Detailed Assessment Using Quality Assessment Framework	2/2/2007	Country Report No. 07/74
Fiscal Transparency Module—Draft Update	2/13/2007	Awaiting authorities' consent for publication.

XI. Recent Technical Assistance

FAD

January 2002: Fiscal data management, quality, and transparency.
January 2003: Tax administration.
February/March 2003: Customs administration.
April 2004: Fiscal reporting.
April 2007: Public financial management.

MCM

November/December 2004: Public debt reform and capacity building program (joint with World Bank).
March/April 2005: Development of the Insurance Sector.
December 2006: Monetary policy framework.
April 2007: Monetary policy framework, the SBP's balance sheet, and the Banking Services Corporation.

STA

February 2002: External sector statistics/SDDS subscription.
April/May 2005: National accounts and consumer price statistics.
May 2007: Statistics on the international investment position.

XII. Resident Representative

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

ANNEX 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 FY2007, World Bank support to Pakistan totaled US$985 million, making it the seventh 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 a four-year period. 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 strengthened 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 through FY2009. The expansion in lending will take place primarily in infrastructure (mainly in energy, water, and transport) and human development. One priority will be to continue 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 FY2002 are summarized below:

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

	FY2002	FY2003	FY2004	FY2005	FY2006	FY2007
Commitments						
IBRD	...	...	50	347	315	100
IDA	800	297	731	500	1,161	885
Disbursements						
IBRD	38	40	13	203	149	154
IDA	830	316	290	778	1,061	1,030
Repayments						
IBRD	255	257	277	299	289	265
IDA	71	83	96	111	117	170
Debt Disbursed and Outstanding						
IBRD	2,820	2,706	2,526	2,406	2,247	2,132
IDA	5,097	5,604	6,020	6,651	7,627	8,700

ANNEX III. PAKISTAN: STATISTICAL ISSUES

1. 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. The Report on the Observance of Standards and Codes (ROSC)—Data Module, a Response by the Authorities, and a Detailed Assessment Using the Data Quality Assessment Framework (DQAF) were published on the IMF website in December 2004. A ROSC reassessment focusing on monetary statistics was conducted in November 2006 and published on the IMF website in February 2007.

2. Pakistan participates in the General Data Dissemination System (GDDS) since 2003, meeting 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) quarterly employment and unemployment data with a timeliness of one quarter; (b) monthly data on central government operations with a timeliness of one month; (c) quarterly data on the national accounts, wages/earnings, and external debt, all with a timeliness of one quarter; (d) more detailed breakdown of data on central government debt and external debt; and (e) 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. The FBS is currently working on producing quarterly national accounts (QNA), which would be completed with a rebasing of the national accounts to the year 2005/06. In mid-2005, an IMF mission provided technical assistance on the development of QNA and the consumer price index (CPI). 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.

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 extrabudgetary funds. Classification and sectorization in source data follow *GFSM 1986* standards to a limited extent. The classification of expenditure deviates 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 scope of the monetary statistics is comprehensive. The classification and sectorization of the monetary survey compiled by the State Bank of Pakistan's (SBP) 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 the *MFSM*, and the SBP has indicated its intention to adopt the *MFSM* in order to further improve monetary statistics. The ROSC mission that conducted the reassessment of monetary statistics in November 2006 found that the authorities had implemented the *MFSM* guidelines on the sectorization of institutional units, classification of financial instruments, and the recording of securities repurchase agreements (repos). Also, a new reporting framework for other depository corporations has been designed and is being implemented. Further progress is needed in resolving discrepancies in the data on interbank positions between the SBP and scheduled banks. The implementation of the Standardized Report Form framework for reporting monetary data to the Fund is yet to be completed.

7. Starting in the third quarter of 2003 (July–September), Pakistan's balance of payments statements have been prepared according to the methodology of *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 revision studies. Differences between the two sources of trade data (customs records for FBS and exchange records for SBP) for exports and 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. Annual international investment position data are compiled and published on the SBP website. Data are available back to 2003. A Fund technical assistance mission in April 2007 found that the SBP has undertaken work to collect data on export processing zones, nonresident portfolio equity holdings, and settlements via accounts abroad and intercompany accounts.

PAKISTAN: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE
AS OF OCTOBER 18, 2007

	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]	Sep. 2007	Oct. 2007	M	M	M		
Reserve/Base Money	Jul. 2007	Sep. 2007	M	M	M	O, O, O, LO	O, O, O, O, LO
Broad Money	Jul. 2007	Sep. 2007	M	M	M		
Central Bank Balance Sheet	Jul. 2007	Sep. 2007	M	M	M		
Consolidated Balance Sheet of the Banking System	Jul. 2007	Sep. 2007	M	M	M		
Interest Rates[2]	Aug. 2007	Oct. 2007	M	M	M		
Consumer Price Index	Aug. 2007	Oct. 2007	M	M	M	O, LO, LO, O	O, LO, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Jun. 2006	Aug. 2006	Q	Q	Q	LO, LO, LNO, LO	O, O, LO, LO, LO
Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government	Jun. 2007	May 2007	Q	Q	Q		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Jun. 2006	Aug. 2006	Q	Q	Q		
External Current Account Balance	Q4 2006	Jul. 2007	M	M	M	LO, LO, LO, O	O, O, O, O, LNO
Exports and Imports of Goods and Services	Sep. 2007	Oct. 2007	M	M	M		
GDP/GNP	2005/06	Jul. 2007	A	A	A	LO, LNO, LO, LO	LNO, LNO, O, LNO, O
Gross External Debt	Jun. 2006	Aug. 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 in December 2004 and its update published in February 2007, and based on the findings of the missions that took place during December 1–16, 2003 for the dataset corresponding to the variable in each row, and during November 1–15, 2006 for monetary statistics, respectively. 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 (respectively) source data, assessment of source data, statistical techniques, assessment and validation of intermediate data and statistical outputs, and revision studies.

Statement by the IMF Staff Representative
December 17, 2007

1. This statement summarizes information that has become available since the issuance of the staff report on November 8, 2007. The new information does not change the thrust of the staff appraisal. However, the rise in international oil prices reinforces the importance of promptly addressing energy subsidies, while higher inflation and the reemergence of State Bank of Pakistan's (SBP) financing of the budget point to the need to increase interest rates in the auctions of treasury bills.

2. Political uncertainties remain. President Musharraf appointed a caretaker government on November 15. After relinquishing the position of army chief of staff, he was sworn in for a second five-year term on November 29. General elections are scheduled for January 8. The economic team under the caretaker government remains unchanged. The stock market has largely recovered the losses it suffered following the declaration of a state of emergency. However, the EMBIG+ spread for Pakistani international bonds was 433 basis points as of December 11, compared with 214 basis points at end-June, and international rating agencies have changed the outlook on Pakistani debt from "stable" to "negative."

3. The economy has shown considerable resilience to the domestic political tensions and the turbulence in international financial markets. Provisional data for activity in large-scale manufacturing show a growth of 7 percent in the first quarter of 2007/08. In the agricultural sector, the cotton harvest is estimated to have fallen short of last year's good performance; however, a bumper sugar cane crop could make up for most of the shortfall. But inflationary pressures have intensified. The 12-month rate of inflation increased to 9.3 percent in October owing mainly to a substantial rise in food prices, with nonfood, nonenergy (core) inflation rising to 7.4 percent. As a result, average inflation was 7.6 percent in July–October 2007.

4. Based on the revised (higher) WEO oil prices of November 2007, the staff estimates that the external current account deficit could be 0.5 percentage points of GDP higher throughout the medium term than in the projections included in the staff report. However, preliminary information provided by the SBP for July–October 2007 suggests that the current account deficit narrowed relative to the same period of 2006. Export growth recovered to 11 percent, remittances and other transfers increased by 27 percent, and import growth moderated. Official disbursements and foreign direct investment increased slightly relative to the same period of 2006, but portfolio inflows reversed in November. Net international reserves fell by US$980 million since end-June 2007, to US$13.3 billion as of December 10, with the decline concentrated in November owing mainly to large oil and debt payments. The Pakistani rupee has depreciated by 1.2 percent since end-October, as the SBP has allowed for some exchange rate flexibility.

5. The fiscal position has deteriorated, owing mainly to expenditure overruns. The cash fiscal deficit reached 1.6 percent of annual GDP in the first quarter of 2007/08, compared with 0.5 percent in the same period of the previous fiscal year. Total revenue rose by

19 percent, but tax revenue turned out lower than originally anticipated. At the same time, total expenditure increased by 52 percent due to strong growth of development spending and higher than envisaged interest payments and energy subsidies. In the absence of adjustments in fuel prices and electricity tariffs, subsidies could exceed the amount budgeted for the fiscal year by more than 1½ percentage points of GDP. The authorities recognize the need for adjustments in energy prices and are taking steps to reduce the pace of development expenditures.

6. Broad money and reserve money growth (year-on-year) slowed to 18.4 percent and 14.1 percent, respectively, as of November 24, 2007, with credit to the private sector growing by 14.9 percent. During July–September, domestic financing of the government was provided mainly by commercial banks, and the SBP was able to offload some of its holdings of government securities. Starting in October, however, SBP's financing of the government increased markedly, as commercial banks reduced their demand for treasury bills and investment bonds at prevailing interest rates. To reduce pressures in the foreign exchange market, in early December the SBP lowered temporarily the reserve requirement on foreign currency deposits from 20 percent to 10 percent.

7. Global Depository Receipts issues for government shares in two of the largest commercial banks are ready, but their launching has been postponed to early 2008 in view of current conditions in global financial markets.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 07/143
FOR IMMEDIATE RELEASE
December 20, 2007

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

IMF Executive Board Concludes 2007 Article IV Consultation with Pakistan

On December 17, 2007, the Executive Board of the International Monetary Fund (IMF) concluded the 2007 Article IV consultation with Pakistan.[1]

Background

Pakistan has experienced a remarkable turnaround in its economic performance since 2001/02. Sound macroeconomic management and wide-ranging structural reforms have contributed to high real GDP growth, a reduction in the debt burden, and an improved business climate. Adherence to pro-poor policies has helped lower poverty rates. Increasingly, Foreign Direct Investment (FDI) and portfolio flows have become an important source of external financing.

Economic developments during the fiscal year ending in June 2007 remained favorable. Real GDP growth increased to 7 percent, with a recovery in agriculture and a strong performance of large-scale manufacturing and services; the debt ratio continued to decline; and the international reserves position strengthened further. The disinflation process, however, slowed somewhat, with average inflation persisting near 8 percent.

Strong capital inflows boosted the overall balance of payments, but the current account deficit widened for the third consecutive year. The growth of exports and private transfers slowed, offsetting a significant decline in import growth. As a result, the current account deficit reached 4.9 percent of GDP (US$7 billion) in 2006/07. A surge in FDI flows and portfolio inflows

[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.

resulted in a record-high surplus in the financial account. Overall, gross official reserves increased by US$3.5 billion, to US$14.3 billion by end-June 2007. The rupee continued to fluctuate within a narrow band against the U.S. dollar, and the real effective exchange rate remained broadly stable.

Although lending to the government by the State Bank of Pakistan (SBP) ceased in 2006/07, reserve money and broad money grew by about 20 percent, driven by the accumulation of international reserves and lending to commercial banks for subsidized credit to the textile industry. The SBP was able to offload some of its holdings of treasury bills to the commercial banks for the first time in four years. The corresponding pickup in commercial banks' credit to government offset a deceleration in credit to the private sector to 17 percent, from 23 percent a year earlier.

The fiscal stance was kept broadly unchanged in 2006/07, with the fiscal deficit (excluding grants) estimated at 4.3 percent of GDP, the same as in 2005/06. Current expenditure overruns were fully offset by a strong performance of revenues (especially nontax) and underspending on investment projects. The deficit was financed in roughly equal shares from external and domestic sources. The public debt ratio declined by an additional 3 percentage points to about 55 percent of GDP.

Progress on privatization and other structural reforms was mixed. Privatization stalled after the Supreme Court annulled the sale of Pakistan Steel Mills in June 2006, but placements of Global Depository Receipts went ahead as planned. Electricity tariffs were adjusted by 10 percent in February 2007, unlocking World Bank loans and preparing the ground for greater private participation in electricity generation. In the financial sector, the regulations regarding broker financing of share trades were strengthened. The authorities have also been working on their second Poverty Reduction Strategy Paper, which is expected to be completed by the spring of 2008.

The authorities' economic program for 2007/08 envisages real GDP growth of 7.2 percent. The budget deficit target has been set at 4 percent of GDP, below last year's outcome, and in its July Monetary Policy Statement the SBP announced tighter monetary conditions to slow broad money growth to 13.7 percent by the end of 2007/08.

The economy has shown considerable resilience to recent domestic political uncertainties and the turbulence in international capital markets, with provisional data for activity in large-scale manufacturing showing continued strong growth in the first quarter of 2007/08. Owing mainly to the increase in food prices, the 12-month rate of inflation was 8.7 percent in November. The stock market has recovered from losses suffered in early November. However, the spread for Pakistani international bonds over 10-year U.S. Treasuries as measured by the J.P. Morgan Emerging Markets Bonds Index Global was 400 basis points as of December 14, compared with 214 basis points at end-June.

Preliminary balance of payments information provided by the SBP for July–October 2007 suggests that the current account deficit narrowed relative to the same period of last year, with export growth recovering and remittances showing a strong increase. Net international reserves fell by US$1 billion since end-June 2007, to US$13.3 billion as of December 14, with the decline concentrated in November owing to large oil and debt payments and some portfolio outflows. The fiscal position deteriorated in the first quarter of 2007/08 relative to the same period of 2006/07, due mainly to strong growth of development spending and higher than envisaged interest payments and energy subsidies. During July–September 2007, domestic financing of the government was provided mainly by commercial banks, but starting in October SBP's financing of the government increased markedly as commercial banks reduced their demand for treasury bills.

Executive Board Assessment

Executive Directors welcomed that Pakistan's economy continued to perform strongly in 2006/07. Real GDP growth increased, the international reserve position strengthened, and debt ratios declined. The favorable economic performance and structural reforms to improve the business climate have spurred capital inflows in recent years. At the same time, Directors noted that inflation remains relatively high, the external current account deficit has widened, and Pakistan's external financing needs remain large. Continued vigilance is required to reduce vulnerabilities and maintain investor confidence in light of recent political uncertainties and developments in the global credit markets.

Looking ahead, Directors considered Pakistan's main challenge to be the maintenance of high growth while lowering inflation and reducing the external current account deficit to a more sustainable level. This will require continued tight fiscal and monetary policies. In this regard, Directors encouraged the authorities to strengthen the fiscal program for 2007/08 to complement monetary tightening, particularly by reducing energy subsidies and capital spending.

Directors welcomed the tightening of the monetary stance since mid-2007. They regretted the re-emergence of central bank financing of the budget, and stressed the need to adjust the interest rates in treasury bill auctions as needed in order to ensure that the government's 2007/08 domestic borrowing requirement is fully met through the commercial banks or nonbank institutions. Many Directors called for greater exchange rate flexibility, to enhance the effectiveness of monetary policy and better absorb external shocks, while some Directors felt that exchange rate stability is important at this juncture to maintain investor confidence.

Looking beyond 2007/08, Directors stressed that further fiscal consolidation will be required to reduce inflation and the external current account deficit while lessening pressures on real interest rates. In this regard, they noted the low ratio of tax revenue to GDP, and recommended to press ahead with reforms to increase revenue so that it can reduce the fiscal deficit while boosting spending on infrastructure and poverty alleviation. Directors called for a broadening of the tax base, including through expanding taxation of the agricultural and services sectors and reducing tax exemptions. They also supported the use of public-private partnerships in infrastructure development, but cautioned that any contingent liabilities should be fully identified and incorporated in the budget.

Directors agreed that the real effective exchange rate is broadly in line with Pakistan's economic fundamentals. They underscored that fiscal adjustment accompanied by higher levels of investment and vigorous implementation of structural reforms constitute the main avenues to improve external competitiveness. Directors welcomed the central bank's intention to gradually shift direct provision of foreign exchange to oil importers to the inter-bank foreign exchange market, with a view to fostering a market-determined exchange rate.

Directors encouraged the authorities to vigorously implement structural reforms in order to sustain growth and poverty reduction. They underscored the need to modernize the energy sector's regulatory and tariff framework and revive the privatization process. It will also be important to reduce subsidized central bank credit to certain sectors and disengage the central bank from development financing, to further deepen domestic financial markets and enhance the efficiency of financial intermediation, and to move forward with plans to shift from the use of short-term government financing instruments to long-term securities. Directors urged action to strengthen public financial management. They also encouraged the authorities to resist pressures to reinstate ad hoc tariff and nontariff barriers, and to press ahead with their plans for further trade liberalization.

Directors welcomed the recent enactment of regulations governing legislation to combat money laundering and terrorism financing. They underscored the need to obtain parliamentary approval of such legislation, make the Financial Monitoring Unit fully operational, and clarify related reporting and accountability issues.

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

Pakistan: Selected Economic Indicators, 2002/03–2006/07 1/

(In percent of GDP; unless otherwise indicated)

	2002/03	2003/04	2004/05	2005/06	Est. 2006/07
Output and prices					
Real GDP at factor cost (percentage change)	4.7	7.5	9.0	6.6	7.0
Consumer prices (period average; percentage change)	3.1	4.6	9.3	7.9	7.8
Consumer prices (end of period; percentage change)	1.9	8.5	8.7	7.6	7.0
Gross national saving	21.6	18.4	17.7	17.7	18.0
Gross capital formation 2/	16.8	16.6	19.1	21.7	23.0
GDP at market prices (in billions of Pakistani rupees)	4,876	5,641	6,500	7,594	8,707
Public finances					
Revenue (including grants)	17.2	14.6	14.1	14.8	15.2
Expenditure (including statistical discrepancy)	18.5	16.4	17.2	18.5	19.2
Budget balance (excluding grants)	-3.8	-2.3	-3.3	-4.3	-4.3
Primary balance (including grants)	2.9	1.7	0.2	-0.6	0.2
Total government debt	74.5	67.8	62.9	57.3	54.6
Monetary sector					
Net foreign assets (change in percent of broad money)	17.5	2.1	2.2	2.5	8.1
Net domestic assets (change in percent of broad money)	0.5	17.5	17.1	12.4	11.3
Broad money (annual change; in percent)	18.0	19.6	19.3	14.9	19.3
Private credit (annual change; in percent)	18.9	29.8	33.2	23.2	17.2
Six-month treasury bill rate (period average; in percent)	4.1	1.7	4.7	8.2	8.8
External sector					
Merchandise exports, U.S. dollars (growth rate; in percent)	20.1	13.5	16.2	14.3	3.2
Merchandise imports, U.S. dollars (growth rate; in percent)	20.1	21.2	38.3	31.7	8.0
Current account including official current transfers	4.9	1.8	-1.4	-3.9	-4.9
External public and publicly guaranteed debt (in percent of exports of goods and services)	229.0	209.5	183.7	167.8	169.2
Gross reserves (in millions of U.S. dollars) 3/	9,529	10,564	9,805	10,760	14,287
In months of next year's imports of goods and services	6.5	5.0	3.5	3.7	4.5
Pakistani rupees per U.S. dollar (period average)	-4.7	-1.5	3.1	0.8	1.3
Real effective exchange rate (annual average, percentage change) 4/	-0.1	-1.8	0.3	5.3	0.5

Sources: Pakistani authorities; and IMF staff estimates and projections.
1/ Fiscal year ends June 30.
2/ Including changes in inventories.
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 Daïri Mohammed, Alternate Executive Director December 17, 2007

As illustrated in the concise and well written staff report, the economy of Pakistan has performed well in recent years, owing to prudent macroeconomic policies and far-reaching structural reforms aimed at laying the foundation for strong private sector-led growth and poverty reduction. The economy has grown at an average 7 percent over the past four years, while concurrently strengthening its resilience. The latter has been manifested in the fact that despite intense regional tensions, domestic political challenges, external shocks, and setbacks to the two major crops, cotton and rice, growth in in the current year is expected to continue at the same brisk pace, including from buoyant activity in the large-scale manufacturing, construction, and service sectors. The financial sector remains sound and profitable, and there is a steady improvement in debt indicators. Although the current account deficit has increased somewhat in 2006/07, it has been financed by large FDI and other capital inflows, allowing net international reserves to build up to $13.5 billion at the end of November, 2007. Recent data suggest a strong export recovery that should have a positive impact on the current account balance. Though the central bank has pursued a tight monetary policy stance since April 2005, progress in reducing inflation has been a challenge in view of the sharp increase in international oil and food prices, compounded by supply bottlenecks.

Against the backdrop of intense domestic political activities in the run-up to the elections in January 2008, downside risks stem from the impact of the global rise in both oil and food prices (including wheat, palm oil, and soybean), which, together, constitute an important component of the country's imports and CPI basket. These risks are expected to be mitigated, not only because, as underlined in the staff report, the economy has shown a remarkable resilience, but because all political players competing in the upcoming elections have made commitment to staying the course of prudent policies and structural reforms that have contributed to past good performance.

The need for an appropriate policy mix between fiscal and monetary policies to reduce domestic demand and improve the external account position and inflation performance is recognized; the focus will be placed on fiscal consolidation that would not only reduce the external account deficit, but also obviate the need for borrowing from the central bank and lessen pressures on real interest rates. The fiscal deficit is estimated to be broadly in line with the budget target in 2006/07, despite an overrun of current expenditure attributed mainly to a bullet interest payment on a maturing obligation that was not foreseen in the budget. The fact that the authorities succeeded in offsetting this expenditure overrun through a strong revenue collection effort attests to their strong commitment to fiscal and external sustainability. The government debt-to-GDP ratio fell by almost 3 percentage points to 54.6 percent, significantly below the 60 percent ceiling stipulated in the 2005 Fiscal Responsibility Law. The authorities recognize that the significant increase in spending in the first quarter of the current fiscal year is not sustainable. Delays in the pass-through of energy prices to consumers and the increase in fuel and other subsidies reflect the authorities' tight margin of maneuver under current political and social conditions. The authorities are taking steps to reduce the rapid pace of capital spending, as indicated in the staff statement. The deficit target for 2007/08 has been set at 4 percent of GDP, below last year's outcome. Moreover, continued improvement in tax revenue is expected to create room for raising capital and social spending and achieving more equitable growth, in line with the authorities' medium-term plan, which calls for additional spending on poverty reduction, while allowing for a further reduction in the fiscal deficit. Following progress achieved by the Federal Bureau of Revenue (FBR) in improving tax administration, its imminent transformation into an autonomous agency should contribute to increasing its efficiency and strengthening tax audits.

Exogenous as well as temporary factors have contributed to less-than-satisfactory inflationary outcome. In addition to the increase in international food prices, domestic supply problems, especially in the distribution channels for wheat and flour, have also generated a surge in food prices. The monetary authorities are mindful of the adverse consequences of rising prices. To this end, the State Bank of Pakistan (SBP) has targeted a decline in money growth to 13.7 percent in 2007/08 and has adopted a number of measures noted in the staff report, including an increase in the discount rate from 9.5 percent to 10 percent in July 2007 and a reduction in the stock of subsidized credit to the textile industry and exporters, together with the requirement that the commercial banks contribute 30 percent of their own funds to new loans to those sectors. It has also recommended to the Government to retire borrowings from the central bank by PRs 62.3 billion by the end of fiscal year 2007/08 in addition to the adoption of quarterly ceilings. The most recent data indicate that the tightened monetary policy stance is paying off as the 12-month rate of inflation has declined from 9.3 percent in October to 8.7 percent in November 2007. Monetary authorities continue to monitor price developments closely and stand ready to implement additional necessary measures.

The external current account deficit is modestly lower in July-October 2007, compared to the same period of last year, reflecting a strong export pickup, a substantial rise in workers' remittances, and a slowdown in import growth. The capital account recorded a somewhat higher surplus, including from higher official financing and FDI. The momentum of foreign flows is expected to pick up in the coming months, supported by the projected floatation of global depository receipts, once post-election political stability is achieved.

The increasing level of foreign exchange flows has resulted, meanwhile, in visible changes in the country's foreign exchange markets, which have grown substantially in capacity. The authorities have raised the bases for calculating the foreign exchange exposure limits of commercial banks from 10 percent to 15 percent of their paid-up capital, thereby facilitating their ability to manage and price large volume transactions for their customers and paving the way to shifting gradually the demand of foreign exchange for oil imports from the State Bank to the interbank market. The authorities note with satisfaction that staff share their view that the real effective exchange rate is broadly in line with fundamentals, with a greater degree of flexibility capturing market dynamics in exchange rate determination. This is reflected in a higher variation in the exchange rate; the coefficient of variation was 0.45 for July–November 2007 compared to 0.32 for the entire 2006/2007.

Turning to medium-term prospects, the authorities recognize that the key policy challenge facing the government emerging from the forthcoming electoral process will be to lower inflation, while maintaining the high growth momentum of recent years and placing the external current account deficit on a downward trajectory. Meeting this challenge will require a steady pursuit of prudent macroeconomic policies and structural reforms, already in train, for raising both savings and investment through increasing government revenue, strengthening public financial management, formulating and implementing sound monetary policy, deepening domestic financial markets, and further improving the investment climate. The ultimate aim of these reforms remains acceleration of growth, strengthening further the gains from poverty alleviation efforts and significant improvement in living conditions of the Pakistani population at large.

Many initiatives have been taken to allow resources to be directed toward social programs as well as to provide room for private investment. Progress has been made in deepening the financial markets and strengthening the soundness and profitability of the banking sector. The authorities plan to give a further boost to the considerable progress in modernizing the Central Directorate of Savings by completing its corporatization and computerization of its operations by the end of the current fiscal year. Export growth, which moderated last year, has recovered strongly in the first quarter of the current fiscal year. The average export value growth since 2000 has been around 12 percent a year, which compares favorably to Pakistan competitors, except China and Sri Lanka. Progress in enhancing the economy's productivity through the development of infrastructure and human capital has been instrumental in this performance. Other factors contributing to the good performance include the relaxation of regulatory impediments and the establishment of export processing zones. The Foreign Private Investment Promotion and Protection Act has extended to foreign investors the possibility of acquiring full ownership in all economic sectors, with few exceptions in agriculture and services. The expected continuation of the high levels of FDI should contribute to a further strengthening of the export potential. Substantial progress has been made in reducing import protection—the simple average tariff rate is estimated at 14.3 percent in 2006—and the authorities have indicated that they plan to rationalize and further reduce tariffs over the medium term.