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December 29, 1998

To: Members of the Executive Board

From: The Secretary

Subject: **Pakistan—Staff Report for the 1998 Article IV Consultation, Second Review Under the Extended Arrangement and Request for Waiver of Performance Criteria, Request for the Second Annual Arrangement Under the Enhanced Structural Adjustment Facility, Use of Fund Resources—Request for Purchase Under the Compensatory and Contingency Financing Facility, and Exchange System**

Attached for consideration by the Executive Directors is the staff report for the 1998 Article IV consultation with Pakistan, the second review under the Extended Arrangement and request for waiver of performance criteria, the request for the second annual arrangement under the Enhanced Structural Adjustment Facility, and the request expected to be received for a purchase under the Compensatory and Contingency Financing Facility. Draft decisions appear on pages 34–39. This subject, together with the policy framework paper for Pakistan (EBD/98/137, 12/28/98), will be brought to the agenda for discussion on a date to be announced.

Ms. Eken (ext. 36511) or Mr. Gajdeczka (ext. 37124) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Unless the Documents Section (ext. 36760) is otherwise notified, the document will be transmitted, in accordance with the procedures approved by the Executive Board and with the appropriate deletions, to the WTO Secretariat on Friday, January 8, 1999; and to the Asian Development Bank (AsDB), the European Investment Bank (EIB), and the Islamic Development Bank (IsDB), following its consideration by the Executive Board.

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INTERNATIONAL MONETARY FUND

PAKISTAN

Staff Report for the 1998 Article IV Consultation, Second Review Under the Extended Arrangement, and Request for Waiver of Performance Criteria, Request for the Second Annual Arrangement Under the Enhanced Structural Adjustment Facility, Use of Fund Resources—Request for Purchase Under the Compensatory and Contingency Financing Facility, and Exchange System

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

(In consultation with other departments)

Approved by P. Chabrier and C. Muñiz

December 29, 1998

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I. Introduction and Background

1. Discussions for the 1998 Article IV consultation, the second review under the extended arrangement and the second annual arrangement under the ESAF (October 1998–September 1999) were held in Islamabad during September 16–27 and November 11–24, 1998, and in Washington at the time of the 1998 Annual Meetings.[1] Initial discussions for the second review under the extended arrangement were held last May. However, the review could not be concluded because of major adverse changes in Pakistan's macroeconomic situation as a result of the loss of confidence and economic sanctions following the nuclear tests carried out on May 28 that seriously affected the level of external financing. Nevertheless, the authorities maintained an active dialogue with the Fund, the World Bank, and the AsDB staffs in order to safeguard their medium-term macroeconomic objectives. The partial lifting of sanctions and the strengthening of policies paved the way for moving forward with the program

2. The September–November discussions provided the basis for the preparation by the authorities, with assistance from the staffs of the Fund and the World Bank, of a Policy Framework Paper (PFP) for 1998/99–2000/2001.[2] The discussions also provided the basis for the formulation of an economic adjustment and reform program for 1998/99 in the context of a revised macroeconomic framework. In the attached letter dated December 21, 1998, the authorities request the completion of the second review under the extended arrangement, the approval of the second annual arrangement under the ESAF and of exchange restrictions, and seek waivers of two quantitative and one structural performance criteria for end-June 1998, as well as the standard performance criterion on the non-introduction of exchange restrictions and multiple currency practices. The accompanying Memorandum on Economic and Financial Policies (MEFP) updates those dated September 8, 1997 and February 22, 1998, and describes economic developments in 1997/98[3] and the authorities' policy intentions for 1998/99. The authorities are expected to request a purchase equivalent to about 46.5 percent of quota under the Compensatory and Contingency Financing Facility (CCFF).

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[1]The staff held discussions with the Finance Minister, the Governor of the State Bank of Pakistan (SBP), the Deputy Chairman of the Planning Commission, the Finance Secretary, and other senior officials. Mr. Mirakhor, the Executive Director for Pakistan, participated in the discussions. The staff team consisted of Ms. Eken (Head of the November mission), Mr. Furtado (Head of the September mission), Messrs. Gajdeczka, Williams and Helbling (all MED), Mr. Bingham (FAD), and Mr. Toujas-Bernate (PDR). The missions overlapped with the technical assistance missions of Mr. Worrell (MAE) and were assisted by Mr. Mansur, the Fund's Senior Resident Representative in Pakistan. Ms. Allaoua and Mr. Byrd from the World Bank participated in the meetings.

[2]The policy framework paper has been issued as EBD/98/137, December 28, 1998.

[3]Fiscal year ending on June 30.

3. The last Article IV consultation with Pakistan was completed on October 20, 1997, when the Executive Board also approved arrangements under the ESAF and EFF amounting to 150 percent of quota, of which SDR 682.38 million (90 percent of quota) under the ESAF and SDR 454.92 million (60 percent of quota) under the EFF.[4] The first review under the extended arrangement and the mid-term review under the first annual ESAF arrangement were completed on March 30, 1998.[5] In the Executive Board discussion, Directors welcomed the progress made under the program in reducing macroeconomic imbalances and in implementing structural reforms, particularly in the areas of banking sector and public enterprises. However, Directors expressed concern over developments in the budget area, where collection shortfalls had occurred for key taxes and the pace of tax reform had been modest, stressing the urgent need for progress in broadening the base of the sales tax.

4. The staffs of the Fund, World Bank, and Asian Development Bank (AsDB) have collaborated closely in assisting the authorities with the elaboration of the proposed program. In recent years, IBRD/IDA lending programs have increased in support of the government's economic reform program, with special emphasis on human development.[6] The IFC has increased significantly its investments, in particular in manufacturing, tourism, petrochemicals, infrastructure, and capital markets. MIGA guarantees have been issued for projects in the financial, infrastructure, and manufacturing sectors. The AsDB supported programs have concentrated on export promotion, capital markets development, and power sector restructuring.

II. Policies and Performance Under the 1997/98 Program

5. In 1997/98 many macroeconomic indicators improved reflecting the combined impact of stronger demand management policies, favorable exogenous factors, and progress in structural reforms (Chart 1). Most targets under the ESAF/EFF-supported program were reached. However, a number of structural problems remained acute, and the economy began to experience the adverse effects of developments in the international financial markets, which only increased its vulnerability to shocks.

A. Macroeconomic Developments and Vulnerabilities

6. **Growth and inflation performance was favorable.** According to preliminary estimates, real GDP grew by 5.4 percent in 1997/98, virtually as programmed, mostly owing to a strong performance of agriculture and its indirect contribution to the expansion in large scale manufacturing (notably sugar), as well as a recovery in other industrial sectors

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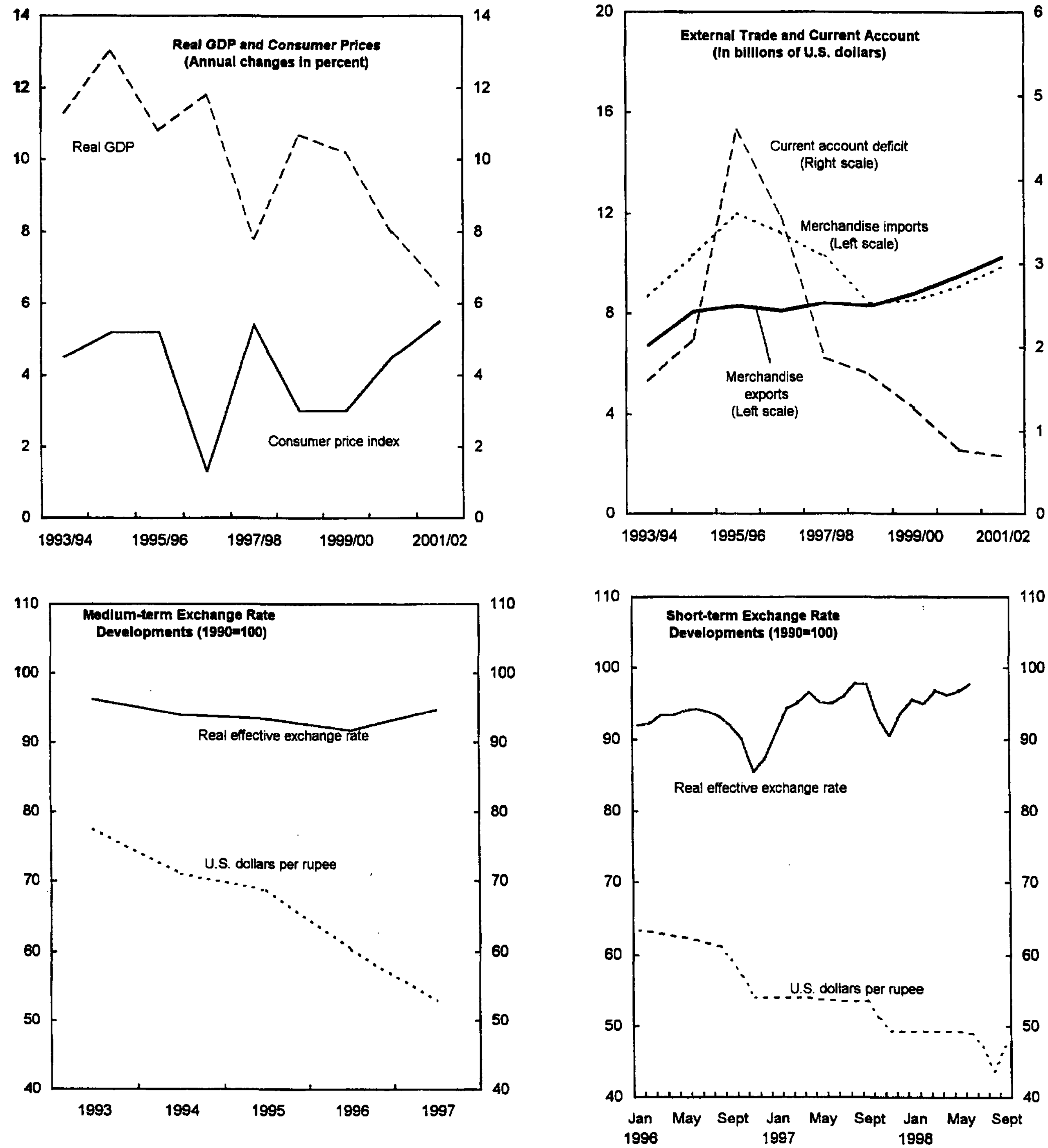
[4]The Board papers are EBD/97/110, EBS/97/185, and EBS/97/185 Supplement I.

[5]The Board paper is EBS/98/51. Pakistan's relations with the Fund are summarized in Appendix II.

[6]Pakistan's relations with the World Bank Group are summarized in Appendix III.

CHART 1
PAKISTAN
SELECTED ECONOMIC INDICATORS, 1993-2002



Sources: Data provided by the authorities of Pakistan; and staff estimates.

(Appendix I, Table 1). The average CPI inflation (year-on-year) decelerated to about 8.0 percent, compared with the program target of 10.5 percent, reflecting tighter demand policies, recovery in output growth, and a decline in import prices.

7. **The external current account deficit contracted by nearly 50 percent, while the capital account deteriorated.** The current account deficit (excluding official transfers) amounted to 3.2 percent of GDP, compared with the program target of 5.1 percent of GDP (Appendix I, Table 2). The bulk of the adjustment was registered in the trade accounts, largely reflecting a temporary improvement in terms of trade and a decrease in imports. The value of imports declined by 8.3 percent, reflecting the declines in petroleum product prices and imports of power generating machinery as major investments in power plants neared completion. Meanwhile, exports increased only by 4.2 percent in U.S. dollar terms, despite a good performance in a range of primary commodities and nontraditional manufactures, largely due to falling prices of cotton and cotton based products and slow sales of textiles, partly attributable to the Asian financial crisis. In the capital account, inflows of long-term private capital declined sharply and net flows of private short-term capital turned negative, reflecting the adverse impact on investor sentiments of the political crisis in Pakistan during November–December 1997 and spillover effects from the economic crisis in East Asia; external financing from commercial sources for the public sector was also below target. The growing reluctance on the part of foreign investors to provide financing was also evident in the failure to issue a new eurobond and in the reduction in foreign currency deposits in Pakistan by institutional international investors. By end-June, gross official reserves had declined to US$932 million, compared with the programmed objective of US$1,673 million.

8. **Financial policies were broadly in line with the program.** The budget deficit was kept within the program ceiling as shortfalls in revenues from customs duties and the General Sales Tax (GST) were offset by higher than programmed petroleum surcharge revenues and lower current expenditure (Chart 2 and Appendix I, Table 3).[7] The overall deficit of the seven major public enterprises is estimated to have contracted significantly in 1997/98 reflecting improvements in the financial position of gas companies, the telecommunication company, and the Karachi Electricity Utility.[8] However, the liquidity position of a number of enterprises deteriorated and intra public sector arrears increased. Central bank foreign exchange losses (associated with exchange rate guarantees under the foreign currency deposit scheme) and loans to the nationalized banks (associated with their downsizing and financial

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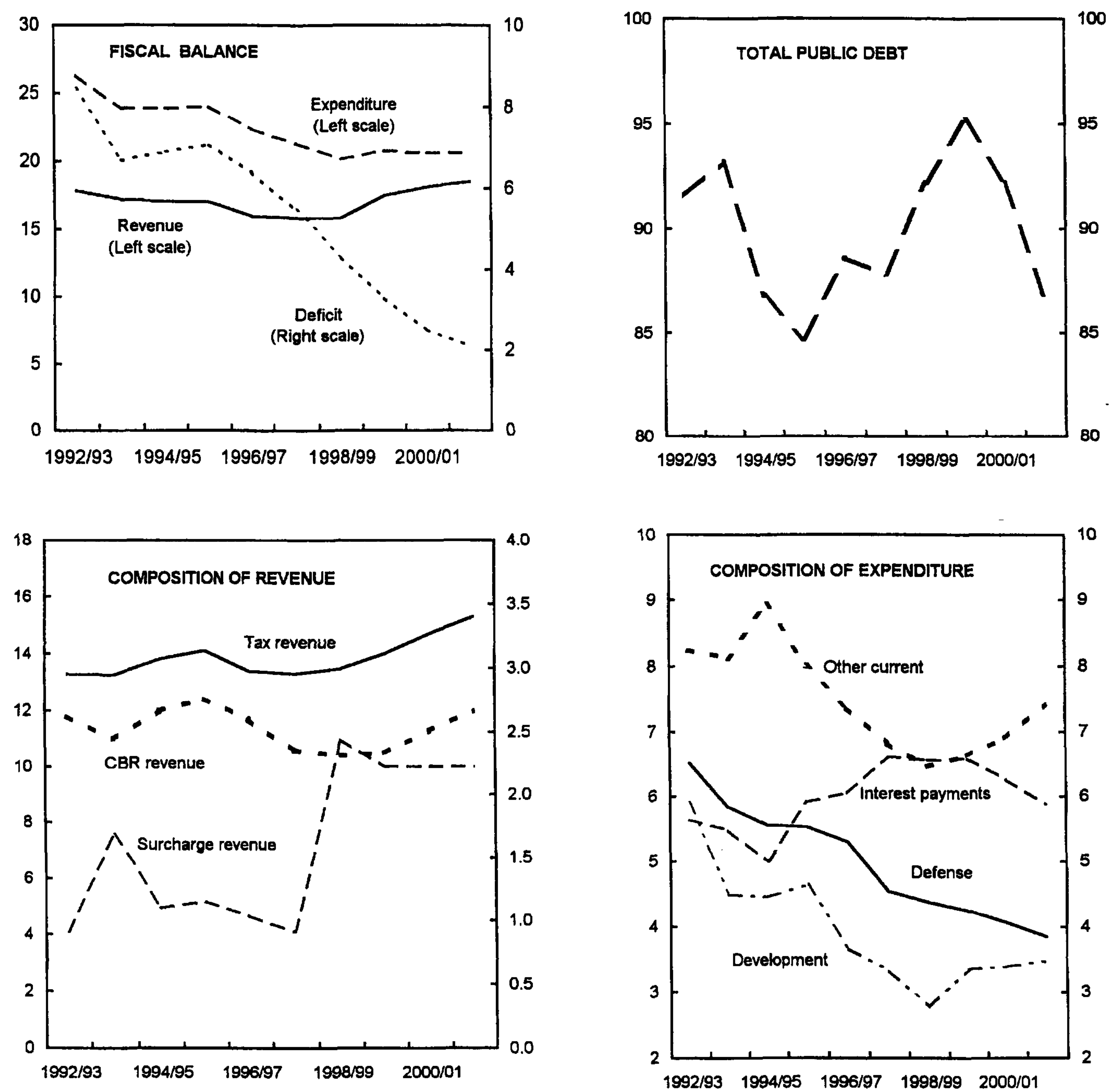
[7]Under the 1997/98 program, the budget deficit was defined to exclude net lending which was higher than envisaged under the program. The budget deficit/GDP ratio was also higher than the programmed ratio of 5.0 percent due to downward revisions in the nominal level of the GDP, which reflected lower than originally estimated industrial output in 1996/97 and the lower than targeted inflation in 1997/98.

[8]Pakistan Railways, the Water and Power Development Authority (WAPDA), the Karachi Electricity Supply Corporation Ltd. (KESC), Sui Northern Gas Pipelines Ltd. (SNGPL), Sui Southern Gas Company Ltd. (SSGCL), the Pakistan Telecommunications Corporation Ltd. (PTCL), and the Oil and Gas Development Corporation (OGDC).

CHART 2
PAKISTAN
FISCAL DEVELOPMENTS, 1992-2001
(In Percent of GDP)



Sources: Data provided by the authorities of Pakistan; and staff estimates.

restructuring), however, led to an expansion of net domestic assets above target levels (Appendix I, Table 4).[9] Broad money growth was lower than programmed with a significant loss of net foreign assets. Following its devaluation by 8.0 percent (in terms of rupees per U.S. dollar) in October 1997, the rupee appreciated only by 2.9 percent in real effective terms on a June to June basis (Chart 1).

9. **All but two quantitative performance criteria for end-June 1998 were met.** The performance criteria on net foreign assets of the SBP for end-June and on the accumulation of budgetary arrears to WAPDA for end-June (missed also for end-March) were not met despite the generally satisfactory implementation of financial policies. The slippage in net foreign assets of the SBP was due to the consequences of the May 1998 developments (described below). As regards the arrears to WAPDA, those reflected the difficulties in reconciliation of electricity bills with provincial governments.

10. **While the general macroeconomic performance improved, many structural weaknesses persisted and even deepened in a number of areas.** In particular: (i) the buoyancy of many taxes remained low and the budget has become unduly dependent on a windfall gained from increased petroleum tax revenue associated with the fall in international prices of oil; (ii) weak financial management of the power sector utilities led to growing interenterprise arrears, undermining the operational viability of other corporations and the budgetary nontax revenues; (iii) the conflict with the independent power producers (IPPs) over tariffs and corruption charges adversely affected the investment climate; (iv) the improvement in the external accounts largely reflected lower petroleum prices and reduced machinery imports financed by foreign investors rather than the export performance; and (v) the SBP's uncovered foreign exchange position increased and peaked at US$9.8 billion by end-April 1998, which decreased the SBP's flexibility in monetary and exchange rate policy even further. In the circumstances, financial market sentiments deteriorated, reflected, *inter alia*, in a decline of about 25 percent in the Karachi stock market index during seven months ending in mid-May 1998, and the premium in the parallel market for foreign exchange over the official exchange rate widened to a 3.5–5.5 percent range (Chart 3).

B. Structural Reforms

11. Progress in the implementation of commitments under the structural reform program is described in detail in the attached MEFP. The main features are highlighted below.

12. **Significant progress was made in banking and financial sector reforms**. The State Bank strengthened prudential regulations, and took measures to improve the capital base of the banking system and redress administrative weaknesses in financial institutions. Two major state-owned banks—United Bank Limited (UBL) and Habib Bank Limited (HBL)—were financially restructured, and due diligence reports were submitted to government, with a view to privatizing them once investment conditions improve. The

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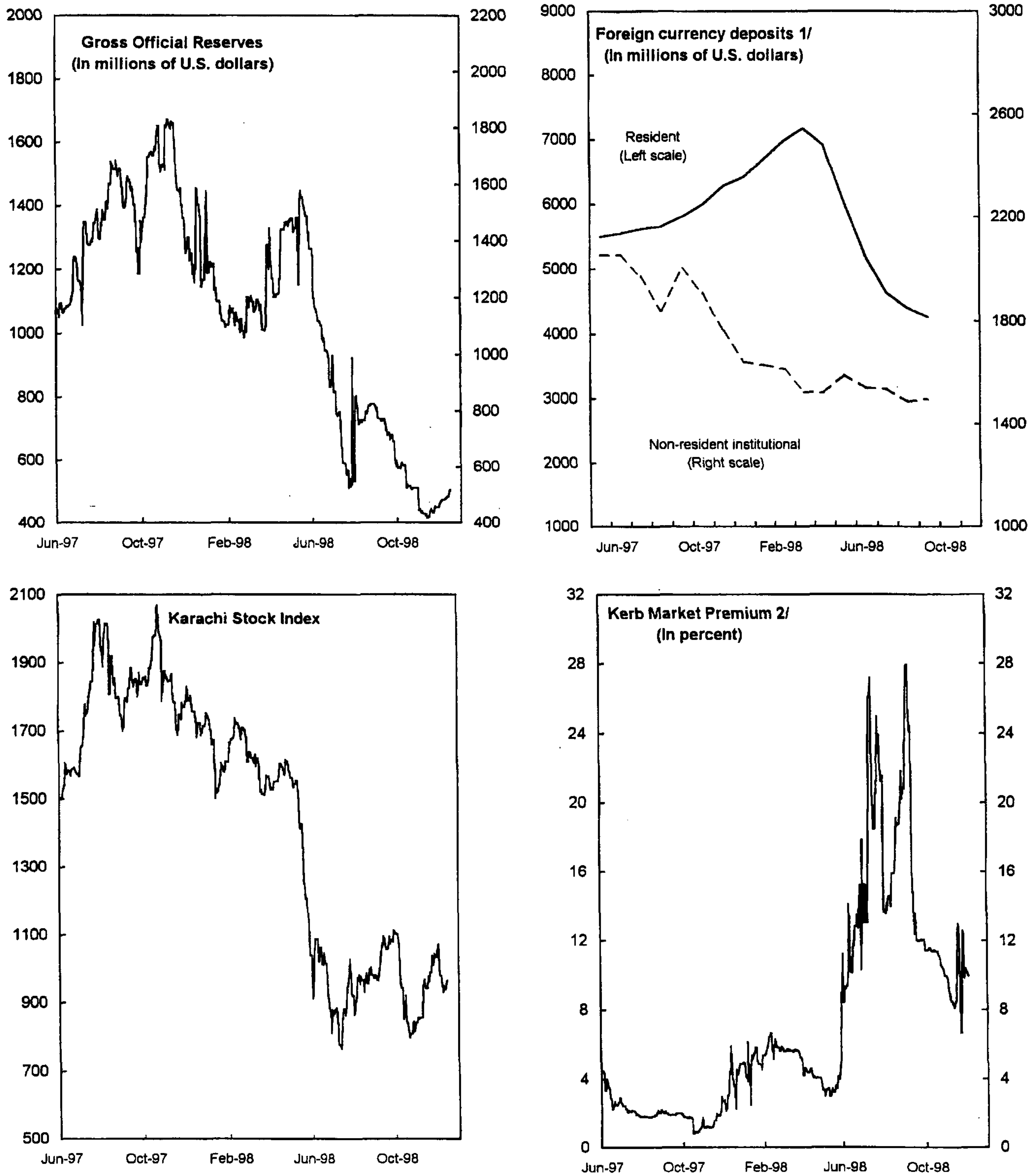
[9]The SBP raised the cut-off yield at auctions of short-term federal bonds to 16 percent at end-March 1998 (from a low of 12.5 percent in mid-November 1997).

Chart 3
Pakistan
Confidence Indicators June 1, 1997-December 15, 1998



Source: State Bank of Pakistan.

1/ Monthly data until October 31, 1998.

2/ From July 31, 1998, relative to the composite rate.

solvency of the banking system was improved by a cash recovery from loan defaulters by banks[10] and capital injections (see box 1).[11] In addition, the implementation of the new loan recovery law is being strengthened to improve the transparency and effectiveness of the banking courts. Financial market deepening continued: a marketable foreign currency bond was issued, treasury bills were introduced to replace the short-term federal bonds, and steps were taken to develop and liberalize the foreign exchange market.

13. **Implementation of fiscal reforms was not fully satisfactory.** The effective expansion of the base of the GST was slower than envisaged under the program. Although GST exemptions for sugar and edible oils were removed, and legislation extending the GST to the retail stage was adopted, setbacks were encountered in enforcing the GST at the manufacturing stage. In particular, portions of the textile sector remained outside the tax net and a large number of industries continued to be taxed under capacity schemes. Moreover, progress with regard to the strengthening of tax administration was slower than envisaged, delayed in part by the initiation of a comprehensive restructuring of the Central Board of Revenue (CBR). Thus, the administration of the refund system remained inefficient, adversely affecting the export sector; and the development of effective tax enforcement and audit programs was impeded by a lack of coordination between the GST, income tax, and customs administration, and a lengthy and cumbersome appeal process. The absence of a single taxpayer identifier was a significant impediment to progress. At the provincial level, although revenue collections under the agricultural income tax were in line with program targets, progress toward implementing an effective tax on agricultural income fell short of the program objectives.[12] The study on the reform of the agricultural income tax system, prepared in collaboration with the World Bank, was completed on schedule in June 1998. However, the harmonization across provinces of the existing land-based taxes was not achieved (a performance criterion for which a waiver is requested) because the appropriate design of a national land-based tax was still under review by the authorities and the World Bank to find the best way to proceed (discussed below).

14. **Finances of major public enterprises improved but their restructuring was delayed.** The financial position of the seven major enterprises improved in 1997/98, largely reflecting strengthened performance of the gas companies and the impact of the March 1998 electricity tariff increase on revenues of WAPDA and KESC (Appendix I, Table 5). However, major delays occurred in the implementation of a comprehensive restructuring program for the energy sector, the envisaged recovery of outstanding dues from provincial and federal governments (which amounted to about PRs 16 billion at end-June 1998), and the

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[10]Amounting to PRs 20 billion in 1997 and PRs 13 billion in the first ten months of 1998.

[11]In mid-1998, two public banks received capital injections totaling PRs 30.7 billion.

[12]Agricultural income is currently undertaxed and a potential vehicle for tax avoidance because it is constitutionally exempt from regular income tax. Given the inequitable distribution of land in Pakistan, lack of progress in this area has also given rise to concerns about equity and governance.

Box 1. Banking System in Pakistan

Commercial banks are the primary source of finance for firms in Pakistan. In mid-1998, total assets of the banking system amounted to PRs 1,295 billion, or 41 percent of GDP, of which about 53 percent constituted claims on the nongovernment sector. The banking system consists of 46 institutions, including four banks wholly owned by the government, two jointly owned by the state and private interests, 21 foreign banks with branches in Pakistan, 13 privately owned domestic banks, four specialized state-owned banks and two banks owned by provincial governments. The banking system is highly concentrated; the top four banks hold about 70 percent of total assets and domestic deposits.

There are significant differences across banks in terms of their deposit base and focus of activity. In mid-1998, about 30 percent of resident deposits was in the form of foreign currency. In domestic nationalized and partially privatized banks domestic currency deposits had a share of 75 percent and above while in foreign banks FCDs accounted for nearly 80 percent of total deposits. Large domestic banks have an extensive branch network and a very diversified scope of activity. Foreign banks' operations are concentrated in large cities and are oriented on the "blue chip" corporate sector and on the financing of international transactions. Domestic banks operate with intermediation costs larger than foreign banks, due to a considerable share of nonperforming loans in their portfolios and high operating costs in part due to overstaffing.

Efforts to improve the soundness of the banking system followed since early 1997 three parallel tracks: (i) strengthening of the regulatory and supervisory environment; (ii) better management of banks; and (iii) improvement in capital adequacy. Following the strengthening of the autonomy of the State Bank of Pakistan (SBP) in early 1997, prudential regulations were modernized and capital adequacy requirements in line with international standards were introduced in November 1997. The SBP is developing its supervisory capacity and new regulations were issued to bring accounting practices and disclosure requirements to international standards. Since end-1997, all banks provide to the SBP reports on prudential ratios, liquidity, asset quality, and income and expenditure, and will publish audited financial statements annually. Operations of state-owned banks are being improved by changes in management, introduction of performance agreements, rationalization of the branch network and reduction in overstaffing. As of June 1998, approximately 10 percent of branches of nationalized banks was closed, one-third of total employment was eliminated, and operating costs and intermediation margins declined. The recovery of defaulted loans considerably improved with the amendment of the Loan Recovery Act of 1997 and the establishment of 34 banking courts. The total cash recovery reached PRs 20 billion in 1997, and additional PRs 13 billion during the first ten months of 1998. Specific loan recovery targets have been agreed with nationalized banks with the objective of reducing their existing stock of defaulted loans by 90 percent within three years.

Prudential indicators of the banking system improved. In mid-1998, most banks, including all private and all but one foreign bank, met or exceeded the minimum **capital-adequacy requirements** on a risk-weighted basis (net of provisions against bad loans). Among the top four banks, however, only one met the 8 percent capital adequacy ratio, for two others this ratio was above 7.5 percent, and for one bank the ratio was 4 percent. The stock of **nonperforming loans** increased from PRs 108 billion at end-1995 to PRs 143 billion at end-1997 and broadly stabilized thereafter, at about 18 percent of the loan portfolio. In some of the largest banks, nonperforming loans account for about 25 percent of the total. There are no significant risks arising from **maturity mismatch** in the banking system. Among assets, short-term lending accounts for a large share of banks' loan portfolios and banks' holdings of liquid securities correspond to 35 percent of deposits. Among liabilities, by contrast, savings deposits and those for one year and longer account for 58 percent of all deposits. Banks are not exposed to significant **foreign exchange risk**, as their open foreign currency positions are very restricted.

settlement of a large portion of WAPDA's arrears to its creditors. Moreover, the pace in implementing the steps needed to strengthen the regulatory environment in the context of the gas and power sector restructuring program has not been fully satisfactory.

15. **A weakening investment climate contributed to delays in privatization.** Poor performance of the stock market, affected by the impact of domestic developments since late 1997 and growing uncertainties associated with the East Asian financial crisis, undermined the privatization process. In the banking sector, only Habib Bank Ltd. was recently offered for sale, while divestiture of remaining government shares in four financial institutions (Muslim Commercial Bank, Allied Bank Ltd, Pakistan Industrial Credit and Investment Corporation, and Bankers' Equity Ltd), originally programmed for March 1998, as well as the envisaged privatization during 1997/98 of 18 enterprises outside the banking sector, were delayed.

III. Developments Since May 1998

16. **The economic situation deteriorated following the nuclear tests of May 1998.** Immediately following the nuclear tests, the United States and Japan imposed economic sanctions, and a subsequent agreement by the "Group of Eight" led to the suspension of new official lending to Pakistan, except for humanitarian purposes. These developments and certain subsequent policy measures contributed to a sharp contraction in private transfers, a further reduction in capital inflows, and a widespread further loss of investor confidence. The Karachi Stock Exchange index declined by 35 percent in a matter of days; massive withdrawals of FCDs were registered; and major credit rating agencies lowered Pakistan's rating to a below investment grade.

17. **The government quickly took policy measures aimed at preventing an immediate exchange rate crisis and insulating domestic economic activity and prices from the sharp decline in external financing and loss of investor confidence.** These measures included in particular:

- **Fiscal measures** (1.2 percent of GDP) were taken to reinforce the macroeconomic adjustment implied by the 1998/99 budget adopted in June. In particular, retail prices of gasoline were raised by 25 percent, the structure of tariffs on telephone calls was revised, and planned development expenditure was reduced.

- **The exchange rate** was adjusted and the exchange system modified. On June 26, 1998, the government devalued the rupee vis-à-vis the U.S. dollar by 4 percent to PRs 46 per U.S. dollar. Subsequently, a dual exchange rate system was adopted and an exchange rate float in the interbank market was introduced on July 22, resulting in an about 10 percent depreciation of the Pakistani rupee vis-à-vis the U.S. dollar (as measured by the "composite rate" described below) during end-July–end-October 1998.

- **Exchange restrictions** were introduced, including a 30 percent advance import deposit, increased withholding of foreign exchange for selected categories of current international payments, suspension of withdrawals from FCDs in foreign exchange, and intensified capital controls.[13]

- **Debt service payments** to official bilateral and commercial creditors were suspended.

- **Reserve and statutory liquidity requirements** were temporarily reduced to ease the anticipated pressures arising from FCD withdrawals on banks' liquidity.[14] This benefited mostly foreign banks whose deposits were dominated by the FCDs. In the event, banks remained very liquid and money market interest rates declined substantially as FCDs were largely converted into rupee deposits (Chart 4).

18. **The external financing constraints magnified the reduction in imports due to other factors, and led to a substantial buildup of arrears and a depletion of foreign exchange reserves.** During July–September 1998, imports declined by 16.2 percent compared with the previous year, largely due to declines in petroleum prices and lower imports of wheat and power generating machinery. Preliminary balance of payments data suggest that the impact of financing constraints intensified from October. Although the contraction in the trade balance deficit was substantial, it was insufficient to offset a US$1.5 billion turnaround in the capital account and a sharp decline in private transfers, and payments delays began on current and capital account transactions. As of end-November, arrears on account of current account payments and debt service obligations amounted to US$1.6 billion. In addition, despite growing restrictions and the official financing support in the form of a two-year deposit of US$ 250 million arranged for the SBP, the stock of official reserves declined to about US$450 million by end-November, of which less than half constituted usable reserves (less than one week of imports). Meanwhile, inflation remained moderate aided by good agricultural crops and falling commodity import prices.

IV. Macroeconomic Adjustment and Reform Program

19. **The program addresses the external payments crisis as well as the structural problems.** In the short-term, the program aims primarily at containing the adverse effects of recent shocks on the domestic economy and the balance of payments, normalizing relations with creditors, eliminating exchange restrictions, and rebuilding investor confidence. Over the medium term, it aims at reducing the structural weaknesses and the vulnerability of the

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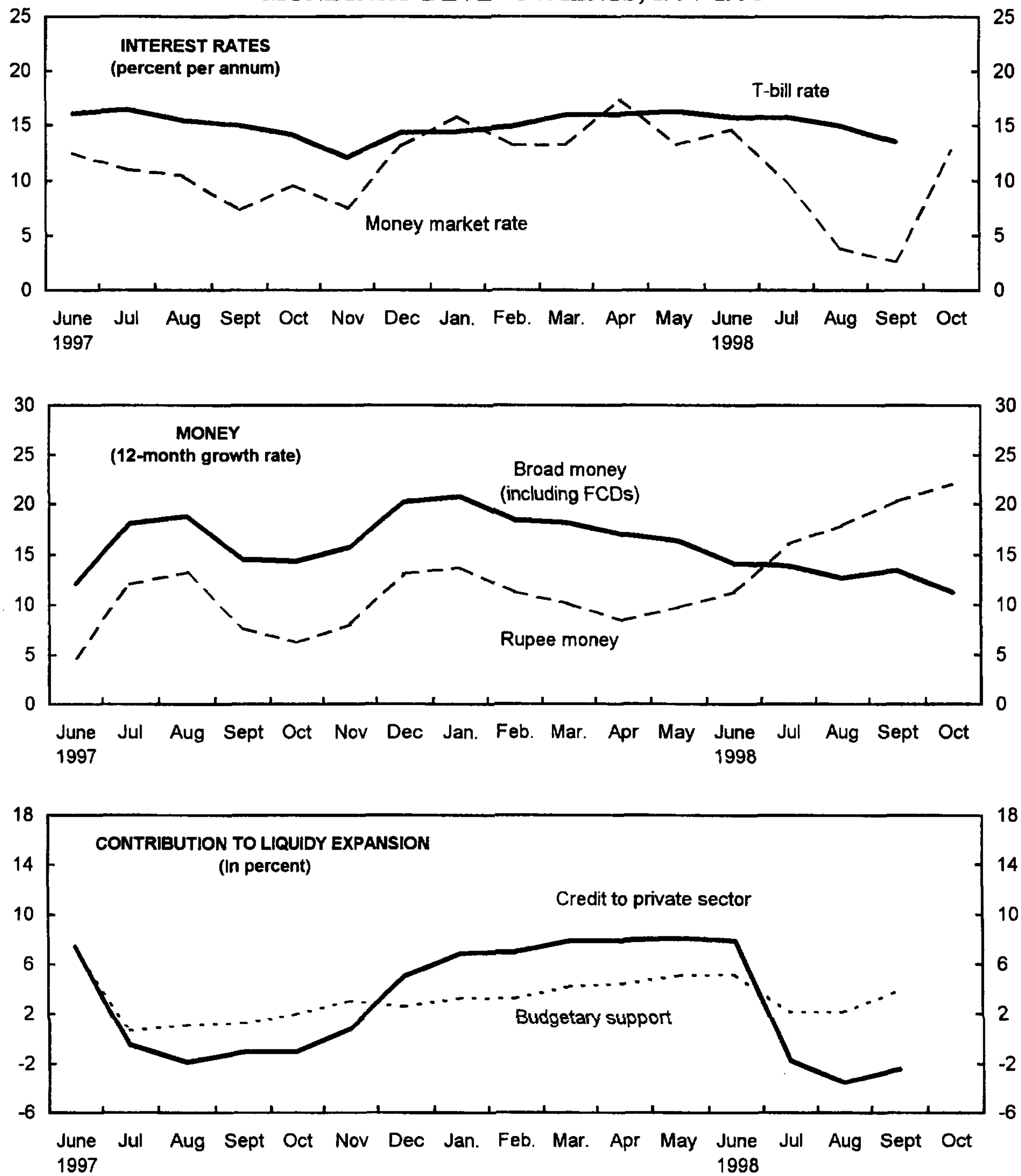
[13]These exchange restrictions were notified to the Fund as national security-based pursuant to Decision 144-(52/51). The exchange restrictions subject to Fund jurisdiction were approved in accordance with that decision.

[14]On June 22, the reserve requirements were reduced to 3.5 percent from 5 percent of liabilities, and the liquidity ratio was reduced to 15 percent from 18 percent of liabilities.

CHART 4
PAKISTAN
MONETARY DEVELOPMENTS, 1997-1998



Sources: Data provided by the authorities of Pakistan.

economy so as to achieve sustainable high rates of growth. With such a strategy, the program envisages sustained implementation of strong demand management policies, significant up-front financial support, and a phased implementation of broad-based structural reforms in line with the required preparations and the administrative constraints.

A. Macroeconomic Framework

20. **Macroeconomic objectives for 1998/99 and 1999/2000 take into account recent economic developments, policy intentions and financing constraints.** The objectives are: (i) annual real GDP growth rates of at least 3 percent (Box 2); (ii) annual average inflation rates of no more than 11 percent this fiscal year and 10 percent next fiscal year; and (iii) a buildup in gross official reserves to a minimum of US$1.3 billion by end-June 1999 (equivalent to less than 2 months of imports) and US$1.7 billion by end-June 2000. To achieve these objectives, the authorities are determined to implement tight fiscal and monetary policies, gradually move to a market-determined, unified exchange rate, move forward with wide-ranging structural reforms, and mobilize external resources, including through debt relief by official and commercial creditors.

21. **The updated medium-term framework is predicated on continued tight demand management policies and acceleration of structural reforms.** Over the medium term, the objectives are: (i) real growth of at least 5 percent per annum; (ii) reduction in inflation to 6 percent; (iii) official foreign exchange reserves of about three months of imports; (iv) higher domestic savings; and (v) enhanced allocative efficiency through increased role of market forces in the economy. Consolidation of public sector finances will be key to achieving the macroeconomic objectives (Appendix IV). The budget deficit will need to substantially decline and the financial position of key public sector enterprises strengthened to release resources for private sector development and to reduce the vulnerabilities associated with the large stock of public debt. Reflecting these policies, gross national savings would rise to above 16 percent in 2002/03, largely on account of increased public sector savings, allowing gross capital formation to increase to almost 18 percent. The recovery in private sector investment would be consistent with the growth targets and the underlying productivity increases expected from the acceleration of the reform package. Monetary and exchange rate policies will be geared toward building up confidence in domestic financial markets, containing inflation, and safeguarding the external position. External sector policies target further liberalization of trade and of the foreign exchange market.

B. Policies for 1998/99 and 1999/2000

Fiscal Adjustment

22. **Policies seek to reverse a sharp widening in the budget deficit during July-September 1998.** Notwithstanding the measures already incorporated under the 1998/99 budget announced in June, including the extension of the GST to the retail stage one year

Box 2. Sources of Growth, 1998/99–1999/2000

Against the background of the external financing constraints that emerged after May 1998, growth of real GDP at market prices is projected to decline to **3 percent in 1998/99** compared with 5.3 percent in 1997/98. Considering the recent experience of other countries that suffered from severe balance of payments constraints, the **projected growth slowdown appears moderate**. The following factors explain why the projections assume that the negative growth effects of balance of payments constraints are limited compared with middle-income developing countries:

- Pakistan's economic structure, which is characterized inter alia by a relatively low openness (merchandise trade value amounted to about 30 percent of GDP in 1997/98), a low share of gross fixed capital formation in GDP (17.3 percent of GDP in 1997/98), a large agricultural sector and related industries (contributing directly to the generation of about 30 to 35 percent of gross value added in 1997/98), and less leverage in the balance sheets of private sector entities;

- bumper crops in all major crops in 1998/1999, which are expected to increase the real gross value added in the agricultural sector by about 5 percent and to ignite the typical supply-driven increase in domestic demand; and

- the expected sharp decline in private sector gross fixed capital formation is partly offset by modest nominal increases in public sector capital formation, so that the decline in total gross fixed capital formation remains limited.

On the supply side, the balance of payments constraints are reflected in the forecasts for the industrial and service sectors. In the industrial sector, low growth or even an output contraction is expected in construction and industries producing components used in gross capital formation and, possibly, durable consumer goods. Moreover, industries producing exportables might suffer from weak import demand in the Asian region. In the services sector, gross value added in real terms is projected to remain unchanged for the commerce and banking industries given the contraction in import volumes and the slowdown in industrial sector activities on the one hand and the increased agricultural activity on the other. On the demand side, the external financing constraints are reflected in the decline of gross capital formation as a percent of GDP from 17.3 percent in 1997/98 to 15 percent in 1998/99 and the adjustment in net exports of goods and nonfactor services as a percent of GDP from -4.4 percent to -1.5 percent during the same period. The projected adjustment in net exports of goods and nonfactor services arises largely on account of a decrease in merchandise imports (1.9 percentage points of GDP).

Real GDP in 1999/2000 is projected to grow also at a rate of 3 percent. Increased growth in export volumes, especially due to the projected recovery in the Asia region, will allow for the financing of somewhat larger import volumes, thereby compensating for the continued stagnation in gross capital formation and public sector demand in real terms.

This scenario of moderate growth in 1998-2000 is subject to **downside risks**, which are mostly related to uncertainties in determining the quantitative effects of the balance of payments constraints and the tightening of financial policies. Also, the disappointing export developments during the first four months of 1998/99 may indicate that exports of manufactured goods may perform worse than expected. The downside risks are likely to apply to growth in 1999/2000 rather than in 1998/99 as (i) the bumper crops of 1998/99 are already being harvested, (ii) lower world market prices of importables (e.g., crude oil and manufactures) in 1998/99 are likely to alleviate the impact of the external financing constraints on import volumes, and (iii) inventories of imported commodities can temporarily ease the negative output effects of lower imports of raw materials and intermediate inputs in 1998/99.

earlier than envisaged under the Fund-supported program,[15] and the fiscal measures implemented in July, the budget deficit widened to PRs 56 billion (1.8 percent of annual GDP) in the first quarter of 1998/99. Without corrective measures and taking into account the cost of the new electricity subsidy for household consumers (PRs 8.2 billion) announced by the Prime Minister in October and the revenue loss associated with the envisaged reform of external tariffs in March (PRs 4.8 billion), the deficit for 1998/99 as a whole could have reached 5.6 percent of GDP.[16]

23. **The primary surplus needs to double to reduce the budget deficit in 1998/99 to 4.3 percent of** GDP. To achieve this fiscal target, the program incorporates the following additional measures: (i) an increase in the GST rate to from 12½ percent to 15 percent (a prior action that has already been implemented); (ii) an increase of the tax incidence on petroleum products; (iii) a reduction in the budgeted amount of military expenditure; (iv) a strengthening of the financial position of WAPDA and KESC;[17] (v) a reduction in the federal subsidy on wheat; and (vi) a lowering of the budget appropriation for several other components of noninterest current expenditure.[18] The fiscal impact of these measures is estimated at about PRs 40 billion (1.3 percent of GDP). Special efforts are being made to protect allocations for high-priority projects and programs within the budgetary Public Sector Development Program and for basic social expenditures under the Social Action Program.

24. **The authorities are committed to fiscal consolidation**. They have already increased the GST rate on December 1 and indicated their intention to fully implement all other

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[15]The 1998/99 budget also included a number of other revenue measures, notably the envisaged extension of the GST to edible oils, the postponement of the reduction in the rate of corporate tax announced in the 1997/98 budget, the introduction of the surcharge on income tax, and the abolishment of the remaining fixed tax capacity schemes. In addition, the budget announced the establishment of an autonomous body, the Pakistan Revenue Service, to replace the CBR as well as a number of additional tax administration measures, including the creation of a common tax identifier number.

[16]The government will phase out the electricity subsidy according to the following schedule: (i) for consumers with a monthly bill of PRs 5,000 and above, the subsidy rate will be reduced by 50 percent in March 1999 and eliminated in June 1999; and (ii) for consumers with monthly bill below this threshold, the subsidy rate will be reduced by 50 percent in June 1999 and eliminated by September 1999. The total cost of the subsidy over the 12-month period is estimated to be PRs 10.8 billion.

[17]This will reduce net lending by the government to these enterprises by about 0.4 percent of GDP.

[18]The budget has a cushion of about 0.3 percent of GDP, arising from a likely understatement of SBP profits, a potential interim dividend payment by the Pakistan Telecommunication Corporation following the recent increase in telephone tariffs, and a contingency reserve.

programmed fiscal measures in a timely manner. In addition, the authorities expressed their preparedness to take additional measures, if needed, to ensure the achievement of the 1998/99 fiscal target, including through cuts in low priority expenditure programs, enhancement of excise duties on cigarettes, increases in withholding tax on prize bonds, imposition of excise duty on motor vehicles, and removal of some of the existing GST exemptions. Furthermore, the authorities are also committed to undertake the necessary fiscal measures to reduce the budget deficit to 3.3 percent of GDP in 1999/2000, including through fiscal reforms described below.

25. **Domestic financing of the budget deficit will amount to 1.2 percent of GDP in 1998/99.** With the targeted reduction in the budget deficit and in view of a large financial impact of reschedulings, net domestic financing requirements will be substantially reduced (to PRs 38.5 billion from PRs 129.4 billion in 1997/98). The domestic financing plan assumes that the government will make net repayments of its bank debt, and that nonbank borrowing will remain broadly unchanged from last year, at about 2.5 percent of GDP.

Monetary and Exchange Rate Policies

26. **A unified exchange rate system will be reintroduced on July 1, 1999.** On July 22, 1998, the SBP introduced a floating exchange rate regime based on the interbank market while maintaining the official exchange rate (PRs 46 per U.S. dollar) as explained in Box 3. Transactions at the official exchange rate were limited;[19] most transactions were conducted at a "composite rate". This approach reflects the desire of the authorities to maintain in some way the current official exchange rate in order to limit the impact of FCD conversions on liquidity and minimize forward cover losses of the central bank.[20] The free interbank market rate (FIBR) has remained broadly stable since early August, at about PRs 54 per U.S. dollar, resulting in a stable "composite" exchange rate of about PRs 50 per U.S. dollar. The authorities agreed to reduce the weight of the official exchange rate in the "composite rate" from 50 percent to 25 percent and move capital account transactions, except conversions of FCDs and related instruments, to the "composite" rate as a prior action and to adopt a market-determined unified exchange rate system on July 1, 1999. The staff argued that the transitional exchange rate regime is not very transparent, the dual rate is distortionary, and that composite rate mechanism creates additional incentives for under- and over-invoicing,

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[19]From October 16, 1998, imports at the official exchange rate were limited to those of wheat and petroleum products. Products that were shifted from the official exchange rate to the composite rate were also made subject to a 30 percent cash deposit requirement (applicable to other import transactions), which was not included in the notification under Decision 144(52/51). The application of the advance import deposit requirement to payments for these other transactions constitutes an exchange restriction, and because these deposits are not remunerated, a multiple currency practice.

[20] With resident FCDs of about US$5.5 billion in mid-July, the potential expansionary effect could have been equivalent to 22 percent of broad money.

and thus would have preferred a full up-front unification of the exchange rate system. In the end, it was decided to go along with the authorities' proposal of a more gradual unification, as it involves close to a *de facto* unification because of a minimal recourse to foreign exchange at the official rate with the prior actions, the composite rate will become a market clearing rate once the accumulation of arrears stops, and the proposed system is limited in duration.[21]

Box 3. Operation of the Exchange Rate Mechanism

Effective July 22, 1998, the SBP introduced a new exchange rate mechanism, based on a two-tier structure of the official exchange rate and the floating interbank rate (FIBR). On the receipts side, 50 percent of export and other proceeds are surrendered to the SBP on repatriation at the official exchange rate of PRs 46 per U.S. dollar. The remainder must now be sold in the interbank market within one week. On the payments side, 50 percent of imports and other current payments are effected at the official exchange rate (supplied by the central bank) and the balance is purchased in the interbank market at a freely determined exchange rate. Under this system, all transactions are effectively conducted at a "composite rate" which is the weighted average between the FIBR and the official exchange rate. The exceptions to this system are conversions of FCDs, capital account transactions and essential imports (pharmaceuticals, pulses, edible oils, fertilizers, pesticides, wheat, and petroleum products until October 16 and only wheat and petroleum products thereafter) which take place at the official rate.

With the prior actions, the exchange rate mechanism will be modified as follows until the unification of the exchange rate on July 1, 1999. The official exchange rate of PRs 46 per U.S. dollar will be maintained for imports of petroleum products and wheat and for conversions of the FCDs and related instruments (special dollar bonds and foreign currency bearer certificates) into rupees. Apart from petroleum, retention of these imports at the official exchange rate will entail only a minimal recourse to foreign exchange at the official rate since the bulk of wheat has already been imported. All other transactions, including capital transactions, will take place at the composite rate. This rate, for both purchases and sales, will be altered from its present 50/50 composition to a weighing of 75 percent for the FIBR and 25 percent for the official rate. As a result, the wedge between the FIBR and the "composite" (weighted average) exchange rate will narrow significantly.

27. **The current policy regarding FCDs will continue until June 1999.** Following the suspension of their convertibility earlier this year, the government decided to rely either on voluntary conversions of FCDs into rupees at the official rate or into U.S. dollar government bonds. Subsequently, the stock of FCDs declined although the pace of withdrawals slowed down substantially (see Box 4). To encourage more conversions of FCDs, new medium-term

[21]The unification of the exchange rate could potentially impact the budget if petroleum taxes are reduced to offset the impact of unification on domestic petroleum prices or if the wheat subsidy is increased to offset the impact on wheat prices. The central bank profit transfer might also be affected if the "exit policy" on FCDs entails significant conversion of FCDs at the unified rate. These factors will be taken into consideration in the design of the "exit policy" and the 1999/2000 budget framework.

Box 4: Foreign Currency Deposits in Pakistan

Individual depositors. The foreign currency deposit (FCD) scheme was introduced in January 1973 to provide Pakistani nationals working abroad with a saving instrument in Pakistan. Participation in the scheme was broadened in 1991 to residents also. FCDs are offered in U.S. dollars, pound sterling, deutsche marks and yen to Pakistani residents and nonresidents. Interest rates for these deposits are based on Libor plus a 0.75 percent margin for three-month deposits to Libor plus 1 5/8 percent margin for three year deposits. The amounts placed into these accounts were exempted from levy of income tax and compulsory deduction of Zakat, and also benefited from an amnesty in terms of the declaration of the source of the funds. The FCDs could be used as collateral for loans extended in domestic currency. The stock of resident and nonresident individuals' deposits increased from about US$0.5 billion in 1990/91 to the peak of US$9.5 billion in April 1998, of which US$7.2 billion represented FCDs of residents. Since end-May 1998, the stock of individuals' FCDs declined by 35 percent to US$6.1 billion at end-October.

Institutional investors. A special deposit scheme (under F.E. Circular No. 45) was opened in 1985 for large institutional investors whereby authorized foreign exchange dealers could accept large foreign exchange deposits and place the full amount of rupee equivalent of a FCD into a domestic currency asset, typically treasury bills. In October 1996, the State Bank of Pakistan (SBP) introduced for a few months a special deposit account into which the banks could place the rupee equivalent of any incremental FCDs with the SBP. The return to the banks on special deposits—at 17 percent per annum— was based on a daily balance basis, payable at the end of each quarter. The stock of institutional deposits peaked at about US$2.2 billion in mid-1997 and since then declined to about US$1.5 billion in April 1998, remaining at that level thereafter.

Forward exchange cover. Given the exchange regime based on surrender requirement, the commercial banks were obtaining forward exchange cover from the SBP to close their open foreign exchange positions. In June 1992, the SBP phased out its policy of providing free full-forward exchange cover to the financial institutions with respect to FCDs. At that time, a forward cover fee of 3 percent per annum was introduced. This fee was subsequently gradually increased to 8 percent for individuals' deposits and to 5.5 percent for institutional FCDs. The exchange rate guarantee from the SBP and the decline in official foreign exchange reserves contributed to a rise in the SBP's uncovered foreign exchange position to US$9.8 billion by end-April 1998.

foreign currency bonds were offered to FCD holders, and the fee for forward exchange cover on individuals' FCDs has been increased from 7 percent to 8 percent in November 1998. Furthermore, the SBP issued a circular eliminating the use of FCDs as collateral with effect from December 1, 1998. Based on the experience with FCD conversions in the coming months and taking into account the unification of the exchange rate system on July 1, 1999, a precise understanding will be reached with the Fund staff on the "exit policy" with regard to these deposits at the time of the next review.

28. **The uncertainties regarding money demand require continuous monitoring under the program.** Broad money growth during 1998/99 is targeted at 7.8 percent, i.e., substantially below the growth of nominal GDP, reflecting largely significant uncertainties regarding the proportion of FCDs converted into rupees that residents will be willing to hold

in domestic deposits. The program also targets a deceleration in the pace of NDA expansion to about 8.4 percent of initial broad money in 1998/99 (from an estimated 16 percent in 1997/98), which will be facilitated by the contractionary impact of the buildup of government deposits in the banking system reflecting the rupee counterpart of payments arrears and debt rescheduling.[22] Consistent with this stance, interest rate policy will be geared to encouraging the holding of domestic currency assets, supporting the exchange rate, and safeguarding the balance of payments.[23] The authorities intend to monitor closely monetary developments and undertake appropriate adjustments in the financial program to ensure the achievement of program targets.

Agenda for Structural Reform[24]

29. **Fiscal reforms will focus on the extension and strengthening of the tax base.** In order to substantially strengthen the revenue base of the budget, while promoting a more equitable distribution of the tax burden, the reform program seeks to include hitherto untaxed income and undertaxed sectors in the tax net. The following steps are envisaged:

- **Extension of the GST base.** The 1999/2000 budget will formally extend the GST to the services sector. In addition, the exemptions for petroleum and electricity will be removed by end-September 1999 and for agricultural inputs by end-December 1999 (actions beyond the original program commitments). The recently enacted extension of the GST to the retail stage will be increasingly enforced, and the administration of the GST in the textiles sector will become more effective.[25]

- **Strengthening of the tax administration.** This will be achieved through the introduction of a unique tax identifier number, enhanced coordination of the administration of major taxes, the development of a joint tax audit program, and

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[22]Government payments on rescheduled debt will be deposited with the SBP, while the debt service payments on rescheduled government guaranteed obligations will be deposited in a special account in the banking system.

[23]The interest rate structure need not increase significantly as risk premia should decline with return of confidence once the program begins to be implemented. Moreover, the intermediation margins should decline following the restructuring of banks and increased competition from foreign banks in the rupee deposit market.

[24]Details of the structural reform agenda are provided in the attached Memorandum and the Policy Framework Paper.

[25]As the GST was extended to the retail sector one year ahead of schedule with no preparation, the initial yield is expected to be modest. The authorities have made progress with establishing the appropriate administrative infrastructure, but it will take time for the tax to become fully established at the retail stage.

improvement in the refund system for exporters. Ordinances were promulgated to repeal the discretionary power to grant exemptions under the GST and from customs duties (prior action) and legislation will be introduced to amend the relevant acts permanently. A review of measures to strengthen the GST refund mechanism will be undertaken and its recommendations will be implemented by March 1999. Staff argued that reform of the refund system was urgently needed to enable the repeal of SDR 826 and Section 60 of the Sales Tax Act, which are potentially a major avenue for tax evasion. In the meantime, operations under these provisions will be suspended (a prior action).[26]

- **Implementation of meaningful agricultural income taxation.** In the near term, all four provinces will strengthen their collection mechanisms to achieve the agreed revenue targets (PRs 2.5 billion in 1998/99). By March 1999, the key elements of an appropriate agricultural income tax and its implementation strategy will be finalized by the authorities in consultation with the World Bank.[27]

- **Reduction in the vulnerability of the budget to the fluctuations in the rate of petroleum surcharge tax.** Accordingly, the PDS mechanism has been changed from a differential tax, depending on the difference between the regulated domestic price and landed cost, to a tax expressed in rupees per unit volume which will be allowed to fluctuate within a band of plus or minus 5 percent around a target rate established under the program. The mechanism will be managed in a manner that will not affect oil industry operating margins.

30. **Budgetary stringency calls for improved composition and effectiveness of public expenditure**. Following a comprehensive review of public expenditure (with technical assistance from the World Bank), the authorities will concentrate on maximizing its effectiveness and developmental impact. The program takes into account the need to safeguard the Social Action Program (SAP) from expenditure cuts, which is particularly important in the current fragile socio-political situation in Pakistan, and to ensure adequate prioritization of the Public Sector Development Program. With regard to the civil service reform, the authorities intend to prepare, by June 1999, an action plan and begin its

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[26]The SRO 826 and SR 60 of the Sales Tax Act exempts exporters from the payment of GST on their inputs. A Fund technical assistance mission with participation from the AsDB will assist with the review.

[27]Each province has introduced a land-based "agricultural income tax". As none of these taxes may provide a suitable basis for a simple uniform land-based tax on agricultural income, it was not possible at this stage to have detailed program provisions on the nature of such a tax. The program therefore seeks instead to set up conditions on the finalization of the key elements of a tax on agricultural income, and its implementation strategy, to enable the program to be in a position to establish appropriate conditionality at the time of the ESAF mid-term review.

implementation during 1999/2000 to improve accountability, enhance the skills base, and rationalize management and compensation, including the pension system.

31. **Successful restructuring of the power sector will yield multiple positive effects for the economy.** Implementation of a comprehensive power sector restructuring program agreed with the World Bank would bring the following results:

- **Enhanced efficiency in the energy sector** to be achieved by completing the corporatization process and establishing commercially oriented autonomous corporations, with National Electric Power and Regulatory Authority (NEPRA) issuing licenses for the new corporatized entities, and by implementing theft and loss reduction programs and introducing other efficiency improvements.

- **Stronger financial position of energy utilities** to be brought about by implementing financial and other restructuring measures, including, if necessary, tariff adjustment to restore the financial viability of corporations and by intensifying efforts for bill collection from both public and private customers.

- **Improved investment climate and enhanced governance** to result from implementing the orderly framework to regularize and maintain normal commercial relations with the IPPs.[28]

32. **In the financial sector, the focus is on improving the SBP's supervisory capacity, and enhancing the financial integrity of the public sector financial institutions,** which should provide the basis for their privatization. In this regard, the SBP: (i) will start its inspection schedule under upgraded procedures in June 1999; (ii) agreed in July 1998 with public sector banks and development financial institutions on targets for a phased reduction of nonperforming loans; and (iii) is engaged in financial restructuring of development financial institutions (DFIs) and consolidation/merger of various financial institutions. In view of the need to further improve the quality of loan portfolio of the banking system, the staff expressed concern about the newly introduced schemes to enhance opportunities for self-employment and for development of small and medium enterprises, and welcomed the authorities' intention to implement them consistent with the prescribed prudential standards and subject to usual bank evaluation procedures. In addition, the SBP is taking measures to develop the secondary market for government securities.

33. **Trade reform will liberalize trade restrictions and further reduce import tariffs.** The maximum tariff rate will be reduced from 45 percent to 35 percent, and the number of nonzero tariff bands will be reduced from five to four by end-March 1999 (three months

[28]The government has reached an agreement with all IPPs which received Notices of Intention to Terminate and one IPP which received a Notice to Terminate.

ahead of the original schedule).[29] A further reduction by end-June 2000 is envisaged in the maximum import tariff to the range of 25–30 percent. Regarding nontariff barriers, the number of export bans was reduced from 24 to 9 in July 1998.[30] The remaining export bans, and export minimum price and quota restrictions will be withdrawn, and most of the remaining restrictions on imports subject to procedural restrictions will be eliminated in July 1999.

34. **The authorities have initiated efforts to increase transparency, enforce the rule of law, and rebuild public institutions and public trust**. The authorities recognize that governance problems have impaired the effectiveness of public expenditures and contributed to poor economic performance, low investment, suboptimal revenue collection and inadequate social services. Politicization of routine decision making has weakened the civil service and diverted expenditures to lower-priority activities. To address these problems, the government efforts center on the following areas:

- **Good financial governance** will improve with the increased enforcement of loan contracts and reduction in the stock of nonperforming loans. The loan recovery process will be further improved, *inter alia*, by simplifying the procedures for the sale of mortgaged property without resorting to court decisions.

- **Reduction in tax evasion** will be achieved by reforming tax administration and by simplifying tax collection procedures and the appeal process. The government has embarked on a program to recover up to PRs 3 billion of tax arrears during July–December 1998.

- **Modern expenditure management procedures** will be facilitated following the implementation of recommendations of the Project for Improvement to Financial Reporting and Auditing (PIFRA). The accounting model proposed under the PIFRA project will be adopted before end-1998, and an action plan will be developed to improve the quality and timeliness of reporting relating to public expenditures.

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[29]The process of trade liberalization resumed in 1997 with a reduction and simplification of the structure of import customs tariff and the elimination of anti-export biases. However, some non-tariff external trade regulations are still used by the authorities to promote sectoral objectives, and import tariffs remain high by international standards. See "Pakistan: Recent Economic Developments", SM/97/253, pp.88-91, for a detailed discussion on nontariff barriers on imports and exports. Based on available information in 1998, Pakistan was rated "8" or highly restrictive by the index of aggregate trade restrictiveness developed in "Trade Liberalization in Fund-Supported Programs", EBS/97/163.

[30]Export bans removed in July 1998 include bans on oil seeds, pulses and beans, wet blue leather, live animals, grains (excluding wheat), blood meals, meat meals, corn gluten meals, hides and skins, empty wooden crates, arms and ammunition, ferrous and nonferrous metals, paper waste, bran and fodders, and hockey blades.

- **Financial discipline and governance in the power sector** will be improved by implementing measures to reduce theft and enforce the collection of electricity bills. The envisaged restructuring of power sector utilities will improve their financial condition, eliminate redundant employment, reduce corruption and improve customer services. In parallel, a new professional framework for negotiations with the IPPs with respect to energy tariffs was established and the pursuit of corruption charges was separated from commercial considerations (see the attached Memorandum, paragraphs 30 and 31).

- **The legislative framework for regulatory agencies is being strengthened.** In the power sector, the autonomy of NEPRA with regard to electricity tariff decisions will be fully respected.

35. **Commitment to privatization remains.** Over the next three years, the authorities intend to privatize all remaining public sector financial institutions, six power generating facilities, six area electricity boards, and 28 industrial units, as well as major public enterprises, including Pakistan railways. In view of uncertainties in the domestic market, as well as international financial markets, they were reluctant to undertake precise commitments for this year. It was agreed that the schedule of privatization will be established by the time of the ESAF mid-term review. In the meantime, the staff encouraged the authorities to press ahead with all the necessary steps up to the point of sale, which would allow a re-acceleration of the privatization process as market confidence is rebuilt.

V. External Financing Issues

36. **The external current account deficit is projected to contract further in 1998/99.** The authorities stressed that the full impact of adjustment measures and external financing constraints began to be felt only by September and that most of the improvement in the trade balance will occur in the second half of the fiscal year. For the year as a whole, the adjustment in the trade balance relative to 1997/98 is projected to amount to 2.9 percent of GDP. However, the favorable impact on the current account of this large trade adjustment and the decline in the deficit of the services account will be offset to a large extent by a decline in private transfers, reflecting mostly the collapse of new inflows to residents' foreign currency deposits. In the circumstances, the current account deficit is projected to decrease only to 3 percent of GDP.

37. **The financing plan envisages repayment of arrears on current account and private capital transactions.** Of the total stock of arrears outstanding, about US$1.0 billion corresponded to arrears on public and publicly guaranteed debt, for a large part of which Pakistan will be requesting reschedulings. Except for a technical delay of a few days on one occasion, obligations to the Fund have been paid on time. All late payments owed to other multilateral creditors will be cleared prior to the Executive Board meeting. However, there remain about US$350 million of arrears on current account transactions and US$250 million payments on private debt. The authorities argued that the envisaged elimination of these arrears should be gradual, in line with the programmed improvement in the availability of foreign exchange inflows, including from foreign assistance. Accordingly, one-half and

one-third of end-December 1998 arrears on current account payments and private debt service, respectively, will be eliminated by end-March 1999, and the remaining stock by end-June 1999. The phased clearance of these arrears is subject to performance criteria for end-March and end-June 1999.

38. **Large but declining exceptional financing is needed to close Pakistan's financing gaps in 1998/1999–2000/01**. For 1998/99, the financing gap is estimated at about US$5.6 billion (Appendix I, Table 6). The authorities expect to obtain in 1998/99 new disbursements of adjustment loans from the World Bank totaling US$550 million and from the AsDB US$300 million. After accounting for balance of payments support from bilateral and multilateral sources (including the Fund), the remaining financing gap is estimated at about US$3.5 billion in 1998/99. To close the gaps for this and the following year, the government intends to request from the Paris Club comprehensive rescheduling of medium- and long-term public and publicly guaranteed debt, as well as to seek comparable treatment from its other bilateral and all its commercial creditors. The authorities will explore with their commercial bank creditors various options for refinancing or restructuring of short-term debt obligations and with institutional non-residents the rollover of their FCDs held in banks in Pakistan to obtain the needed cash-flow relief. The staff urged the authorities to contact commercial bank creditors as early as possible and to retain services of professional legal and financial advisors. The program now provides for quarterly reviews of financing until the Fund determines that satisfactory arrangements for the funding of the program have been reached and the remaining outstanding external payments arrears have been eliminated.

39. **The foreign exchange cash-flow situation is very tight and does not allow for an immediate removal of exchange restrictions.** Projections of the balance of payments over November 1998–January 1999, assuming regularization of payments by Pakistan to multilateral institutions, indicate that reserves would be virtually depleted by end-1998. Given that a large part of the current reserves is not usable, Pakistan would need bridge financing in order to keep a minimum level of usable reserves while making payments to multilateral institutions. In response to the staff's concern about the tight foreign exchange cash-flow situation, the authorities stated that they have arranged short-term financing and will purchase foreign exchange from the market in order to maintain their reserves at around US$450 million. Part of the resources that would be available after approval of the program by the Board will be used to pay back the bridge financing. The authorities are keen to remove exchange restrictions, but in the above-described circumstances decided to delay it to allow for a reconstitution of reserves earlier in the program and for confidence to build up.[31] Thus, the removal of the remaining exchange restrictions on travel and education as well as the 30 percent import margin requirement will be implemented by end-March 1999.

40. **The Pakistan authorities intend to request a purchase under the CCFF in respect of an export shortfall in 1998** (see Appendix V). The shortfall calculated by the staff of SDR 352.7 million (equivalent to about 46.5 percent of quota) in merchandise

[31]In addition to financing from the Fund, disbursements of US$350 million from the World Bank and US$150 million from the AsDB are expected in early 1999.

exports is attributable largely to the drop in export volumes of raw cotton and cotton manufactures, combined with a decline in prices. Beyond 1998, the outlook is for a strong recovery in raw cotton exports based on higher production and an increase in exports of cotton manufactures as the demand for Pakistan cotton yarn and cloth mainly coming from other Asian economies is expected to recover.

VI. MEDIUM-TERM EXTERNAL OUTLOOK AND CAPACITY TO REPAY THE FUND

41. **A steady improvement in the current account position is expected over the medium term** (Appendix I, Table 2).[32] Export volume growth would progressively reach around 6 percent per year while import volume growth, after being depressed during initial years because of financing constraints, would resume during the later years of the period at slightly above real GDP growth. Private transfers are projected to increase steadily, staying however well below the levels observed in recent years when part of the transfers were channeled through foreign currency accounts. Reflecting these trends, the current account deficit before official transfers would narrow to 2.4 percent in 1999/2000 and 1.3 percent in 2002/03.

42. **Annual net capital inflows after 2000/2001 would reach around US$1.3 billion.** It is assumed that net official assistance would decline over the medium term, reflecting decreasing balance of payments support. Regarding private flows, the stabilization program and the implementation of reforms aimed at providing an environment conducive to private sector investment would provide the basis for a progressive revival in foreign direct and portfolio investment. As a result of these trends, gross official reserves would increase to the equivalent of 3 months of imports by 2001/02. The scenario suggests that the stock of public and publicly guaranteed external debt would initially increase and reach 60 percent of GDP in 1999/2000, reflecting the assumption that most of the financing gaps in 1998/99 and 1999/2000 would be filled with official assistance, but would decline thereafter to 54 percent by 2002/03 (Appendix I, Table 8).

43. **Pakistan's external prospects nevertheless remain vulnerable.** There are risks to the above described scenario: private transfers, in particular workers remittances, may not recover as rapidly as envisaged; access to foreign capital may be affected for a number of years to come; and export earnings are vulnerable due to their high dependence on cotton manufactures. To illustrate the vulnerability of the balance of payments outlook to less favorable external developments, the staff has prepared a scenario based on lower growth for exports of raw cotton and cotton manufactures (by 1 percent each year), which might arise from lower domestic production of cotton and reduced world demand for cotton and textile products. Under these conditions, the current account deficit would be larger by 0.4 percent of GDP in 2002/03, and gross official reserves would be lower by about US$800 million (about one month of imports) in 2002/03.

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[32]The baseline balance of payments scenario for the next five years has been developed on the basis of the macroeconomic assumptions described in Appendix IV.

44. **The staff believes that under the envisaged policies Pakistan should not encounter difficulties with respect to its capacity to repay the Fund.** Assuming that all purchases under the EFF and ESAF disbursements are made together with the requested purchase under the CCFF, Pakistan's liabilities to the Fund would represent 6.4 percent of total public and publicly guaranteed debt at end-June 1999, and 6.8 percent at end-June 2000 (Appendix I, Tables 9 and 10). They would be equivalent to 18.3 and 20.0 percent of projected exports in 1998/99 and 1999/2000, respectively. Pakistan's debt service obligations to the Fund would increase in 2002/03 and 2003/04 when repurchases under the CCFF would come due. These obligations, however, would remain below 3 percent of exports throughout the repayment period, and below 14 percent of gross official reserves after 1999/2000 in a context of a projected steady improvement in Pakistan's external position.

VII. PROGRAM MONITORING AND PHASING

45. **Program will be monitored closely.** The attached memorandum introduces quantitative performance criteria for end-December 1998, end-March 1998 and end-June 1999; the NDA of the SBP has been set as an indicative target, rather than a performance criterion, for end-June 1999 because of large uncertainties related to money demand (Table 3 of the attached Memorandum).[33] It also specifies structural performance criteria and benchmarks (Table 4 of the attached Memorandum). The program includes quarterly reviews. In addition, the following prior actions have been specified in the MEFP for the completion of the present review: (i) raising the GST rate from 12½ percent to 15 percent; (ii) an assurance that provinces have agreed to empower the federal government to collect GST on services; (iii) promulgation of ordinances to repeal government's discretionary power to grant exemptions from the GST and customs duties; (iv) suspend operations under SRO 826 Section 60 of the Sales Tax Act, which enables exporters to purchase inputs free of GST; (v) application of the composite exchange rate (with weights of 25 percent to the official exchange and 75 percent to the free interbank rate) to all external transactions, except for wheat and petroleum imports and FCD conversions; (vi) agreement on WAPDA finances and submission of tariff filing to NEPRA; (vii) adoption of an orderly framework for the resolution of disputes between the government and the independent power producers; (vii) regularization of payments by the government to multilateral institutions; and (ix) initiation of negotiations with private creditors on debt restructuring.

46. **Phasing of purchases under the extended arrangement will be changed.** In view of the request for a purchase under the CCFF amounting to about 46.5 percent of Pakistan's quota, the total amount of which would be available upon Board approval, and the programmed implementation of important structural measures in 1999/2000, the authorities have requested a rephasing of purchases under the extended arrangement. It is proposed that a purchase amounting to 5 percent of quota be available upon the completion of this review and the remaining amounts be phased as detailed in Appendix I, Table 11. Phasing of disbursements under the second and third annual arrangements under the ESAF will also be

[33]The indicative target on the NDA of the SBP for end-June 1999 will be converted into a performance criterion at the time of the next review under the extended arrangement.

revised to comprise three disbursements; the first upon approval of the arrangement, and the remaining upon completion of a mid-year and a final review.

VIII. Statistical and Technical Assistance Issues

47. **The staff considers the economic and financial data in Pakistan to be of sufficient coverage, quality, frequency, and timeliness to enable adequate and timely assessments of economic developments.** The data submitted to the Fund for publication are provided on a timely basis, and any additional data requests are met promptly. Monthly data submissions to the Fund include the monetary accounts, and statistics on consumer prices, federal tax revenue, government bank borrowing, and foreign trade. Moreover, the authorities provide daily data through the resident representative's office on international reserves, exchange rates, and the Karachi Stock Exchange index with one-day lag. The staff is confident that the additional data required for program monitoring (in particular on arrears and deposits on account of rescheduled debts) will be provided without difficulties. The data on government finances continue to suffer from lack of information on economic and financial classification of government outlays and reporting by provinces on their operations remains inadequate. The authorities are developing an action plan to address weaknesses in the quality and timeliness of data on public expenditures. In addition, they will address remaining deficiencies in the economic database of Pakistan: in national accounts, through the use of results of the surveys of households and enterprises undertaken in the framework of the Improvement of National Accounts Statistics in Pakistan project; and, in money and banking statistics, through the implementation of the recommendations of previous Fund technical assistance missions. There are also weaknesses in Pakistan's external debt reporting in terms of frequency and reconciliation of data collected by different departments. In that context, the authorities initiated a complete inventory of public sector external liabilities and will work on improving the timeliness of information and the monitoring mechanism.

48. **Pakistan has received substantial technical assistance in formulation and implementation of structural reforms.** The authorities expect to benefit from further support in this regard during the ESAF/EFF supported program. Technical assistance from the IMF will be requested for: (i) reforming the GST refund system; (ii) undertaking a comprehensive review of the income tax system; (iii) reforming the primary dealer system for government securities; (iv) improving foreign exchange market operations and the SBP's monitoring/supervisory capacity; and (v) improving the compilation and reporting of the monetary statistics. Technical assistance from the World Bank and the AsDB will also continue in various areas as detailed in the Policy Framework Paper.

IX. Staff Appraisal

49. In 1997/98, Pakistan's macroeconomic performance improved and compared well in relation to the targets under the program supported by the ESAF and the extended arrangement. Economic growth picked up as targeted, inflation decelerated faster than programmed, and the external current account deficit was halved to a level much lower than the program target. These developments were underpinned by financial policies broadly in line with the program and were aided by a favorable performance of agriculture and a decline

in import prices. Progress continued to be made in the implementation of structural reforms, but the implementation of certain fiscal reforms fell short of the program objectives and the restructuring of public enterprises was delayed.

50. In an adverse external environment, however, the progress in macroeconomic and structural reforms was not sufficient to reduce the significant vulnerabilities of the Pakistan economy. First, the balance of payments financing continued to rely heavily on inflows into FCDs and private transfers, which are highly sensitive to market sentiments. Second, the SBP's uncovered forward exchange position increased and by end-May, FCDs held by residents and nonresidents amounted to almost 9 times the level of gross official reserves. Third, budget revenues remained relatively low, and became increasingly dependent on receipts from petroleum surcharges, while the domestic tax base remained limited; these problems have led to an undesirable compression of development expenditures and resources available for critical expenditure programs. Fourth, financial difficulties of power sector utilities adversely affected the financial position of other corporations and the budget. Finally, despite progress, nonperforming loans in the banking system remained high.

51. The nuclear bomb tests in May, the subsequent sanctions, and the loss of market confidence have engendered a precarious economic situation in 1998/99. The authorities took some immediate policy measures, including fiscal measures, exchange rate depreciation and exchange restrictions primarily to avoid an exchange crisis; but the policy response was not adequate. In the event, large capital outflows were registered, the budget deficit widened, usable official foreign exchange reserves declined to one week of imports, and external payments arrears have been accumulated.

52. To manage the adverse effects of recent shocks and lay the basis for achieving over the medium term sustainable high rates of growth, the authorities have adopted a program of macroeconomic policies and structural reforms in the context of a revised medium-term framework under the ESAF and extended arrangements. On the fiscal side, the budget deficit reduction target of 1.2 percentage points to 4.3 percent of GDP in 1998/99 is adequately ambitious in a year of low growth and with less than a full-year impact for most measures. The staff welcomes the package of fiscal measures envisaged to achieve such an adjustment and underscores the importance of their rigorous implementation. The staff notes the commitment of the authorities to reduce the deficit further to 3.3 percent of GDP in 1999/2000. The need for fiscal consolidation in 1999/2000 and over the medium term to stabilize the public debt dynamics and release resources for private sector development makes it essential to move forward expeditiously with the envisaged fiscal reforms, including the extension of the GST to the services sector, petroleum products, electricity, and agricultural inputs; the development of the agricultural income tax; the strengthening of tax administration, including through the establishment of a proper refund system; and the improvement in the composition and effectiveness of budgetary expenditures. Without meaningful and permanent revenue increases, fiscal consolidation cannot be achieved without jeopardizing basic government services, in particular health and education, and infrastructure.

53. The staff attaches great importance to the reform of agricultural income taxation, which, given the lack of progress in this area and in light of the importance of this sector in the overall economy, is widely perceived as the quintessential indicator for the government's commitment to reforms. Therefore, the staff urges the authorities to develop expeditiously, in consultation with the World Bank, a package of measures that will steadily raise the level of revenue from agricultural income taxation to levels that are comparable to other countries with a large agricultural sector. In view of the constraints—administrative and political—on raising agricultural income tax revenue sharply in the short-run, the extension of the GST to agricultural inputs would be consistent with approaches adopted in other countries. Moreover, in the Pakistan context, it is the most effective way of taxing agriculture and will strengthen the structure of GST, as a large number of the remaining exemptions are related either directly or indirectly to the exempt status of the agricultural sector. It is recognized, however, that there could be some efficiency and equity issues.

54. The high level of uncertainty with regard to FCDs is constraining the exchange rate policy and has increased the burden on monetary policy in maintaining external stability. In the circumstances, and given the low level of reserves, the monetary program has been based on conservative assumptions. Nevertheless, given the uncertainties, developments need to be closely monitored and appropriate adjustments to the financial program be made, as needed, to ensure the achievement of program targets. The staff welcomes the increased role of market forces in the determination of the exchange rate and notes the commitment of the authorities to move to a market-determined unified exchange rate by July 1, 1999. To this end, it is essential to resolve the issue of FCDs, including through measures that encourage voluntary conversions of FCDs into rupees, without creating large contingent liabilities in the medium term that would be difficult to manage.

55. Structural reforms in the program are phased in gradually taking into account the current economic circumstances of Pakistan, the time needed for their preparation and the administrative capacity to implement them. The staff welcomes the authorities' structural reform agenda and urges its steadfast implementation. More specifically, it is essential to improve the financial performance of the public sector enterprises, in particular, those in the power sector. To this end, the staff urges the authorities to finalize detailed restructuring plans for WAPDA and KESC expeditiously, and for WAPDA, to implement the tariff decision of NEPRA and formulate a comprehensive plan for the elimination of outstanding stocks of payables and receivables by March 1999. The staff welcomes the progress made in resolving disputes with the IPPs and the authorities' intention to resolve the disputes with the remaining IPPs. The resolution of IPP issues in an orderly framework is essential to limit the already significant adverse impact on investment climate and investor confidence. While the slowdown in the privatization program is understandable in the current domestic economic and international environment, the staff encourages the authorities to press ahead with all necessary steps, most importantly with enhancing the financial integrity of public sector financial institutions, so as to allow a reacceleration of the privatization process as conditions improve. The staff regrets the introduction of new credit schemes, which affects adversely allocative efficiency and contributes to undermining the soundness of the banking system, and recommends phasing them out. The staff welcomes the authorities efforts to improve

governance and increase transparency, which should improve public finances, encourage private sector activity, and contribute to better economic performance.

56. The external current account deficit is projected to contract further reflecting a substantial improvement in the trade balance that offsets a sharp drop in private transfers. Nevertheless, and notwithstanding a fairly modest foreign exchange reserves target, large exceptional financing will be required to close the financing gaps in 1998/99 and 1999/2000. In addition to expected financing from the World Bank and the AsDB, the authorities intend to seek a comprehensive rescheduling of public and publicly guaranteed debt owed to bilateral and commercial creditors. They have already initiated discussions with the Paris Club and other bilateral creditors as well as with banks and nonbank financial institutions. The staff urges the authorities to retain services of independent legal and financial advisors during the negotiations. The authorities are also expected to request a purchase under the CCFF on the basis of a shortfall in merchandise export earnings in 1998.

57. The realization of the envisaged external financing, together with the programmed tight fiscal and monetary policy, should allow for the implementation of the tariff reform as well as the repayment of arrears on current account and private capital transactions as programmed. The staff believes that the lifting of the temporary restrictions that were imposed in mid-1998 would help improve market sentiments and attract capital to the private sector—essential elements for the recovery in private sector investment.

58. The program entails substantial risks. On the policy side, a number of important measures are in the form of commitments for future action, and any failure in their steadfast implementation would undermine macroeconomic stability and investor confidence. In particular, the more politically sensitive extensions in the GST base, increase in agriculture taxation and the exchange rate unification are envisaged in 1999/2000. The external financing plan of the program, which involves a request for comprehensive debt reschedulings as well as financing from multilateral organizations conditional on the implementation of specific reform agendas, is also subject to significant risks. Shortfalls in external financing could constrain imports and adversely affect the growth performance, with consequences for budgetary revenues and fiscal targets. Furthermore, restoration of private investment and capital flows will depend on return of market confidence. In light of uncertainties related to policy implementation and program financing, a large number of measures are prior actions for Board consideration, some of which have already been put in place, and the program will be closely monitored with quarterly reviews, including financing reviews. Furthermore, the authorities have indicated their willingness to undertake additional measures, if needed, to achieve the program targets.

59. Despite the above-mentioned risks, and the fact that the policy package is less than optimal due to socio-political and institutional constraints, in the staff's view, the proposed program merits support because it embodies a significant adjustment effort and wide-ranging structural reforms that should engender an improvement of the economic performance of Pakistan over the medium term; goes beyond the original program in addressing issues of governance and transparency and in the timing of the GST extension to the retail stage and the tariff reform; and entails a degree of ownership on the part of the authorities that is

essential for its success. Accordingly, the staff recommends completion of the second review under the extended arrangement, the approval of the second annual arrangement under the ESAF, and the request of a purchase under the CCFF.

60. The staff also recommends that the noncompliance with the performance criteria for end-June 1998 on the NFA of the SBP, the accumulation of budgetary arrears to WAPDA and the harmonization of provincial taxation of agricultural income be waived. Moreover, in view of the fact that additional imports were subject to the 30 percent import deposit requirement because they were shifted from the official exchange rate to the composite rate and given the authorities' intention to remove this requirement by end-March 1999, and its consistency with other criteria for approval, the staff recommends that the resulting exchange restriction and multiple currency practice be approved until end-March 1999. Additionally, given that the end-December performance criteria are set with respect to the purchase scheduled for March 1999, it is also proposed that the applicability of these performance criteria be waived with respect to the purchase associated with completion of this review.

61. In general, the economic and financial data in Pakistan are of sufficient coverage, quality, frequency, and timeliness to enable the staff to undertake adequate and timely assessment of economic developments and prospects. However, data deficiencies remain in particular in the quality and timeliness of data on public expenditures, and in the area of national accounts. The staff urges the authorities to fully implement the recommendations of Fund statistical technical assistance missions, including further improvements in public expenditure reports in the context of the PIFRA project.

62. In concluding, the present program, if fully implemented, represents a major reform effort that tackles issues that had in the past been inadequately addressed. However, to get Pakistan's economy performing at its full potential, the progress on the economic front should be paralleled by innovative and constructive political contacts that would allow to reduce the political tensions in the region and improve the security situation.

63. It is proposed that the next Article IV consultation with Pakistan be held on the standard 12-month cycle.

X. Proposed Decisions

The following decisions are proposed for adoption by the Executive Board:

A. Review Under the Extended Arrangement

1. Pakistan has consulted with the Fund in accordance with paragraph 3 of the extended arrangement (EBS/97/185, Supplement 2), as amended, and the second paragraph of the letter dated September 8, 1997 from the Minister of Finance and Economic Affairs and the Governor, State Bank of Pakistan, in order to reach understandings regarding the circumstances in which purchases under the Extended Arrangement can be resumed.

2. The letter from the Minister of Finance and Economic Affairs and the Governor, State Bank of Pakistan dated December 21, 1998, with the attached Memorandum on Economic Policies, shall be attached to the letter dated September 8, 1997, as amended, and attached memorandum shall be read as supplemented and modified by the letter dated December 21, 1998.

3. Accordingly,

(a) paragraph 2(a) of the Extended Arrangement shall be deleted in its entirety and replaced with:

"2. (a) Purchases under this Extended Arrangement shall not, without the consent of the Fund exceed the equivalent of SDR 37.91 million until March 30, 1998, the equivalent of SDR 56.86 million until January --, 1999, the equivalent of SDR 94.78 million until March 15, 1999, the equivalent of SDR 132.69 million until June 15, 1999, the equivalent of SDR 170.60 million until September 15, 1999, the equivalent of SDR 284.33 million until December 15, 1999, the equivalent of

SDR 341.20 until March 15, 2000, and the equivalent of SDR 398.07 until June 15, 2000."

(b) paragraphs 2(b) and 2(c) the Extended Arrangement shall be deleted.

(c) paragraph 3(a) of the Extended Arrangement shall be deleted in its entirety and replaced with the following:

"(i) the limit on the net foreign assets of the State Bank of Pakistan, or

(ii) the limit on the net domestic assets of the State Bank of Pakistan, or

(iii) the limit on the overall budget deficit, or

(iv) the limit on the overall budgetary support from the banking system, or

(v) the limit on credit to the seven major public enterprises, or

(vi) the limit on the stock of public and publicly guaranteed external debt, or

(vii) the limit on the contracting of nonconcessional medium- and long-term public and publicly guaranteed external debt, or the limit on the contracting of external debt with an initial maturity of over one year and up to five years, or

(viii) the limit on accumulation of budgetary arrears to WAPDA, or

(ix) the limit on the stock of arrears on current account transactions, or

(x) the limit on the stock of arrears on private external debt service payments,"

(d) the limits referred to in paragraph 3(a) of the Extended Arrangement for end-December 1998, end-March 1999 and end-June 1999 shall be as specified in Tables 3 and 4 of the memorandum attached to the letter dated December 21, 1998.

(e) the following paragraph 3(aa) shall be added after paragraph 3(a) of the Extended Arrangement:

"(aa) if, at any time during the period of the second annual arrangement,

(i) until June 30, 1999, the ceiling of PRs 45.8 billion on total budgetary support specified in Table 3 to the memorandum, is not observed, or

(ii) the petroleum development surcharge rate is not maintained within the bands as set forth in paragraph 27 of the memorandum and Table 4 thereto, or

(iii) Pakistan incurs new external payment arrears of the public sector to official creditors, other than on external debt subject to rescheduling as described in paragraph 42 of the memorandum, or"

(f) paragraph 3(b) of the Extended Arrangement concerning structural performance criteria shall be deleted in its entirety and replaced with the following:

"(b) if Pakistan has not carried out its intentions with respect to,

(i) by end- March 1999,

(1) the adoption of a unique tax-payer identification number, or

(2) the implementation of the power tariff decision as approved by NEPRA based on the WAPDA filing of December 1998, or

(3) the corporate restructuring of WAPDA's power wing into 12 independent and autonomous companies regulated by NEPRA, or

(4) the reduction of the maximum tariff to 35 percent and the number of non-zero tariff rates to four, or

(5) the elimination of the exchange restrictions for travel and education abroad notified to the Fund in July 1998, or

(6) the reduction by 50 percent of the electricity subsidy for households with monthly bill larger that PRs 5,000, or

(ii) by end-June 1999,

(1) the extension of the GST to services, or

(2) the harmonization of provincial taxation of agricultural income with that prevailing in the province of Punjab and strengthening of collection mechanisms to reach a collection target of PRs 2.5 billion, or

(3) The elimination of the electricity subsidy for households with monthly bills larger than PRs 5, 000 and reducing by 50 percent the electricity subsidy bill for all other households, or

(iii) by July 1, 1999, the unification of exchange rates, or

(iv) by end-September 1999,

(1) The removal of the GST exemptions for petroleum products and electricity, or

(2) the elimination of the electricity subsidy for all households,

specified in the memorandum and Table 4 thereto; or"

(g) paragraph 3(c) of the Extended Arrangement concerning reviews shall be amended by the replacing the remainder of the paragraph after "May 14, 1998" with the following:

> "March 14, 1999, June 14, 1999, September 14, 1999, December 14, 1999, March 14, 2000, and June 14, 2000, respectively, until the reviews contemplated in paragraph 45 of the memorandum attached to the letter dated December 21, 1998 are completed; or"

(h) the following paragraph 3(cc) shall be added after paragraph 3(c) of the Extended Arrangement:

> "(cc) after March 14, 1999, June 14, 1999, September 14, 1999, December 14, 1999, March 14, 2000, and June 14, 2000 until the quarterly reviews contemplated by paragraph 45 of the memorandum are completed, provided that no such review shall be necessary after the Fund determines that satisfactory arrangements for the financing of the program have been reached; or"

4. The Fund determines that the second review specified in paragraph 3(c) of the Extended Arrangement has been completed, and notwithstanding (a) the non-observance of the quantitative performance criteria for end-June 1998 with respect to the net foreign assets of the State Bank of Pakistan and the accumulation of budgetary arrears to the Water and Power Development Authority, (b) the structural performance criterion with respect to the implementation of the agricultural income tax, (c) the performance criteria set forth in paragraph 3(d)(i) and (ii), and (d) the non-availability of data with respect to the end-December 1998 quantitative performance criteria set forth in paragraph 3(a) of the Extended Arrangement, Pakistan may proceed to make purchases under the Extended Arrangement.

B. Second Annual ESAF Arrangement

1. Pakistan has requested the second annual arrangement under the Enhanced Structural Adjustment Facility.

2. The Fund has appraised the progress of Pakistan in implementing the policies and achieving the objective of the program supported by the first annual arrangement, and notes the updated policy framework paper set forth in EBD/98/137.

3. The Fund approves the second annual arrangement set forth in EBS/98/231.

C. Purchase Under Compensatory and Contingency Financing Facility

1. The Fund has received a request by the Government of Pakistan for a purchase equivalent to SDR 352.7 million for the compensatory financing of a shortfall in export earnings under the Decision on the Compensatory and Contingency Financing Facility (Decision No. 8955-(88/126), adopted August 23, 1988, as amended).

2. The Fund approves the purchase in accordance with the request.

3. The Fund waives the limitation in Article V, Section 3(b)(iii).

D. Exchange System

1. Pakistan maintains an exchange restriction and multiple currency practice arising from an advance import deposit requirement on payments for certain current international transactions. In the circumstances of Pakistan, the Fund grants approval of this exchange restriction and multiple currency practice until March 31, 1999.

Table 1. Pakistan: Key Economic Indicators, 1993/94–2002/03

	1993/94	1994/95	1995/96	1996/97	Prog. 1997/98	Prel. 1997/98	Prog. 1998/99	Proj. 1999/00	Proj. 2000/01	Proj. 2001/02	Proj. 2002/03
	(Annual changes in percent)										
Output and prices											
Real GDP at factor cost	4.5	5.2	5.2	1.3	5.5	5.4	3.0	3.0	4.5	5.5	6.0
GDP deflator at factor cost	12.8	13.8	9.9	11.4	11.0	8.9	11.1	10.0	8.0	6.5	6.0
Consumer price index (annual average)	11.3	13.0	10.8	11.8	10.5	7.8	10.7	10.2	8.0	6.5	6.0
Consumer price index (end-of-period)	11.8	12.1	10.3	12.5	9.0	6.5	14.9	8.4	7.6	6.5	6.0
Nominal GDP at market prices	17.2	19.7	15.1	11.0	17.1	14.8	14.5	13.3	12.9	12.4	12.4
	(In percent of GDP)										
Investment and savings											
Total investment	19.4	18.4	18.7	17.4	17.8	17.3	15.0	14.5	15.5	16.9	17.9
Public	7.7	6.9	7.0	5.8	4.9	4.8	5.0	5.0	5.1	5.1	5.1
Private	11.7	11.5	11.7	11.6	12.8	12.5	10.0	9.5	10.4	11.8	12.8
Gross national savings	15.8	14.5	11.2	11.2	12.6	14.0	12.0	12.1	14.0	15.7	16.6
Public	-0.3	-0.9	-0.7	-2.3	-1.2	-1.3	-0.2	1.4	2.2	2.7	2.9
Private	16.1	15.3	11.9	13.5	13.8	15.4	12.2	10.7	11.8	13.0	13.7
Savings-investment balances	-3.6	-3.9	-7.5	-6.2	-5.1	-3.2	-3.0	-2.4	-1.5	-1.2	-1.3
Public	-8.1	-7.7	-7.6	-8.1	-6.2	-6.1	-5.2	-3.6	-2.8	-2.4	-2.2
Private	4.4	3.8	0.2	1.8	1.0	2.9	2.2	1.2	1.4	1.3	0.9
Budgetary Operations											
Budgetary revenue	17.2	17.0	17.0	16.0	15.7	15.8	15.9	17.5	18.1	18.5	18.8
Budgetary expenditure	23.9	23.9	24.1	22.4	20.6	21.3	20.2	20.8	20.6	20.6	20.6
Budgetary balance	-6.7	-6.9	-7.1	-6.4	-4.9	-5.5	-4.3	-3.3	-2.5	-2.1	-1.8
Primary balance	-1.2	-1.9	-1.2	-0.3	1.4	1.1	2.3	3.3	3.8	3.8	3.8
Domestic debt	43.9	41.4	41.3	42.7	39.3	41.9	37.7	35.0	32.4	29.9	27.2
	(Changes in percent of beginning-of-period stock of broad money)										
Monetary sector											
Net foreign assets	5.6	3.8	-4.7	-3.5	1.3	-0.9 4/	-0.6	...	...	...	...
Net domestic assets	12.4	13.4	18.5	15.8	14.4	13.8 4/	8.3	...	...	...	...
Of which : credit to the private sector	11.2	17.8	14.9	7.5	8.1	7.9 4/	8.5	...	...	...	...
Broad money	18.0	17.2	13.8	12.2	15.7	12.9 4/	7.8	...	...	...	...
	(In percent of GDP)										
External sector											
Exports	12.9	13.2	12.9	13.1	13.5	13.2	14.0	14.9	15.1	15.2	15.3
Imports	16.6	16.8	18.6	18.2	17.1	16.1	14.2	14.5	14.5	14.7	14.9
Current account excluding official transfers	-3.6	-3.9	-7.5	-6.2	-5.1	-3.2	-3.0	-2.4	-1.5	-1.2	-1.3
External public debt 1/	49.3	45.4	43.5	45.9	46.1	46.0	54.4	60.3	60.1	57.0	53.6
	(In millions of U.S. dollars)										
External sector											
Current account, excluding official transfers	-1,904	-2,413	-4,820	-3,851	-3,418	-2,076	-1,791	-1,408	-913	-800	-939
Current account balance	-1,590	-2,101	-4,593	-3,562	-3,283	-1,874	-1,676	-1,282	-734	-616	-747
Gross reserves 2/	2,302	2,741	2,053	1,141	1,673	932	1,340	1,750	2,150	2,650	2,950
Gross reserves 2/ (in weeks of imports)	12.6	12.7	8.2	4.9	7.0	4.3	7.6	9.8	11.8	12.8	13.0
External debt service ratio 1/ 3/	22.7	23.8	25.3	28.2	24.9	24.3	33.0	32.9	27.1	24.5	24.3
Memorandum item:											
Nominal GDP at market prices (PRs billion)	1,573	1,882	2,166	2,405	2,931	2,760	3,159	3,579	4,039	4,538	5,099

Sources: Data provided by the Pakistan authorities; and staff estimates and projections.

1/ Excludes foreign currency deposit liabilities and is based on GDP in U.S. dollars valued at the average annual exchange rate.
2/ Excluding gold.
3/ Medium- and long-term debt service (commitment basis) in percent of exports of goods and services and receipts of private transfers.
4/ Preliminary monetary data for 1997/98 is shown on the basis of program exchange rates rather than actual exchange rates. See Table 4 for monetary data based on actual exchange rates.

Table 2. Pakistan: Summary Balance of Payments, 1995/96–2002/03

	1995/96	1996/97	Prog. 1997/98	Prel. 1997/98	Prog. 1998/99	Projections 1999/00	2000/01	2001/02	2002/03
	(In millions of U.S. dollars)								
Current account balance before official transfers	-4,820	-3,851	-3,418	-2,076	-1,791	-1,408	-913	-800	-939
Trade balance	-3,704	-3,145	-2,364	-1,874	-121	256	396	375	266
Exports f.o.b.	8,311	8,096	9,004	8,437	8,299	8,801	9,488	10,268	11,119
Imports f.o.b.	-12,015	-11,241	-11,368	-10,311	-8,420	-8,545	-9,092	-9,893	-10,853
Services (net)	-3,499	-3,662	-3,650	-3,409	-2,990	-3,188	-3,211	-3,260	-3,312
Of which : interest payments	-1,631	-1,745	-1,849	-1,876	-1,581	-1,835	-1,940	-1,973	-1,981
Private transfers (net)	2,383	2,956	2,596	3,207	1,320	1,524	1,902	2,084	2,107
Of which : workers' remittances	1,461	1,409	1,400	1,490	1,100	1,300	1,650	1,800	1,800
Official transfers (net)	227	289	135	202	115	126	179	184	192
Current account balance	-4,593	-3,562	-3,283	-1,874	-1,676	-1,282	-734	-616	-747
Capital account	4,163	2,530	3,524	1,593	-3,182	-3,135	102	1,239	1,380
Public medium- and long-term	936	747	1,724	1,026	-764	-1,234	5	876	928
Project and nonproject loans	681	199	971	749	-612	-296	5	861	883
Disbursements	2,364	1,996	2,882	2,628	1,370	1,523	1,755	2,541	2,593
Of which : program financing	19	0.0	900	625	0.0	0.0	0.0	700	650
Amortization	-1,683	-1,797	-1,911	-1,879	-1,982	-1,819	-1,750	-1,680	-1,710
Commercial banks 1/	104	54	444	399	-345	-430	30	45	45
Other official capital	151	494	309	-122	193	-508	-30	-30	0.0
Public sector short-term (net)	180	30	104	307	-904	-360	-30	20	-9
Private medium- and long-term	1,700	1,493	1,745	755	-293	-161	265	473	625
Private short-term (including errors and omissions)	1,347	260	-49	-495	-1,221	-1,380	-137	-130	-164
Overall balance	-431	-1,032	241	-281	-4,858	-4,417	-631	623	633
Financing	431	1,032	-241	281	4,858	4,417	631	-623	-633
Net international reserves (increase -)	395	1,199	-435	148	-512	-472	-545	-429	-300
Use of Fund credit 2/	36	-167	194	133	-192	-266	-243	-194	-332
Financing gap	0.0	0.0	0.0	0.0	5,562	5,156	1,420	0.0	0.0
Memorandum items:									
End-year gross official reserves 3/	2,053	1,141	1,673	932	1,340	1,750	2,250	2,650	2,950
(In weeks of c.i.f. imports)	8.2	4.9	7.0	4.3	7.6	9.8	11.8	12.8	13.0
Change in net foreign assets of banking system	-1,285	-811	300	-67	-212	401	776	726	763
State Bank of Pakistan	-778	-994	241	-475	-468	59	623	594	632
	(In percent of GDP)								
Current account before official transfers	-7.5	-6.2	-5.1	-3.2	-3.0	-2.4	-1.5	-1.2	-1.3
Current account balance	-7.1	-5.8	-4.9	-2.9	-2.8	-2.2	-1.2	-0.9	-1.0
Exports f.o.b.	12.9	13.1	13.5	13.2	14.0	14.9	15.1	15.2	15.3
Imports f.o.b.	-18.6	-18.2	-17.1	-16.1	-14.2	-14.5	-14.5	-14.7	-14.9
External public debt	43.5	45.9	46.1	46.0	54.4	60.3	60.1	57.0	53.6
	(Annual percentage change)								
Exports f.o.b.	7.1	-2.6	9.9	4.2	-1.6	6.0	7.8	8.2	8.3
Imports f.o.b.	16.7	-6.4	-0.4	-8.3	-18.3	1.5	6.4	8.8	9.7
Export volume	5.4	4.3	10.2	11.3	3.5	4.8	5.8	6.0	6.1
Import volume	10.4	-4.7	2.4	1.5	-14.6	1.8	5.3	8.0	8.8
Terms of trade	-3.7	-4.8	2.5	3.4	-0.6	1.4	0.9	1.3	1.2

Sources: State Bank of Pakistan; Ministry of Finance; and Fund staff estimates.
1/ Includes loans from the Islamic Development Bank.
2/ Excludes the possible use of Fund resources during 1998/99–2001/01.
3/ Excluding gold.

Table 3. Pakistan: Summary of Consolidated Federal and Provincial Budgetary Operations, 1994/95–2001/02

	1994/95	1995/96	1996/97	Prog. 1997/98	Prel. 1997/98	Prog. 1998/99	Projections 1999/00	2000/01	2001/02
	(In billions of Pakistan rupees)								
Total revenue	320.7	368.6	384.2	461.3	436.6	501.2	627.5	732.4	841.7
Tax	260.1	305.6	322.5	372.9	361.9	425.9	510.7	597.5	690.2
Of which: CBR revenue	226.5	268.0	282.1	323.2	293.6	327.9	404.8	475.3	550.8
Surcharges	20.7	24.9	24.8	30.2	49.9	77.1	79.6	89.8	100.9
Nontax	60.5	63.0	61.7	88.5	74.7	75.3	116.8	134.9	151.6
Total expenditure	445.9	521.8	539.8	604.7	588.1	637.2	745.6	833.4	937.0
Current	362.1	421.2	451.7	519.2	496.3	549.3	625.7	696.3	778.9
Of which : Interest	94.2	128.0	145.6	185.4	182.6	207.1	236.4	253.7	267.6
Defense	104.5	119.7	127.4	134.0	125.2	138.0	151.8	163.9	174.6
Development and net lending 1/	83.8	100.6	88.1	85.5	91.9	87.9	119.9	137.1	158.1
Budget deficit	-125.2	-153.2	-155.6	-143.4	-151.5	-136.0	-118.1	-101.0	-95.3
(excl. net lending) 2/	-123.8	-146.8	-151.0	-148.0	-147.3	-146.4	-110.6	-92.6	-85.8
Financing	125.2	153.2	153.9	143.4	151.5	136.0	118.1	101.0	95.3
External	28.9	27.0	21.4	29.5	22.2	97.5	58.8	44.0	46.3
Domestic	85.2	114.2	132.7	113.9	129.4	38.5	59.3	56.9	49.0
Bank	36.2	49.5	67.8	58.0	48.5	-41.2	39.3	38.4	38.4
Nonbank	49.0	64.7	64.9	55.9	80.9	79.7	20.0	18.6	10.6
Privatization proceeds	11.1	12.0	1.5	0.0	0.0	0.0	0.0	0.0	0.0
	(In percent of GDP)								
Total revenue	17.0	17.0	16.0	15.7	15.8	15.9	17.5	18.1	18.5
Tax	13.8	14.1	13.4	12.7	13.1	13.5	14.3	14.8	15.2
Of which: CBR revenue	12.0	12.4	11.7	11.0	10.6	10.4	11.3	11.8	12.1
Surcharges	1.1	1.1	1.0	1.0	1.8	2.4	2.2	2.2	2.2
Nontax	3.2	2.9	2.6	3.0	2.7	2.4	3.4	3.3	3.3
Total expenditure	23.7	24.1	22.4	20.6	21.3	20.2	20.8	20.6	20.6
Current	19.2	19.4	18.8	17.7	18.0	17.4	17.5	17.2	17.2
Of which : Interest	5.0	5.9	6.1	6.3	6.6	6.6	6.6	6.3	5.9
Defense	5.6	5.5	5.3	4.6	4.5	4.4	4.2	4.1	3.8
Development and net lending	4.5	4.6	3.7	2.9	3.3	2.8	3.3	3.4	3.5
Budget deficit	-6.7	-7.1	-6.5	-4.9	-5.5	-4.3	-3.3	-2.5	-2.1
(excl. net lending)	-6.6	-6.8	-6.4	-5.0	-5.3	-4.6	-3.1	-2.3	-1.9
Memorandum items:									
Current balance	-2.2	-2.4	-2.8	-2.0	-2.2	-1.5	0.1	0.9	1.4
Primary balance	-1.6	-1.2	-0.4	1.4	1.1	2.3	3.3	3.8	3.8
Government debt 3/	86.8	84.7	88.6	84.6	87.8	92.2	95.2	92.2	86.6

Sources: Ministry of Finance and Economic Affairs; and Fund staff estimates and projections.

1/ Includes certain current outlays under the public sector development program.
2/ Under the program, the budget deficit for 1997/98 was defined to exclude domestically financed net lending.
3/ Includes government-guaranteed debt. Foreign currency debt is valued at the average annual exchange rate.

Table 4. Pakistan: Factors Affecting Changes in Broad Money, 1993/94–1998/99

	1993/94	1994/95	1995/96	1996/97	Prel. 1997/98	Sept. 1/ 1998/99	Prog. 1998/99 1/ Dec.	March	June
	(Changes in millions of Pakistan rupees)								
Net foreign assets	33,409	26,957	-38,998	-45,828	-20,225	-16,008	-34,416	-21,381	-7,036
Net domestic assets	73,863	94,376	152,900	159,711	164,031	19,189	147,072	119,281	100,342
Net claims on government	27,963	38,696	54,297	70,675	56,745	18,183	45,242	-6,649	-31,188
Of which:									
Net bank borrowing	22,842	36,158	49,497	67,842	49,286	23,998	45,798	6,000	-41,188
Budgetary support	22,842	36,158	49,497	67,842	49,286	46,798	88,798	74,200	47,912
Domestic currency counter-part deposits for debt relief	...	...	...	...	...	-22,800	-43,000	-68,200	-89,100
Commodity operations	6,582	4,733	5,858	5,702	10,585	-6,152	-556	-12,647	10,000
Claims on non-government sectors	39,425	69,977	68,707	70,085	82,930	-28,423	72,401	96,501	102,101
Other items net 2/	6,475	-14,298	29,896	18,951	24,356	29,429	29,429	29,429	29,429
Broad money	107,272	121,333	113,902	113,883	148,466	3,181	112,656	97,900	93,306
	(Changes in percent of initial stock of broad money)								
Net foreign assets	5.6	3.8	-4.7	-4.9	-1.9	-1.3	-2.9	-1.8	-0.6
Net domestic assets	12.4	13.4	18.5	17.0	15.6	1.6	12.4	10.0	8.4
Of which:									
Net bank borrowing by government	3.8	5.1	6.0	7.2	4.7	2.0	3.8	0.5	-3.4
Claims on non-government sectors	6.6	9.9	8.3	7.5	7.9	-2.4	5.9	6.9	6.9
Broad money	18.0	17.2	13.8	12.1	14.1	0.3	9.5	8.2	7.8
Memorandum item:									
Velocity of broad money	2.24	2.28	2.31	2.28	2.30	...	...	...	2.44

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

1/ Cumulative changes from July 1, 1998.

2/ Includes the impact of inflows and use of privatization proceeds.

Table 5: Accounts of Seven Key Public Sector Enterprises, 1992/93–1998/99

	Actuals					Prel.	Proj.
	1992/93	1993/94	1994/95	1995/96	1996/97	1997/98	1998/99
	(In millions of Pakistan rupees)						
Current balance	28,870	29,604	29,780	38,379	16,295	22,720	42,227
WAPDA	9,391	10,853	9,912	24,584	3,045	2,585	8,537
KESC	2,043	175	189	-470	-6,368	-4,674	1,928
OGDC	2,102	1,540	1,861	3,790	5,234	7,475	8,551
SSGCL	877	492	590	538	851	2,239	3,204
SNGPL	345	434	440	415	500	88	262
PTCL	14,148	16,024	16,835	12,774	14,866	15,424	19,757
Railways	-36	86	-47	-3,251	-1,833	-417	-12
Current Expenditure	58,110	72,228	85,271	116,432	133,829	140,201	134,335
Capital Expenditure	56,928	64,733	63,487	72,198	69,655	60,127	61,693
WAPDA	22,573	25,591	24,120	31,064	21,652	21,760	28,787
KESC	2,152	3,813	7,457	10,261	9,031	6,755	3,457
OGDC	1,730	4,472	5,554	3,710	13,342	6,821	9,004
SSGCL	1,858	3,934	3,999	4,299	1,968	4,200	2,655
SNGPL	3,326	4,360	3,969	3,894	4,967	2,942	1,666
PTCL	23,128	20,459	15,517	14,950	16,000	14,000	14,000
Railways	2,161	2,104	2,871	4,020	2,695	3,649	2,124
Overall balance	-28,058	-35,128	-33,707	-33,818	-53,360	-37,407	-19,466
WAPDA	-13,182	-14,738	-14,208	-6,480	-18,607	-19,175	-20,250
KESC	-110	-3,638	-7,269	-10,731	-15,399	-11,429	-1,529
OGDC	372	-2,932	-3,693	80	-8,108	654	-453
SSGCL	-981	-3,442	-3,409	-3,761	-1,117	-1,961	549
SNGPL	-2,981	-3,926	-3,528	-3,480	-4,467	-2,854	-1,404
PTCL	-8,980	-4,435	1,318	-2,176	-1,134	1,424	5,757
Railways	-2,197	-2,018	-2,918	-7,271	-4,528	-4,066	-2,136
Budget deficit	-109,185	-93,700	-106,100	-148,800	-153,428	-148,000	-148,000
Budgetary capital expenditure of WAPDA/OGDC/Railways/PTCL	16,376	14,597	16,526	15,079	15,939	19,520	19,520
Consolidated deficit	-120,868	-114,232	-123,281	-167,539	-190,849	-165,887	-147,946
	(In percent of GDP)						
Current balance	2.2	1.9	1.6	1.8	0.7	0.8	1.3
Of which : WAPDA	0.7	0.7	0.5	1.1	0.1	0.1	0.3
Capital expenditure	4.2	4.1	3.4	3.3	2.9	2.2	2.0
Of which : WAPDA	1.7	1.6	1.3	1.4	0.9	0.8	0.9
Overall balance	-2.1	-2.2	-1.8	-1.6	-2.2	-1.4	-0.6
GDP (in billion rupees)	1,342	1,573	1,882	2,166	2,405	2,760	3,159

Sources: Pakistan authorities; and Fund staff estimates.

Table 6. Pakistan: External Financing Requirements, 1997/98–2000/01

(In millions of U.S. dollars)

	Prel.	Prog.	Proj.	
	1997/98	1998/99	1999/00	2000/01
Current account before interest payments	2	-95	553	1,206
Net international reserves (increase -)	148	-512	-472	-545
Debt service payments, including to the Fund	-7,580	-7,551	-7,521	-4,961
Principal	-5,704	-5,970	-5,686	-3,021
Interest	-1,876	-1,581	-1,835	-1,940
Public and publicly guaranteed debt	-4,772	-5,245	-5,351	-4,179
Principal	-3,645	-3,989	-3,823	-2,503
Interest	-1,127	-1,256	-1,528	-1,676
Private debt	-2,808	-2,306	-2,170	-780
Principal 1/	-2,059	-1,981	-1,863	-518
Interest	-749	-325	-307	-262
Gross external financing requirements	-7,430	-8,157	-7,441	-4,300
Identified capital inflows	7,101	2,595	2,285	2,880
Public medium- and long-term capital	3,282	1,650	1,543	1,815
Project and nonproject loans	2,628	1,370	1,523	1,755
Of which : program financing	625	0	0	0
Commercial banks	595	30	20	60
Other official capital	59	250	0	0
Public sector short-term 2/	1,501	479	420	420
Private medium- and long-term	1,180	186	322	739
Private short-term (incl. errors & omissions)	1,138	280	0.0	-93
Disbursements from the Fund	328	n.a	n.a	n.a
Financing Gap	0.0	5,562	5,156	1,420
Probable financing	0.0	2,110	1,467	820
Multilateral disbursements (including the Fund)	0.0	1,710	1,467	820
Of which : the Fund	0.0	860	617	120
World Bank	0.0	550	450	400
AsDB	0.0	300	400	300
Bilateral Disbursements	0.0	400	0.0	0.0
Residual financing gap	0.0	3,452	3,688	600

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

1/ Includes around US$1.3 billion of institutional non-residents FCDs maturing in 1998/99, and around US$1.4 billion in 1999/2000.

2/ Includes trade credit from the the Islamic Development Bank.

3/ Includes debt service on medium- and long-term debt to official bilateral, commercial, and supplier creditors (excluding bonds).

Table 7. Pakistan: Government and Government-Guaranteed External Debt and Debt Service due, 1998/99–1999/2000 1/

(In millions of U.S. dollars)

	Outstanding Stock as of end-June 1998	Debt Service Due		Payments made 1998/1999 Jul.–Nov.
		1998/99	1999/2000	
Total government and government-guaranteed debt 2/	28,322	4,402	4,081	853
Principal	...	3,379	3,003	...
Interest	...	1,023	1,078	...
Debt to multilateral creditors (including IMF)	13,731	1,334	1,460	317
Principal	...	871	900	...
Interest	...	463	560	...
Debt to bilateral creditors and suppliers (including military debt)	11,639	...	...	430
Medium- and long-term	11,524	1,751	1,625	349
Principal	...	1,355	1,185	...
Interest	...	396	441	...
Of which: Paris Club creditors 3/	9,848	1,301	1,312	...
Principal	...	990	942	...
Interest	...	311	370	...
Other creditors	1,676	451	314	...
Principal	...	365	243	...
Interest	...	86	71	...
Of which: Debt contracted after end-December 1997	392	96	92	36
Principal	...	82	82	...
Interest	...	14	11	...
Short-term debt	115	119	0	81
Principal	...	115	0	...
Interest	...	4	0	...
Debt to commmercial banks (excluding bonds)	1,488	...	...	101
Medium-term debt	796	406	482	42
Principal	...	346	450	...
Interest	...	61	32	...
Short-term debt	692	733	0	59
	...	692	0	...
Interest	...	41	0	...
Bonds	628	59	513	5
Principal	...	0	468	...
Interest	...	59	45	...
Memorandum items:				
Non-Guaranteed debt of the private sector	...	729	710	...
Principal	...	479	483	...
Interest	...	250	227	...
Institutional FCDs (FE-45) maturing	1,593	1,313	280	...
Deposits of foreign banks with SBP maturing	643	343	300	43

Sources: Ministry of Finance of Pakistan; multilateral creditors; and Fund staff estimates.

1/ Fiscal year ending in June

2/ Excluding liabilities of the State Bank of Pakistan other than to the IMF, and government bearer certificates in foreign currency. These bearers certificates issued on a tap basis, can only be encashed in local currency since end-May 1998.

3/ Includes debt to all creditors residents of Paris Club member countries.

Table 8. Pakistan: Summary of External Debt and Debt Service, 1995/96–2002/03

	1995/96	1996/97	Prel. 1997/98	Prog. 1998/99	Proj. 1999/00	Proj. 2000/01	Proj. 2001/02	Proj. 2002/03
	(In millions of U.S. dollars)							
Total public and publicly guaranteed external debt	28,105	28,384	29,477	32,300	35,574	37,714	38,402	38,968
Long-term	25,097	25,793	26,777	29,329	32,301	34,611	35,474	36,388
Project and nonproject aid	22,275	22,734	23,693	23,266	23,098	23,202	24,144	25,087
Commercial banks and IDB	647	701	1,100	755	325	355	400	445
Other 1/	2,175	2,358	1,984	5,307	8,878	11,053	10,929	10,855
Short-term	1,469	1,271	1,340	918	858	828	848	839
Commercial banks and IDB	990	840	946	584	584	584	634	684
FEBCs and DBCs	479	431	394	334	274	244	214	155
Fund credit and loans 2/	1,539	1,320	1,360	2,053	2,415	2,275	2,081	1,742
Service of medium- and long-term public and publicly guaranteed debt	3,185	3,641	3,234	3,699	3,964	3,605	3,544	3,764
Of which: to the Fund 2/	289	369	237	243	335	312	257	386
Amortization	2,215	2,693	2,284	2,562	2,549	2,037	1,928	2,136
Of which: to the Fund 2/	241	319	195	192	266	243	194	332
Interest	970	948	950	1,137	1,415	1,568	1,616	1,628
Of which: to the Fund 2/	48	50	42	51	68	69	63	54
Interest on public and publicly guaranteed short-term debt	71	106	106	69	63	60	60	59
	(In percent of GDP)							
Total public and publicly guaranteed external debt	43.5	45.9	46.0	54.4	60.3	60.1	57.0	53.6
Long-term	38.8	41.7	41.8	49.4	54.7	55.2	52.6	50.0
Short-term	2.3	2.1	2.1	1.5	1.5	1.3	1.3	1.2
Fund credit and loans 2/	2.4	2.1	2.1	3.5	4.1	3.6	3.1	2.4
Service of medium- and long-term public and publicly guaranteed debt	4.9	5.9	5.0	6.2	6.7	5.7	5.2	5.2
Amortization	3.4	4.4	3.6	4.3	4.3	3.2	2.9	2.9
Interest	1.5	1.5	1.5	1.9	2.4	2.5	2.4	2.2
Interest on public and publicly guaranteed short-term debt	0.1	0.2	0.2	0.1	0.1	0.1	0.1	0.1
	(In percent of exports of goods and services and private transfers)							
Total public and publicly guaranteed external debt	223.5	219.6	220.8	288.4	295.1	283.0	265.7	251.4
Of which: Fund credits and loans 2/	12.2	10.2	10.2	18.3	20.0	17.1	14.4	11.2
Service of medium- and long-term public and publicly guaranteed debt	25.3	28.2	24.2	33.0	32.9	27.1	24.5	24.3
Of which: to the Fund 2/	2.3	2.9	1.8	2.2	2.8	2.3	1.8	2.5
Amortization	17.6	20.8	17.1	22.9	21.2	15.3	13.3	13.8
Of which: to the Fund 2/	1.9	2.5	1.5	1.7	2.2	1.8	1.3	2.1
Interest	7.7	7.3	7.1	10.2	11.7	11.8	11.2	10.5
Of which: to the Fund 2/	0.4	0.4	0.3	0.5	0.6	0.5	0.4	0.3
Interest on public and publicly guaranteed short-term debt	0.7	0.8	0.8	0.6	0.5	0.4	0.4	0.4

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

1/ Includes part of the financing gap which is assumed to be covered by exceptional financing to the government of Pakistan.
2/ Includes the possible use of Fund resources in 1998/99–2000/01.

Table 9. Pakistan: Fund Position, 1998/99–2000/01

(In millions of SDRs)

	Prog. 1998/99	Proj. 1999/2000	Proj. 2000/01	Total 1998/99 2000/01
Transactions under ESAF/EFF and CCFF arrangements (net)	465.2	214.9	-145.2	534.9
Disbursements	648.4	466.3	91.0	1,205.7
ESAF arrangements	182.0	182.0	91.0	454.9
EFF arrangements	113.7	284.3	0.0	398.1
CCFF arrangements	352.7	0.0	0.0	352.7
Repayments	183.2	251.4	236.2	670.7
Principal	144.6	200.0	184.0	528.6
Charges and interest	38.5	51.4	52.2	142.1
Total Fund credit outstanding at the end of period 1/	1,547.7	1,814.0	1,721.0	1,721.0
Memorandum item:				
Total Fund credit outstanding at the end period (in millions of U.S. dollars)	2,053	2,415	2,275	2,275

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

1/ Includes SDR 30 million in obligations to the Saudi Fund for Development.

Table 10. Pakistan: Indicators of Fund Credit, 1996/97–2007/08 1/

		Prel.	Prog.	Projections								
	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08
Outstanding Fund Credit												
In millions of SDRs	947	1,044	1,548	1,814	1,721	1,574	1,322	1,047	874	671	459	261
In millions of U.S. dollars	1,320	1,418	2,053	2,415	2,275	2,081	1,742	1,380	1,150	883	603	343
In percent of:												
Quota	124.8	137.7	204.1	239.2	227.0	207.6	174.4	138.1	115.3	88.5	60.5	34.4
GDP	2.1	2.2	3.5	4.1	3.6	3.1	2.4	1.8	1.4	1.0	0.6	0.3
Exports 2/	10.2	10.6	18.3	20.0	17.1	14.4	11.2	9.5	7.3	5.2	3.3	2.1
Public and publicly guaranteed debt	4.6	4.8	6.4	6.8	6.0	5.4	4.5	3.5	2.9	2.3	1.5	0.9
Debt service to the Fund												
In millions of U.S. dollars	367	271	243	335	312	257	386	405	261	296	303	278
In percent of:												
Exports 2/	2.8	2.0	2.2	2.8	2.3	1.8	2.5	2.8	1.7	1.8	1.7	1.7
Gross official reserves	29.7	29.1	18.1	19.8	13.9	9.7	13.1	12.7	7.6	8.0	7.5	6.4

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

1/ Under the assumptions of the medium-term program.
2/ Exports of goods, nonfactor services, and net private transfers.

Table 11. Pakistan: Disbursements and Purchases Under the ESAF and EFF Arrangements, 1997/98–2000/01

(In millions of SDRs)

Timing of Purchase/ Disbursement	Conditions	ESAF	EFF
		(In percent of quota)	
October 1997	Board approval of the first ESAF annual and EFF arrangements	113.73 (15)	37.91 (5)
March 1998	ESAF mid-term and first EFF reviews—end-December 1997 performance criteria	113.73 (15)	18.96 (2.5)
January 1999	Board approval of the second ESAF annual arrangement Second EFF review—end-June 1998 performance criteria	90.98 (12)	37.91 (5)
March 1999	EFF review—end-December 1998 performance criteria		37.91 (5)
June 1999	ESAF mid-term review—EFF Review—end-March 1999 performance criteria	90.98 (12)	37.91 (5)
September 1999	EFF review—end-June 1999 performance criteria		113.73 (15)
December 1999	ESAF end-year review—EFF Review—end-September 1999 performance criteria	45.49 (6)	56.87 (7.5)
January 2000	Board approval of third ESAF annual arrangement	45.49 (6)	
March 2000	EFF review—end-December 1999 performance criteria		56.87 (7.5)
June 2000	ESAF mid-term review—EFF Review—end-March 2000 performance criteria	90.98 (12)	56.85 (7.5)
December 2000	End-September 2000 performance criteria	90.98 (12)	

Pakistan: Fund Relations

(As of November 30, 1998)

I. **Membership Status**: Joined 7/11/50; Article VIII

A. Financial Relations

II. **General Resources Account**:	**SDR Million**	**% Quota**
Quota	758.20	100.0
Fund holdings of currency	1,229.73	162.2
Reserve position in Fund	0.06	0.0

III. **SDR Department**:	**SDR Million**	**% Allocation**
Net cumulative allocation	169.99	100.0
Holdings	0.65	0.4

IV. **Outstanding Purchases and Loans**:	**SDR Million**	**% Quota**
Stand-by arrangements	294.69	38.9
Extended arrangements	176.90	23.3
SAF arrangements	136.58	18.0
ESAF arrangements	399.66	52.7

V. **Financial Arrangements**:

Type	**Approval Date**	**Expiration Date**	**Amount Approved (SDR Million)**	**Amount Drawn (SDR Million)**
EFF	10/20/97	10/19/00	454.92	56.86
ESAF	10/20/97	10/19/00	682.38	227.46
Stand-by	12/13/95	09/30/97	562.59	294.69

VI. **Projected Obligations to Fund** (SDR million; based on existing use of resources and present holdings of SDRs):

	Overdue	Forthcoming				
	11/30/98	1998	1999	2000	2001	2002
Principal	--	30.9	183.3	217.5	137.1	69.6
Charges/Interest	--	1.3	27.1	22.2	15.8	12.7
Total	--	32.2	210.4	239.7	152.9	82.3

B. Nonfinancial Relations

VII. **Exchange System**

Over the last few years, Pakistan implemented a fixed exchange rate system with periodic step devaluation to compensate for the domestic-external inflation differential. On July 21, 1998, a dual exchange system was introduced consisting of a fixed official exchange rate and a floating interbank market exchange rate (FIBR). Under the dual exchange rate system, export proceeds and all foreign exchange inflows continue to have to be surrendered to the banking system. For each transaction, 50 percent of the inflow has to be surrendered immediately (as in the past) at the official exchange rate. The remainder may be now retained in a special foreign currency account for up to one week, by which time it must be sold to any commercial bank at the FIBR. Payments for essential imports, payments of official debt and interest, and payments against repayment schedules registered with the State Bank of Pakistan under supplier's credits/buyers credit are allowed at the official exchange rate; all other payments including imports, repatriable loans, other remittances and travel, health and education expenses are split in equal amounts into the official exchange rate and the interbank rate. As of August 27, 1998 the official rate stood at PRs 46.00 per U.S. dollar and the FIBR was PRs 53.87 per U.S. dollar. In addition, since May 28, 1998, withdrawals from foreign currency accounts have only been allowed in rupees (at the official exchange rate). Also, an advance import deposit of 30 percent was introduced on July 12, 1998. An extensive set of exchange restrictions were notified to the Fund as national security-based, pursuant to Decision 144-(52/51).

VIII. **Last Article IV Consultation**

The last Article IV consultation discussions were held in Islamabad, Washington, and Hong Kong during July-September 1997. The staff report (EBS/97/185) together with Pakistan's request for arrangements under the Enhanced Structural Adjustment Facility and the Extended Fund Facility was discussed by the Executive Board on October 20, 1997. In concluding the 1997 Article IV consultation, the Executive Board adopted the following decisions (Decisions No. 11589-97/104 and No. 11590-97/104):

"Pakistan-Extended Arrangement

1. The government of Pakistan has requested an Extended Arrangement in an amount equivalent to SDR 454.92 million for a period of three years.

2. The Fund approves the Extended Arrangement set forth in EBS/97/185, Supplement 2."

"Pakistan-Enhanced Structural Adjustment Arrangement

1. The government of Pakistan has requested a three-year arrangement under the Enhanced Structural Adjustment Facility and the first annual arrangement thereunder.

2. The Fund notes the policy framework paper for Pakistan set forth in EBD/97/110.

3. The Fund approves the arrangements set forth in EBS/97/185, supplement 3."

Pakistan is on the standard 12-month Article IV consultation cycle.

IX. Recent Technical Assistance

a. **FAD**: In May/June 1997, a mission conducted a review of the public expenditure management system. In May 1997 and again in May 1998, missions reviewed the operation of the GST and recommended measures to improve tax administration and increase tax compliance.

b. **MAE**: In May/June 1996, a mission provided technical assistance on the transition to indirect monetary control. In June/July 1997, a technical assistance mission assisted the authorities in developing a strategy to phase out subsidized forward cover for foreign currency deposits and identify key steps to improve the institutional structure of the foreign exchange market. In February, May/June, and November 1998, MAE fielded follow-up technical assistance missions on foreign exchange market reform.

X. Resident Representative

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

Pakistan: Relations with the World Bank Group

Background

1. IBRD and IDA have made 97 loans and 130 credits to Pakistan since 1952, totaling US$6,948.1 million and US$5,384.8 million respectively (both net of cancellations). Of these amounts, US$2,342.7 million has been repaid and US$1,604.6 million remained undisbursed. Current total obligations to the Bank stand at $6856.1 million, of which $3755.9 million are IDA and $3100.2 million are IBRD, as of November 30, 1998. IDA Credits constituted 4.55 percent and IBRD Loans 2.74 percent of the Bank portfolio in fiscal year 1998. IFC's portfolio consists of 51 projects totaling $991 million, $860 million of which was disbursed as of October 31, 1998. MIGA has been active in Pakistan since 1991. As of November, 1998, Pakistan accounted for 6 percent of MIGA's portfolio with a total of eighteen contracts of guarantee for an outstanding maximum contingent liability of US$160 million.

2. IBRD and IDA assistance to Pakistan steadily increased during the 1980s, with average annual commitments growing from about US$225 million in the early 1980s to US$730 million during FY 1988–91, owing in large part to substantial adjustment lending supporting the government's reform program. In FY 1992–93, new commitments slowed to about US$400 million per annum, reflecting mainly delays in reaching agreement on new adjustment lending and slow progress in finalizing a large power development loan. New commitments in FY 1995–96 averaged about US$583 million. Due to the uncertainties, no commitments of IBRD resources were made in FY 97 while IDA commitments the same year totaled US$85 million. In FY 98 IDA commitments, however, increased to US$558 million while IBRD lending was restored at a level of US$250 million. This reflected substantial lending in support of reform programs in banking, irrigation and drainage, and the second phase of the Social Action Program.

3. The composition of IBRD/IDA lending has shifted significantly in recent years, reflecting an increasing emphasis on human development. In FY 1980–88, 70 percent of total commitments went to agriculture (including irrigation) and infrastructure (mainly energy), while the social sectors accounted for 6 percent. Over the last five years, by contrast, commitments to the social sectors averaged 20 percent while commitments to agriculture declined to 12 percent in favor of electricity and energy 33 percent, infrastructure 18 percent, and other sectors (finance, industry, public sector) 16 percent.

4. Market-friendly reforms pursued by the government over the past few years have allowed IFC to increase significantly its investments and participate in a more diversified range of activities. IFC-financed projects have been in textiles, cement and construction, tourism, timber, pulp and paper, oil and gas, chemicals, petrochemicals, fertilizers, infrastructure, and capital markets. MIGA guarantees have been issued for projects in the financial, infrastructure, and manufacturing sectors.

Program focus

5. The overriding objective of the Bank Group's assistance strategy is to help Pakistan reduce poverty through rapid sustainable improvements in living standards. To achieve this objective, the Bank Group is working with Pakistan in three main areas of strategic emphasis. Expanding access and improving the delivery of core social services represents the first area of World Bank Group assistance to Pakistan. In addition to supporting the Social Action Program through strategy development, analysis, and financial and technical assistance, the Bank Group is financing related investment operations in education, health, and population welfare. The Bank is assisting a government/NGO joint effort to establish a Poverty Alleviation Fund aimed at creating a stronger social safety net for the poor and may join in its financing. The second area of strategic emphasis that the Bank Group is assisting is the fiscal adjustment effort. In addition to maintaining an active dialogue and outreach on fiscal reform and public expenditure restructuring, the Bank reviews annually the public investment program. The Bank has completed a broader public expenditure review to better inform the policy dialogue on expenditure restructuring. Through studies on intergovernmental fiscal relations and provincial finances, the Bank is also encouraging a stronger provincial resource mobilization effort and greater devolution of social and other public services to local governments, communities, and the private sector. Finally, the Bank Group is supporting a more competitive environment for private investment and accelerated growth by assisting Pakistan's privatization effort, financing investments to reduce infrastructural constraints, and helping to foster a competitive environment, improve financial intermediation, strengthen institutional capacities and raise agricultural productivity, as well as to implement policies and programs to arrest environmental and natural resource degradation and reduce urban poverty.

6. The Bank has worked with Pakistan on the development and implementation of a banking sector reform program. A Banking Sector Adjustment Loan in support of these reforms was approved in December 1997 and disbursed by March 1998. To promote agricultural productivity, Bank's policy is to support institutional changes and investments that would create an incentives regime and competitive environment for sustainable growth of the agriculture sector. Water resource management remains a critical issue for Pakistan's future, and in the coming year the Bank will continue to support this effort through a fourth On-Farm Water Management project and preparation of a Canal Command Development project. To support reforms of the incentives systems and public expenditure in agriculture, later in FY 99 we also intend to support an Agricultural Sector Investment Project. In supporting urban poor, the Bank has the policy of expanding the delivery of urban services (e.g., improving water supply, sewerage systems, and solid waste management). The upcoming Punjab Municipal Development Fund Project will have the objective of improving urban infrastructure services in a sustainable manner, strengthening the financial, administrative and managerial capacities, and providing incentives for greater local resource mobilization.

7. To undertake this program effectively, the Bank Group is promoting the government's efforts to more fully involve communities, the private sector, and Pakistani

NGOs in its programs. Partnership with these groups is necessary for both the Bank Group and the government to deliver results on the ground faster.

8. Successful implementation of the program has also called for a strategic alliance among IBRD/IDA, IFC, and MIGA. IBRD and IDA are focusing their assistance strategy on public policy, institutions, and critical public investments for private sector-led growth. Under the present situation, IFC's strategy is to focus on areas where it will have an immediate impact on the economy, particularly support for small and medium enterprises. MIGA's insurance coverage for the political risks faced by private investors in Pakistan complements the Bank's and IFC's assistance to the private sector.

New commitments by the Bank Group

9. The Bank Group monitors the government's progress toward and pace of macroeconomic and structural reforms. If the government is taking concrete action to maintain macroeconomic stability, achieve its fiscal targets, and continue to move forward on structural reforms, Bank Group assistance levels could be raised substantially from the FY 97 level.

10. Total annual new IBRD and IDA commitments (including guarantees) in coming fiscal years could average between US$500 million and US$750 million, depending on the pace and depth of structural reforms. IBRD guarantees could be a part of this program so long as Pakistan remains creditworthy for IBRD lending. When business confidence begins to be restored in Pakistan, IFC's strategy will be to focus on areas where foreign and domestic investment can have an immediate impact on the economy. Within infrastructure, IFC would have interest in distribution and fuel transportation. In addition, IFC foresees assisting development of local long-term funding to support small- and medium-scale enterprises, investment in sound agribusiness ventures and export-oriented projects.

Technical assistance by the World Bank

11. The World Bank provides technical assistance in agriculture, public sector management, tax administration, telecommunications, finance, oil and gas, industry, electric power and energy, transportation, urban development, education, health, and water supply and sanitation. Nearly half of the active projects in the FY 97 Pakistan portfolio have explicit technical assistance components or can be categorized as stand-alone technical assistance projects. The total amount of this TA was approximately US$225 million. Many of the remaining projects have technical assistance built into the project design, though this is not separately identified or listed below.

12. World Bank-funded technical assistance supports a wide range of activities. Bank financing is supporting restructuring and institution building within a number of public sector agencies, including the National Highway Board, the National Housing Authority, the Oil and Gas Development Corporation, the Ministry of Petroleum and Natural Resources, WAPDA, the Pakistan Revenue Service, and federal and provincial education and health

ministries. Pakistan's privatization program is also being assisted. For example, ongoing assistance is being provided to the Privatization Commission and to privatization of the railways, the telecommunications company, a water and sewerage company, gas companies, and to banking sector reform. Public sector management procedures, such as financial reporting and auditing capacity, are being improved with World Bank financial assistance. Technical assistance is also supporting improvements and the establishment of regulatory frameworks in Pakistan, especially in the power and the telecommunication sectors. Other types of activities supported by technical assistance include project preparation and management, operations and maintenance improvements, and sector studies.

Pakistan: Financial Relations with the World Bank Group
Statement of Loans and Credits
As of November 30, 1998

(In millions of U.S. dollars)

	IBRD	IDA	Total
IBRD/IDA lending operations			
1. Fully disbursed operations	5,868.5	3,751.1	9,619.6
2. Ongoing operations			
Agriculture	0.0	446.8	446.8
Public sector management	0.0	75.6	75.6
Telecommunications	35.0	0.0	35.0
Education	0.0	454.2	454.2
Social action program II	0.0	250.0	250.0
Finance	66.0	0.0	66.0
Oil and gas	0.0	0.0	0.0
Population, health and nutrition	0.0	121.9	121.9
Industry	0.0	0.0	0.0
Multisector	0.0	0.0	0.0
Electric, power and energy	980.0	0.0	980.0
Transportation	0.0	0.0	0.0
Urban development	0.0	21.5	21.5
Environment	0.0	63.5	63.5
Water supply and sanitation	0.0	325.2	325.2
3. Total (1 + 2)	6,949.5	5,509.8	12,459.3
4. Repayments	1,956.2	386.5	2,342.7
5. Undisbursed	555.5	1,049.1	1,604.6
6. Total outstanding (3-4-5)	4,437.8	4,074.2	8,512.0

Source: World Bank.

Note: Ongoing operations are commitments less cancellations.

Pakistan: Medium-Term Macroeconomic Projections

1. The baseline macroeconomic scenario illustrates a policy strategy that aims at overcoming by end-1999/2000 through tight macroeconomic policies and substantial exceptional balance of payments financing the external payments crisis that started in May 1998. At the same time, the implementation of structural reforms to reinvigorate private sector-led and export-oriented growth would continue. The policy strategy would prepare the grounds for a rapid convergence to the targeted medium-term annual growth rate of real GDP of 5 to 6 percent once external financing, including both official and private flows, has normalized and the main macroeconomic balances have improved.

2. Fiscal adjustment will be key in achieving the macroeconomic objectives. Higher public savings will not only contribute to increasing the financial resources available for private sector developments but also to reducing the vulnerabilities associated with the outstanding large stock of public debt and budgetary financing needs. The consolidated budget deficit, the main intermediate target in this regard, is programed to decline rapidly from an estimated 5.5 percent of GDP in 1997/98 to 4.3 percent GDP in 1998/99 and to 3.3 percent of GDP in 1999/2000. Subsequently, it would be reduced gradually to 1.8 percent of GDP in 2002/03. In 1998/99, expenditure reductions (as a percent of GDP) would account for almost the entire deficit adjustment in terms of GDP because the revenue measures implemented in the budget and the second annual program under the current ESAF/EFF-arrangement, e.g., increase in the GST rate from 12½ to 15 percent, are needed to maintain the revenue ratio given the revenue losses implied by the tariff reform to be adopted by end-March 1999, administrative reforms (e.g., increased refunds), and the balance of payments constraint (i.e., lower growth and decreased imports). From 1999/2000 onward, the fiscal adjustment strategy would have to rely largely on revenue increases since further cuts in overall expenditure allocations would jeopardize the provision of government services in the areas of education, health, and basic infrastructure given the projected path for interest payments on government debt.

3. Monetary policy, in conjunction with the external sector policies specified below, is the key instrument in ensuring that growth and inflation targets are consistent with external viability, particularly the external reserves target. During 19998/99–1999/2000, the monetary policy stance would have to remain tight so as to restore confidence in domestic financial markets and contain inflation. Nevertheless, with the targeted paths for the public sector savings and external budgetary financing, private credit demand could still be accommodated adequately. Once the adverse effects of the external shocks of 1998 will be absorbed and confidence restored, inflation should decline rapidly and foreign exchange inflows are expected to converge to the levels of the mid-1990s. Monetary policy could then accommodate the anticipated increase in real money demand, which would enhance prospects for private investment and foster fiscal sustainability. Coupled with the planned financial sector reforms, such a policy stance would remain consistent with the needed increase in private sector savings in the medium-term.

4. The recently adopted external sector policy measures, including restrictions on external current account transactions, aimed at restraining aggregate demand to cope with the external shocks experienced during 1998. The exchange restrictions, however, are inconsistent with the trade liberalization and other structural reforms advanced by the government under the current ESAF/EFF-arrangement to foster export-oriented growth. With the programed tight fiscal and monetary policies, external sector policies during the remainder of 1998/99 would therefore focus on sustaining the expenditure switching required by the external finance constraints, including through the adoption of a floating exchange rate by end-June 1999, while the temporary restrictions on external current account transaction imposed in mid-1998 would be phased out. These policies would be supported by a substantial amount of exceptional balance of payments financing during 1998/99–1999/2000. In the medium-term, the reduction of Pakistan's vulnerability to external shocks would require a strengthening of Pakistan's external position. Key instruments in this regard would be an active exchange rate policy to maintain external competitiveness and the implementation of the ambitious structural reform package to increase productivity in the sectors producing tradable goods.

5. With the expected improvement in the external environment associated mainly with the recovery in important regional trading partners, the increase in exports of goods and nonfactor services in nominal U.S. dollar terms is projected to gradually increase from a rate of 5.6 percent in 1999/2000 to a rate of about 8 percent in 2002/03. In volume terms, merchandise exports are forecasted to raise from 3.5 percent to 6.1 percent during the same period. After a sharp decline in 1998/99 and a small increase in 1999/2000, imports of goods and nonfactor services are forecasted to increase at a rate slightly above nominal GDP growth, primarily on account of the projected improvement in the terms of trade that would allow for relatively faster expansion of import volumes compared with the growth of export and output volumes. Following the significant improvements in macroeconomic balances targeted for end-1999/2000, private transfers are projected to recover gradually from their low reached in 1998/99 and 1999/2000 during the remainder of the projection period.

6. With these macroeconomic policies and external sector developments, the annual real GDP growth rate is expected to accelerate gradually from 3 percent in 1998/99 and 1999/2000 to 6 percent in 2002/03 and thereafter. Local inflation is expected to be contained at an average annual rate of about 10-11 percent during 1998/99–1999/2000 before gradually declining to 6 percent by 2002/03. Gross capital formation is projected to increase to about 18 percent in 2002/03 after reaching a low of about 15 percent in 1999/2000 associated with the private sector adjustment to the balance of payments constraints and uncertainties. The recovery in private sector investment from the shocks experienced in 1998/99 would be consistent with both the growth target and the productivity increases that are expected to emerge with the implementation of the envisaged structural reform package. Gross national savings would rise from 12 percent to about 17 percent of GDP during the same period, largely on account of increased public sector savings. After accommodating the temporary decline in real, private gross national disposable income during 1998/99–1999/2000, private sector savings are projected to recover gradually to about 14 percent of GDP during the remainder of the program period as income would raise again with the higher GDP growth and the expected turnaround in current account receipts such as workers' remittances.

Nevertheless, in this scenario of a private sector-led turnaround in growth, the private sector savings investment balance would decrease gradually throughout the projection period. The projected improvement in the overall savings-investment balance would therefore be associated with the improved public sector savings-investment balance ensuing the fiscal adjustment. In the external accounts, the improving overall savings-investment balances are reflected in a turnaround in the trade balance from a deficit of 0.2 percent of GDP in 1998/99 to a surplus of 0.4 percent of GDP in 2002/03 and, with the recovery in services receipts and private transfers. The external current account deficit (excluding official rants) would decrease from 3 percent of GDP in 1998/99 to 1.3 percent in 2002/03. In conjunction with the projected capital account recovery due to the improved macroeconomic and financial balances, this path of current account improvements allows for an increase in gross foreign exchange reserves from US$932 million at end-1997/98 to US$2,900 million at end-2002/03, which is equivalent to a rise from 4.3 weeks of imports to 12.8 weeks of imports.

7. The improvements in government savings are associated with an increase in the primary surplus of the consolidated government accounts from 2.2 percent of GDP in 1998/99 to 3.8 percent of GDP in 2002/03. Accordingly, the ratio of domestic public debt to GDP is projected to fall from 41.9 percent of GDP at end-1997/98 to about 27 percent of GDP at end-2000/03. Coinciding with the end of a two-year period with large net new external financing provided by the international community, the external public debt (including publicly guaranteed debt) would reach a maximum of about 60 percent of GDP at end-1999/2000 but would then decline slightly to 53.3 percent at end-2002/03 with the projected improvements in the overall savings-investment balances.

Pakistan: Compensatory Financing

1. The Pakistan authorities are expected to request a purchase in the amount of SDR 352.7 million (equivalent to about 46.5 percent of quota) under Section II, paragraph 12 (a) (ii), of the CCFF decision (Decision No. 8955-(88/126), adopted on August 23, 1988, as amended). The request is being made in respect of an export shortfall, related mainly to lower volumes and prices of cotton and cotton-based manufactures during the period January 1, 1998–December 31, 1998 (Table 12).

2. The calculations supporting the request for compensatory financing relating to an export shortfall for the 12-month period ending December 1998 are made in accordance with the early drawing procedure set out in paragraph 14 of the CCFF decision. Actual data on exports are available through October 1998. In consultation with the authorities, the staff has estimated the value of exports for the last two months of the shortfall year. In accordance with the provisions of paragraph 16(a) of the CCFF decision, the authorities will be expected to make a prompt repurchase in respect of the outstanding purchase in an amount equivalent to the overcompensation if the amount purchased on the basis of estimated data exceeds the amount that could have been purchased on the basis of actual data for the entire shortfall year. As soon as actual data for the entire shortfall year become available, the staff will report to the Board on this matter.

Causes of the export shortfall

3. The calculated shortfall of SDR 352.7 million in merchandise exports is attributable largely to the drop in export volumes of raw cotton and cotton manufactures, combined with a decline in prices. Pakistan's export earnings (in SDR terms) are estimated to have declined by 2.6 percent during the shortfall year, and these earnings are projected to rise by 6-8 percent a year in the two post-shortfall years (Table 13). Beyond 1998, the outlook is for a strong recovery in raw cotton exports based on higher production and an increase in exports of cotton manufactures as the demand for Pakistan cotton yarn and cloth mainly coming from other Asian economies is expected to recover. In addition, prices of cotton products are projected to stabilize after a significant decline over the last two years. Therefore, it is the staff's assessment that the estimated shortfall in export earnings in 1998 will be *temporary*.

4. The staff also believes that the anticipated shortfall is *largely beyond the control of the authorities*. Several factors have contributed to this shortfall. First, the domestic production of cotton was adversely affected by bad weather conditions and parasite infestation in 1996/97–1997/98. Second, the sluggish economic activity in other Asian economies has contributed to much weaker demand for cotton material, as well as a decline in cotton prices.[1]

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[1]Japan, Hong Kong, and South Korea accounted for about 50-60 percent of exports of Pakistan yarn in 1996/97–1997/98.

Calculation of the export shortfall and underlying assumptions

5. The reduction in export earnings in 1998 over 1996 and 1997 is almost entirely due to lower earnings from raw cotton and cotton manufactures, which together accounted for about 60 percent of Pakistan's total exports in 1996 and in the shortfall year.

6. During the 12-month period ending 1998, a net export shortfall of about SDR 314 million is projected with respect to raw cotton and cotton manufactures. The shortfall in raw cotton earnings is almost entirely attributable to the estimated fall in volumes. Because of bad weather conditions and parasite infestation, domestic production in 1996/97 and 1997/98 was lower by about 12 percent compared with 1995/96, and about 10 percent lower than the estimated production in 1998/99. The shortfall in cotton manufactures is mainly with respect to yarn and cloth, of which export volumes, and to a lesser extent prices, declined significantly over the last two years.

7. Production of raw cotton in 1998/99 is currently estimated at about 10.2 million bales, compared with 9.2 million bales in 1997/98, as a result of good weather conditions and larger use of parasite resistant cotton seeds. Production in 1999/2000 is projected to increase slightly, as the improvement in cotton seeds would continue. On this basis, the exportable surplus of raw cotton is projected to be larger by about 1 million bales in 1999 and 2000 relative to the shortfall year (Table 14). With a projected recovery in other Asian economies, export volumes of yarn are projected to increase by about 5 percent per year in 1999 and 2000, while export volumes of cloth would remain virtually constant. Cotton manufactures prices projections for 1999 and 2000, which are in line with WEO projections, indicate a slight increase of about 1-2 percent per year.

8. Other export categories, including rice, leather, and fish, are expected to show either a small net export shortfall, or a net excess. The shortfall in fish and fish preparations mainly reflects a temporary ban on Pakistan products imposed by the EU during part of 1998.

Cooperation and access limit

9. Pakistan has a satisfactory record of relations with the Fund. Close cooperation has been maintained during the recent years under various Fund arrangements.

10. Based on the above considerations, and the fact that the authorities are committed to an arrangement in the upper credit tranches and Pakistan's record of cooperation, Pakistan falls within paragraph 12 (a) (ii) of the CCFF decision, which permits access up to 50 percent of quota. In light of Pakistan's strong adjustment measures, the staff supports the Pakistan authorities' request for a purchase in an amount of SDR 352.7 million.

Table 12. Pakistan: Calculation of Export Shortfall Under the CCFF, 1996–2000

(In millions of SDRs)

	Year Ending December 31					In percent of quota
			Est. 1/	Projected		
	1996	1997	1998	1999	2000	
Merchandise exports	6366.1	6257.6	6094.2	6572.9	6979.0	
Trend value 2/			6446.9			
Calculated export shortfall (- excess) 3/ 4/			352.7			46.5
Proposed Purchase			352.7			46.5
Memorandum items:						
Pakistan's quota in the Fund (SDR millions)			758.2			
Exchange rate (US$/SDR)	1.4520	1.3760	1.3390	1.3260	1.3220	
Merchandise exports (US$ million)	9243.6	8610.4	8160.1	8715.7	9226.3	

Sources: Pakistan authorities; and Fund staff estimates.

1/ The 1998 estimated export receipts are based on actual data for the first ten months of the year.

2/ Geometric average of export earnings for the five years centered on the shortfall year.

3/ The amount by which export earnings in the shortfall year are below their trend value.

4/ The constraint that the average export earnings in the two post-shortfall years not exceed 20 percent of their average level in the two pre-shortfall years is not binding in this case (paragraph 15 of the CCFF Decision).

Table 13. Pakistan: Merchandise Exports Earnings, 1996–2000

	Year Ending December 31					Geometric Shortfall	
				Projections			
	1996	1997	1998 1/	1999	2000		
	(In million of SDRs)						(in percent of quota)
Total exports	6,366	6,258	6,094	6,573	6,979	352.7	46.5
Main primary commodities	633	427	477	695	697	97.7	12.9
Cotton	289	76	47	232	222	92.9	12.2
Rice	344	351	430	464	475	-21.2	-2.8
Cotton manufactured	3,720	3,664	3,407	3,565	3,800	221.3	29.2
Yarn	1,099	987	758	803	856	134.3	17.7
Cloth	964	940	863	849	875	34.3	4.5
Readymade garments	517	557	499	514	551	27.9	3.7
Tents and canvas	24	34	38	38	38	-4.3	-0.6
Hosiery	513	494	534	579	629	13.8	1.8
Made-up articles (incl. towels)	602	652	716	783	851	-0.5	-0.1
Other traditional exports	800	845	788	774	804	14.1	1.9
Leather	181	163	139	125	130	7.0	0.9
Carpets	164	143	149	158	157	5.0	0.7
Fish and fish preparation	100	128	91	113	120	18.5	2.4
Synthetic textiles	355	411	408	378	397	-19.1	-2.5
All other exports	1,213	1,322	1,422	1,538	1,678	3.2	0.4
	(Annual percentage change)						
Total exports	21.7	-1.7	-2.6	7.9	6.2		
Main primary commodities	55.4	-32.5	11.6	45.8	0.3		
Cotton	187.8	-73.7	-38.7	397.7	-4.0		
Rice	12.1	2.1	22.4	7.8	2.4		
Cotton manufactured	23.7	-1.5	-7.0	4.6	6.6		
Yarn	7.5	-10.2	-23.2	6.0	6.6		
Cloth	39.7	-2.6	-8.2	-1.6	3.0		
Readymade garments	33,2	7.8	-10.5	2.9	7.2		
Tents and canvas	-1.1	37.7	14.1	-1.5	2.0		
Hosiery	16.9	-3.6	8.0	8.5	8.6		
Made-up articles (incl. towels)	35.8	8.3	9.8	9.4	8.8		
Other traditional exports	15.6	5.6	-6.7	-1.7	3.8		
Leather	5.4	-9.8	-14.7	-9.9	3.4		
Carpets	68.1	-12.9	4.3	5.7	-0.2		
Fish and fish preparation	3.8	27.1	-28.5	24.4	5.6		
Synthetic textiles	8.9	15.9	-0.6	-7.4	5.0		
All other exports	7.7	9.0	7.6	8.1	9.1		

Sources: Pakistan authorities and Fund staff projections.

1/ The 1998 estimated export receipts are based on actual data for the first ten months of the year.

Table 14. Pakistan: Exports by Major Commodities: Value, Volume, and Unit Value, 1996–2000

(1998 = 100; in terms of SDRs)

	Year Ending December 31				
				Projections	
	1996	1997	1998 1/	1999	2000
Value					
Cotton	621.4	163.2	100	497.7	478.0
Rice	80.0	81.7	100	107.8	110.4
Basmati	93.1	82.2	100	111.5	114.6
Others	70.2	81.2	100	105.0	107.2
Yarn	145.1	130.2	100	106.0	112.9
Cloth	111.8	108.9	100	98.4	101.4
Volume					
Cotton	569.4	158.7	100	534.0	497.8
Rice	78.6	87.8	100	103.0	105.0
Basmati	107.4	85.8	100	107.6	110.6
Others	69.0	88.4	100	101.4	103.1
Yarn	134.3	118.7	100	104.1	109.8
Cloth	118.3	104.6	100	97.9	99.9
Unit value (in SDRs)					
Cotton	109.1	102.9	100	93.2	96.0
Rice	101.8	93.0	100	104.6	105.1
Basmati	86.7	95.8	100	103.6	103.6
Others	101.8	91.9	100	103.6	104.0
Yarn	108.1	109.7	100	101.8	102.9
Cloth	94.5	104.1	100	100.5	101.5
Memorandum items:					
Cotton production (thousands of bales–fiscal year ending in June)	10,595	9,374	9,184	10,200	10,400
Exports of raw cotton (thousands of bales)	1,529	326	269	1,434	1,337

Source: Pakistan authorities and Fund staff projections.

1/ The 1998 estimated export receipts are based on actual data for the first ten months of the year.

Pakistan: Statistical Issues

1. The economic and financial data in Pakistan are generally of sufficient coverage, quality, frequency, and timeliness to enable the staff to undertake timely and adequate assessment of economic developments, and to form a view on medium-term prospects. The authorities are responsive to data requests. They report to the Fund, on a routine basis, monthly data on external trade, government tax revenues, government bank borrowing, and price indices with a lag of less than a month. Moreover, the authorities provide daily data through the resident representative's office on international reserves, exchange rates, and the Karachi Stock Exchange index with a one day lag. The staff is confident that the additional data required for program monitoring will be provided without difficulties.

2. The authorities are developing an action plan to address weaknesses in the quality and timeliness of data on public expenditures. In addition, the government will address remaining deficiencies in the economic database of Pakistan: in national accounts, through the use of results of the surveys of households and enterprises undertaken in the framework of the Improvement of National Accounts Statistics in Pakistan project; and, in money and banking statistics, through the implementation of the recommendations of previous Fund technical assistance missions.

3. At present, the methodology for the compilation of national accounts extrapolates certain components of GDP using a variety of indicators and data sources that have limited coverage. The estimates for some activities, particularly small-scale manufacturing, dwelling services, and other services continue to be made using constant growth rates estimated from an outdated benchmark. In other areas, such as large scale manufacturing, the substantial changes introduced in mid-1998 to the previous estimates of sectoral output growth resulted in a significant revision in GDP growth for 1996/97. In addition, data on wages and employment are not reported; and systems for the compilation of quarterly GDP are not yet well developed.

4. The Federal Bureau of Statistics produces three price indices: CPI, WPI, and SPI (sensitive price indicator). The CPI and WPI are compiled on a monthly basis and have been rebased to 1990/91. The SPI is compiled on a weekly basis and consists of 46 essential commodities that are consumed by the lowest income group. Weights for the 46 items are the same as in the CPI.

5. The data on government finances continue to suffer from a lack of information on economic and functional classification of government outlays; and inadequate reporting by provinces on their fiscal operations. Moreover, the current system is characterized by lack of coordination between the Ministry of Finance and Pakistan Accounts Department in generating fiscal reports and lack of facility to compile data on commitments or accounts payable. The accounting model and chart of accounts to be adopted under the PIFRA project will overcome these deficiencies. Further FAD and STA technical assistance would help ensure that these improvements are realized in timely and comprehensive GFS compatible fiscal reports.

6. In the monetary area, the quality of statistics would benefit from implementation of previous STA technical assistance mission recommendations, in particular with regard to the adoption of the monthly call report forms for banks and the monetary survey. Because the quality of the monetary statistics can be significantly improved from the new monthly reporting system, the 1995 mission reiterated and underscored that priority should be given to processing the monthly return forms from banks and their use for compiling data on deposit money banks. There are also weaknesses in the compilation of monetary reports derived from data in foreign currency units. In particular, following a change in the method for compilation of the SBP's foreign assets and liabilities and for reporting by the commercial banks of their foreign exchange assets and liabilities from one based on historical to the current exchange rates basis, a comprehensive review of the reporting system in this area may be required.

7. Notwithstanding the good provision of statistics on balance of payments, the discrepancy between the customs data and those reported by the State Bank of Pakistan would need to be addressed; and timely reporting on capital flows, including both official assistance and private investment flows, would be desirable.

8. External debt statistics have been compiled for government and government-guaranteed debt by the Ministry of Finance and on private debt by the SBP. The balance of payments difficulties that surfaced since May 1998 revealed significant weaknesses in Pakistan's external debt reporting, as data were not available with required frequency and there was no comprehensive reconciliation of data collected by different departments. In that context, the authorities initiated a complete inventory of all public sector debt liabilities. Most of the public sector debt data are in a manual bookkeeping system. In 1996, the authorities began developing, with the assistance of the AsDB, a computerized debt management system, covering official assistance and supplier credits to Pakistan's public sector. This system is expected to become operational in 1999.

Table 15. Pakistan: Survey of Reporting of Main Statistical Indicators
(as of December 15, 1998)

	Exchange Rates	International Reserves	Reserve/ Base Money	Central Bank Balance Sheet	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance	GDP/GNP	External Debt	Debt Service
Date of latest observation	9/11/98	9/11/98	10/98	10/98	10/98	11/98	10/98	11/98	9/98	9/98	1998	9/98	10/98
Date received	9/14/98	9/14/98	11/98 Mission	11/98 Mission	11/98 Mission	12/98	11/98	12/98	11/98 Mission	11/98 Mission	5/98 Mission	11/98 Mission	11/98 Mission
Frequency of data	D	D	M	M	M	M	M	M	Q	Q	A	A	Q
Frequency of reporting 1/	D	D	M	M	M	M	M	M	Mission and officials visit to headquarters	Mission and officials visit to headquarters	Mission and officials visit to headquarters	Mission	Mission
Source of data	SBP 2/	SBP	SBP	SBP	SBP	SBP	FBS 3/	FBS	SBP	Ministry of Finance and Economic Affairs	FBS	Ministry of Finance and Economic Affairs	Ministry of Finance and Economic Affairs
Mode of reporting	through RR office to MED	through RR office to MED	MED/STA	MED/STA	MED/STA	MED/STA	MED/STA	MED/STA	MED/STA	MED/STA	MED/STA	MED	MED
Confidentiality	Unrestricted	Unrestricted	Unrestricted	Unrestricted	Unrestricted	Unrestricted	Unrestricted	Unrestricted	Unrestricted	Unrestricted	Unrestricted	Unrestricted	Unrestricted

1/ Data received from the authorities prior/during missions and officials' visits to headquarters, supplemented by data sent to STA.
2/ State Bank of Pakistan.
3/ Federal Bureau of Statistics.

Pakistan: Second Annual Arrangement Under the Enhanced Structural Adjustment Facility

Attached hereto is a letter dated December 21, 1998, with an annexed memorandum of economic and financial policies (hereinafter the "memorandum"), from the Minister of Finance and Economic Affairs and the Governor of the State Bank of Pakistan requesting from the International Monetary Fund the second annual arrangement under the Enhanced Structural Adjustment Facility, and setting forth the objectives and policies of the program to be supported by the arrangement.

To support these objectives and policies, the Fund grants the requested arrangement in accordance with the following provisions, and subject to the Instrument to Establish the Enhanced Structural Adjustment Facility Trust:

1. (a) Under the second annual arrangement:

(i) a first disbursement in an amount equivalent to SDR 90.984 million, will be available on or after January --, 1999 at the request of Pakistan; and

(ii) a second disbursement in an amount equivalent to SDR 90.984 million, will be available on or after June 15, 1999 at the request of Pakistan, subject to paragraph 2 below.

(iii) a third disbursement in an amount equivalent to SDR 45.492 million, will be available on or after December 15, 1999 at the request of Pakistan, subject to paragraph 2 below.

2. Pakistan will not request disbursement of the second and third loans specified above in paragraphs 1(a)(ii) and 1(a)(iii), respectively

(a) if the Managing Director finds that the data indicate that

(i) the limit on the net foreign assets of the State Bank of Pakistan, or

(ii) the limit on the net domestic assets of the State Bank of Pakistan, or

(iii) the limit on the overall budget deficit, or

(iv) the limit on the overall budgetary support from the banking system, or
(v) the limit on credit to the seven major public enterprises, or

(vi) the limit on the stock of public and publicly guaranteed external debt, or

(vii) the limit on the contracting of nonconcessional medium- and long-term public and publicly guaranteed external debt, or the limit on the contracting of external debt with an initial maturity of over one year and up to five years, or

(viii) the limit on accumulation of budgetary arrears to WAPDA, or

(ix) the limit on the stock of arrears on current account transactions, or

(x) the limit on the stock of arrears on private external debt service payments,

specified in Table 3 of the memorandum with respect to end-March 1999 and as will be determined at the time of the first review with respect to end-September 1999, was not observed; or

(b) if the Managing Director finds that Pakistan has not carried out its intentions with respect to,

(i) by end- March 1999,

(1) the adoption of a unique tax-payer identification number, or

(2) the implementation of the power tariff decision as approved by NEPRA based on the WAPDA filing of December 1998, or

(3) the corporate restructuring of WAPDA's power wing into 12 independent and autonomous companies regulated by NEPRA, or

(4) the reduction of the maximum tariff to 35 percent and the number of non-zero tariff rates to four, or

(5) the elimination of the exchange restrictions for travel and education abroad notified to the Fund in July 1998, or

(6) the reduction by 50 percent of the electricity subsidy for households with monthly bill larger that PRs 5,000, or

(ii) by end-June 1999,

(1) the extension of the GST to services, or

(2) the harmonization of provincial taxation of agricultural income with that prevailing in the province of Punjab and strengthening of collection mechanisms to reach a collection target of PRs 2.5 billion, or

(3) the elimination of the electricity subsidy for households with monthly bills larger than PRs 5, 000 and reducing by 50 percent the electricity subsidy bill for all other households, or

(iii) by July 1, 1999, the unification of exchange rates, or

(iv) by end-September 1999,

(1) the removal of the GST exemptions for petroleum products and electricity, or

(2) the elimination of the electricity subsidy for all households,

specified in the memorandum and Table 4 thereto; or

(c) if, at any time during the period of the second annual arrangement,

(i) until end-June, the ceiling of PRs 45.8 billion on total budgetary support specified in Table 3 to the memorandum, is not observed,

(ii) the petroleum development surcharge rate is not maintained within the bands as set forth in paragraph 27 of the memorandum and Table 4 thereto, or

(d) if Pakistan

(i) has imposed or intensified restrictions on payments and transfers for current international transactions, or

(ii) has introduced or modified multiple currency practices, or

(iii) has concluded bilateral payments agreements that are inconsistent with Article VIII, or

(iv) has imposed or intensified import restrictions for balance of payments reasons; or

(e) after June 14, 1999 and December 14, 1999, respectively, until the reviews contemplated in paragraph 45 of the memorandum are completed.

If the Managing Director finds that any of the performance clauses that have been established in or under this paragraph 2 have not been met, the second and third disbursements specified in paragraphs 1(a)(ii) and 1(a)(iii) above may be made available only after consultation has taken place between the Fund and Pakistan, and understandings have been reached regarding the circumstances in which Pakistan may request that disbursement.

4. In accordance with the fourth paragraph of the letter, Pakistan will provide the Fund with such information as the Fund requests in connection with the progress of Pakistan in implementing the policies and reaching the objectives supported by these arrangements.

5. In accordance with paragraph 46 of the memorandum, during the period of the second annual arrangement, Pakistan will consult with the Managing Director on the adoption of any measures that may be appropriate at the initiative of the government or whenever the Managing Director requests such a consultation. Moreover, after the period of the second arrangement and while Pakistan has outstanding financial obligations to the Fund arising from loans under that arrangement, Pakistan will consult with the Fund from time to time, at the initiative of the government or whenever the Managing Director requests consultation on Pakistan's economic and financial policies. These consultations may include correspondence and visits of officials of the Fund to Pakistan or of representatives of Pakistan to the Fund.

December 21, 1998

Mr. Michel Camdessus
Managing Director
International Monetary Fund
Washington, D.C. 20431
U.S.A.

Dear Mr. Camdessus:

The Pakistan authorities have held a series of discussions with the Fund staff for the 1998 Article IV consultation, and in the context of the second annual ESAF arrangement (October 1998–September 1999) and the second review under the extended arrangement approved by the Fund's Executive Board on October 20, 1997. Based on these discussions, the attached Memorandum on Economic and Financial Policies (MEFP), which supplements those dated September 8, 1997 and February 22, 1998, reviews latest developments to date under the program, specifies the program targets and benchmarks for 1998/99 and the broad objectives for years 1998/99 and 1999/2000, and discusses the policies which have been agreed in the context of the present review.

The government asks that its request for completion of the review be considered by the Executive Board of the Fund after confirmation is received that the prior actions specified in paragraph 44 of the MEFP have been taken. Concurrently, we request a rephasing of purchases under the extended arrangement. In addition, as detailed in paragraphs 3 and 11, the government is seeking waivers of 2 quantitative and 1 structural performance criteria under the extended arrangement, as well as the standard performance criterion on exchange restrictions, as a part of its request for completion of the review.

The Government of Pakistan intends to request access to Fund resources under the Compensatory and Contingency Financing Facility to help meet the balance of payments need directly related to shortfalls in export earnings from goods in 1998. Data required for calculation of compensable amount have been submitted to Fund staff.

The Government of Pakistan will provide the International Monetary Fund with such information as the International Monetary Fund may request in connection with Pakistan's progress in implementing the economic and financing policies and achieving the objectives of the program.

The government believes that the policies set out in the attached Memorandum are adequate to achieve the objectives of the program. However, it stands ready to take any additional measures appropriate for this purpose, and will consult with the Fund on the matter in accordance with the policies of the Fund on such consultations.

Sincerely yours,

/s/
Muhammad Ishaq Dar
Minister of Finance and Economic Affairs

/s/
Muhammad Yaqub
Governor
State Bank of Pakistan

Attachment:
Memorandum on Economic and Financial Policies

INTERNATIONAL MONETARY FUND

PAKISTAN

Memorandum on Economic and Financial Policies

1. The Government of Pakistan held a series of discussions with the Fund staff for the 1998 Article IV consultation and with respect to the second review under the extended arrangement and for the reactivation of the ESAF/EFF which was approved by the Executive Board on October 20, 1997. On the basis of these discussions, the Government has prepared the present memorandum, which updates and supplements the policy memoranda dated September 8, 1997 and February 22, 1998. The discussions have also provided a basis for the Policy Framework Paper, which the government has updated, with the assistance from the Fund and World Bank staffs, setting forth the main elements of economic, social, and structural policies for 1998/99–2000/01.

I. Recent Macroeconomic Developments and Performance under the Program

Economic developments and demand management policies in 1997/98

2. In 1997/98, Pakistan performed well in relation to the targets for the domestic economy under the ESAF/EFF program. Real GDP grew by 5.4 percent, virtually as programmed, reflecting a favorable performance of agriculture and its indirect contribution to the expansion in large scale manufacturing, as well as a recovery in other sectors. Inflation decelerated to 7.8 percent from 11.8 in 1996/97, and compared very favorably with the program target of 10.5 percent. The better-than-programmed performance on the inflation front reflected pursuit of prudent fiscal and monetary policies as well as recovery in output growth, and was also facilitated by a decline in import prices. Furthermore, the external current account deficit (excluding official transfers) was halved to 3.2 percent of GDP compared with the program target of 5.1 percent of GDP, mainly on account of a lower than programmed level of imports. Macroeconomic data up to end-May indicated that economic performance was on track for meeting the performance criteria for end-June 1998. However, the subsequent external shocks led to a sharp deterioration in the capital account of the balance of payments. As a result, gross official reserves fell substantially short (by about US$740 million) of the June 1998 program target.

3. Financial policies were broadly in line with the program in 1997/98. The budget deficit was kept within the program ceiling with lower-than-programmed revenues offset by lower-than-programmed expenditures. Meanwhile, the overall deficit of the seven major public enterprises (listed in Table 1) contracted more rapidly than envisaged in the program. Reflecting the decline in the net foreign assets, broad money growth was less than programmed. All quantitative performance criteria for end-March and for end-June 1998 were

met except those on net foreign assets of the State Bank of Pakistan (SBP) for end-June and on the accumulation of budgetary arrears to Water and Power Development Authority (WAPDA) for end-June (which was also missed at end-March). The slippage in net foreign assets of the SBP was due to the consequences of the May 1998 developments. As regards the arrears to WAPDA, those arose from slippages in payments by provincial governments mainly due to delays in reconciliation of electricity bills between provincial governments and WAPDA. The government requests waivers of these performance criteria.

4. In the changed circumstances after the May developments, the management of the economy became more complicated, in particular due to an adverse effect on the private sector confidence. In view of a low reserve level and a large amount of the uncovered short-term foreign currency liabilities, the government suspended withdrawals in foreign exchange from foreign currency deposits (FCDs). This measure precluded the threat of an immediate run on foreign exchange reserves, but heightened uncertainties and the perception of impending balance of payments difficulties. The impact of this step on private transfers and capital inflows was subsequently compounded by the adverse effect of bilateral sanctions imposed on Pakistan. Moreover, the suspension of new nonhumanitarian lending to Pakistan by multilateral financial institutions aggravated the situation.

5. In view of these developments, and the changed outlook regarding economic activity, balance of payments and external financing, the government took decisive policy measures to safeguard the internal and external financial position of the country. In the fiscal area, it raised retail gasoline prices by 25 percent (instead of lowering them in line with international price developments as planned in the budget), and revised the structure of the tariffs on telephone calls. At the same time, planned development expenditure was also reduced. These fiscal measures amounted to about 1.2 percent of GDP.

6. In addition to the above-described fiscal measures, the government devalued the rupee vis-à-vis the U.S. dollar by about 4 percent on June 26, 1998. This was reinforced by a subsequent decisive move towards a market-determined exchange rate system through the introduction of an exchange rate float in the interbank market, which resulted in a further depreciation of the Pakistan rupee vis-à-vis the U.S. dollar by about 10 percent by end-October 1998. Pending the resolution of the issues related to FCDs (whose liquidation at a new unitary rate would have injected an unmanageable amount of liquidity into the economy through central bank losses), the government adopted this floating regime in the context of a dual exchange rate system. Under this system, conversions of frozen FCDs into rupees, as well as some basic imports and capital flows, were effected at the official exchange rate (PRs 46 per U.S. dollar), while all other transactions were conducted at the "composite" exchange rate (the average of the free interbank market rate (FIBR) and the official exchange rate). These policy measures were, however, not enough to offset the impact of a sharp decline in official and private capital inflows. Accordingly, the government had to temporarily

impose exchange restrictions (a 30 percent advance import deposit requirement and diversion of travel-related payments to the curb market), and also incurred external payments arrears.[1]

7. Following the suspension of withdrawal in foreign exchange of individuals' FCDs, the government has given both resident and nonresident FCD holders the option of purchasing federal foreign currency bonds in addition to allowing the conversion into rupees at the official exchange rate. Initially, residents converted substantial amounts of these deposits into rupees at the official exchange rate; the outstanding stock of FCDs declined by US$3.2 billion during June-October, of which US$2.6 billion are accounted for by withdrawals of residents. Subsequently the pace of withdrawals slowed down substantially over time, from about US$900 million in June to less than US$130 million in October. A part of the FCDs converted into rupees leaked out of the banking system. Out of concern for the liquidity of the banking system, the SBP temporarily reduced reserve and liquidity requirements. In the event, contrary to earlier expectations, the banks' liquidity position was consistent with the overall slowdown in economic activity as well as the increasingly more prudent lending policies induced by recent reforms, and the State Bank increased reserve requirements to their original level.

8. The above-described measures prevented overshooting of the exchange rate, contained inflationary pressures, and limited spillover to the real sectors. Nevertheless, the overall climate led to a slowing down of economic growth compared with last year, despite the strong performance in agriculture and related industries. As regards the balance of payments, the financing constraint led to a significant compression of imports, as the uncertain economic environment discouraged inflows of private transfers, and the capital account registered large outflows. By end-October, external payments arrears had built up on both current and capital account transactions (to US$1.4 billion) and official foreign exchange reserves had declined to US$440 million (three weeks of imports). The slowdown in growth and the compression of imports adversely affected budgetary revenues and, despite the additional fiscal measures discussed above, the budget deficit widened in the first quarter of 1998/99. Moreover, a new electricity subsidy (equivalent to 30 percent of the prevailing electricity tariff) for household consumers introduced in October is estimated to have a budgetary cost of PRs 8.2 billion in 1998/99. The weak fiscal position together with substantially lower external financing increased the need for budgetary support from the banking system. However, the expansionary effect of government borrowing was partially offset by the seasonal contraction of credit to the private sector in the first quarter of 1998/99.

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[1]The Fund was notified of the temporary exchange restrictions through a communication dated July 31, 1998 from the State Bank of Pakistan. Subsequently, the shift of other products from the official rate to the interbank market also made them subject to the advance import deposit requirement. The government requests temporary approval of the resulting exchange restrictions.

Implementation of structural policies under the program

9. During 1997/98, progress continued to be made in the implementation of structural reforms. In line with commitments under the program: (i) in the fiscal area, GST exemptions for sugar and edible oils were removed, and legislation extending the GST to the retail stage was adopted, with the initiation of implementation of the relevant measures one year ahead of schedule; (ii) in the financial sector, a marketable foreign currency bond was issued, banks' nostro accounts were increased by 15 percent, and 3-month, 6-month, and 1-year treasury bills were introduced; (iii) in the foreign exchange market, steps were taken to develop the interbank market, and, in March 1998, the SBP's buy/sell spread for the U.S. dollar was widened to 1 percent and banks were allowed to quote their own spot exchange rates for transactions with their customers within this band; (iv) in the regulatory area, the Pakistan Telecommunications Authority was made operational, the National Electric Power Regulatory Authority (NEPRA) was strengthened, and the Gas Regulatory Authority was established in June 1998 by an Ordinance and the necessary legislation has been submitted to parliament; and (v) in the public sector management area, operational plans for restructuring a number of federal government ministries and divisions were prepared, and action plans for restructuring the seven major public enterprises were developed.

10. Significant further progress was made in banking reforms, where efforts were focused on enhancing the soundness of the banking system, with a view to privatizing the state-owned banks. The financial restructuring of United Bank Limited (UBL) was completed in May 1998. A financial advisor to UBL was appointed in March 1998, and due diligence is expected to be completed in December 1998. With regard to Habib Bank Limited (HBL), its recapitalization was completed in June 1998. In addition, a preliminary due diligence report has been submitted to the government, an informal market sounding has been undertaken, and privatization of the Habib Bank has been initiated. As a part of the restructuring program, staffing and branch networks were rationalized. The total cost of restructuring operation of the public sector financial institutions amounted to PRs 30.7 billion, and was financed mainly by a World Bank loan. In the areas of loan recovery, a total of about PRs 33.3 billion was recovered by banks in cash from loan defaulters during January 1997–October 1998. The implementation of the new loan recovery law (Banking Companies Act 1997) is being made more effective, particularly to improve the transparency and effectiveness of the banking courts.

11. However, in a number of other areas, progress was short of what was envisaged in the program, and some of the related structural performance criteria and benchmarks were not observed (Table 2). In the tax area, the GST was extended to edible oils and sugar as envisaged, but delays were encountered in enforcing the GST in certain sectors. In particular, a large segment of the textile sector remained outside of the GST net and a significant number of industries continued to be taxed under fixed tax (capacity) schemes. Progress was slower than expected in reforming the refund system, with a consequent adverse impact on the export sector, as well as in converting audit activities into increased GST revenue because of the lengthy appeal process associated with audit claims. Collections under the audit program

amounted to PRs 0.9 billion compared to the program end-June benchmark of PRs 4.5 billion. The finalization of the information exchange system among the GST, income tax, and customs administrations was delayed pending a comprehensive review in the context of the restructuring of the Central Board of Revenue (CBR). At the provincial level, taxation of agricultural income was not harmonized by Baluchistan and Sindh with that prevailing in the province of Punjab. Since this reform measure is now scheduled to go into effect in these two provinces by end-June 1999, the government requests a waiver of the performance criterion on harmonizing taxation of agricultural income. With respect to the Social Action Program (SAP), the federal and provincial governments made efforts to adequately fund and effectively implement the SAP in 1997/98, in line with understandings reached with the donors. However, performance of the SAP was adversely affected by fiscal difficulties of the provinces as well as implementation bottlenecks.

12. In the public enterprise sector, delays occurred in the implementation of a comprehensive restructuring program for the energy sector. In particular, the implementation of the envisaged institutional and financial restructuring of WAPDA fell behind the original schedule. The envisaged recovery of WAPDA's outstanding dues from provincial and federal governments, as well as settlement of a large portion of WAPDA's arrears to its suppliers, were delayed into the current fiscal year and the effective implementation of the enacted regulatory changes was delayed into late 1998. With regard to privatization, despite significant progress in restructuring and taking the enterprises to the point of sale, progress has also been less than envisaged, largely due to the increased uncertainty and the lack of investment demand. Divestiture of remaining government shares in four financial institutions (Muslim Commercial Bank, Allied Bank Ltd, Pakistan Industrial Credit and Investment Corporation, and Bankers' Equity Ltd), originally programmed for March 1998, as well as the envisaged privatization during 1997/98 of 18 enterprises outside the banking sector were delayed.

II. Macroeconomic Objectives and Policies for 1998/99 and 1999/2000

Program objectives

13. Substantial adjustment and reform efforts are needed to contain the adverse effects of the recent shocks on the domestic economy and the balance of payments. These efforts, supported by exceptional financing from the international community, should lay the basis for achieving over the medium term sustainable high levels of growth in an environment of financial stability and a viable external position.

14. Over the medium term, the objectives of the program are: (i) achieving real growth rates of at least 5 percent per annum; (ii) reducing inflation steadily to 6 percent; (iii) gradually building official foreign exchange reserves to about three months of imports; (iv) improving the savings performance of the economy primarily through better performance in public finances; and (v) enhancing allocative efficiency through reduction in price distortions and increased role of market forces in the economy.

15. Within these medium-term objectives, specific macroeconomic targets for 1998/99 and 1999/2000 are: (a) annual real growth rates of at least 3 percent; (b) annual average inflation rates of no more than 11 percent this year and 10 percent next year, and (c) a buildup in gross official reserves to a minimum of US$1.3 billion by end-June 1999 and US$1.7 billion by end-June 2000. While growth in the agricultural sector is expected to be sustained at a healthy rate of 5 percent, economic uncertainties, the negative impact of the developments in the Far East, and import compression are expected to contribute to a deceleration in the growth of industrial output, which will slow down real GDP growth. The acceleration in inflation in 1998/99, notwithstanding the pursuit of tight fiscal and monetary policies, would reflect the one-time impact of cost push factors, such as exchange rate depreciation, the increase in gasoline prices, and the increase in the standard rate of the GST. In the following year, inflation is expected to decline. Restoration of normal international financial relations and improvement in the reserve position will be predicated on resumption of normal inflows from the international financial institutions.

Demand management policies

16. The key element of the adjustment effort is fiscal consolidation, which will aim at improving the budgetary accounts while protecting expenditures with the highest yield in terms of economic growth and social development. Despite a reduction in profit transfer from the SBP (0.8 percent of GDP in 1997/98) and a contraction of imports and the related revenue base, the government is committed to doubling the primary surplus (to 2.3 percent of GDP). This will enable the budget deficit in 1998/99 to be reduced by 1.2 percentage points to 4.3 percent of GDP. To achieve this fiscal target, in addition to measures already incorporated under the 1998/99 budget announced in June and the fiscal measures implemented in July, the program incorporates the following additional measures: (i) an increase in the GST rate to 15 percent (from 12½ percent) prior to the Board meeting; (ii) an enhancement of the tax incidence on petroleum products; (iii) a reduction in the budgeted amount of unproductive expenditure; (iv) a strengthening of the financial position of WAPDA and KESC; (v) a reduction in the federal subsidy on wheat; and (vi) a lowering of budget appropriations for several other components of noninterest current expenditure. The fiscal impact of these measures (about PRs 40 billion) will be partly offset by the revenue loss associated with the cost of the electricity subsidy and the proposed reform of tariffs in March (see paragraph 37). The program has also a number of safeguards to protect the fiscal targets against possible slippages. These include an understatement of SBP profits,[2] a potential interim dividend payment by the Pakistan Telecommunication Corporation, and a contingency reserve in the expenditure program. In addition, fiscal developments will be monitored closely, and in the

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[2]In preparing revenue estimates for 1998/99, the State Bank profits transferable to the government have been placed at zero. Over the last two years such profits have amounted to PRs 10 billion (1996/97) and PRs 22 billion (1997/98). The State Bank believes that with the exchange rate having been fixed until end-June 1999, there is a likelihood of profit transfers to the government of around PRs 10 billion.

event that there is a need for additional contingency measures these could, inter alia, include cutting further the expenditures on low priority development and nondevelopment projects. Moreover, the government will be prepared to take appropriate revenue measures including enhancement of excise duties on cigarettes, increase in withholding tax on prize bonds, imposition of excise duty on motor vehicles, and removal of some of the existing GST exemptions. The government is also committed to undertake necessary fiscal measures to bring down the budget deficit to 3.3 percent of the GDP in the year 1999/2000.

17. The government has decided to phase out the electricity subsidy given in October 1998 according to the following schedule: (i) for consumers with a monthly bill of PRs 5,000, and above, the subsidy rate (PRs/KWh) will be reduced by 50 percent in March 1999 and eliminated by June 1999; and (ii) for consumers with a monthly bill below PRs 5,000, the subsidy rate will be reduced by 50 percent in June 1999 and eliminated by September 1999. In 1998/99, the government is committed to maintain the level of the budgetary Public Sector Development Program (PSDP) at PRs 98 billion while protecting allocations for high-priority projects and programs. With respect to basic social services, the government will ensure that total rupee expenditures (not including foreign project assistance) under the SAP will be at least PRs 56.5 billion in 1998/99, including at least PRs 5.5 billion on critical quality-enhancing nonsalary SAP recurrent expenditures in the provinces and federal areas.

18. The government will seek to achieve a further improvement in the financial performance of the public sector enterprises. In particular, their combined overall deficit is projected to narrow to the equivalent of 0.6 percent of GDP in 1998/99, compared with 1.4 percent of GDP in 1997/98, reflecting mostly the envisaged improvements in the performance of the Karachi Electricity Supply Corporation (KESC) and the telecommunications company (PTCL). Regarding the seven major public sector corporations, the implementation of a restructuring plan for the railways, as well as the rationalization and modernization of telephone tariff policy by PTCL, are being forcefully implemented and will further improve their financial performance. The KESC and WAPDA are finalizing detailed restructuring plans as part of the overall program for reform of the power sector in consultation with the World Bank and the Asian Development Bank (AsDB) (discussed below).

19. The monetary program for 1998/99 takes into account, inter alia, the modalities adopted for the conversions of FCDs (discussed below). Broad money growth is targeted at 7.8 percent, i.e., substantially below the growth of nominal GDP, reflecting the decrease in the demand for money due to partial leakage of converted resident FCDs out of the banking system. The program would target a deceleration in the pace of net domestic asset expansion to about 8.4 percent of initial broad money in 1998/99 (from an estimated 16 percent in 1997/98). This will be facilitated by contractionary impact of the buildup of government deposits in the banking system reflecting rupee counterpart of payment arrears/debt restructuring. Consistent with this stance, interest rate policy will be geared to encouraging the holding of domestic currency assets, supporting the exchange rate, and safeguarding the balance of payments. In view of the uncertainties regarding money demand, the performance

criteria for the NDA of the SBP have been set only for end-December 1998 and end-March 1999, and an indicative target has been specified for end-June 1999. Monthly monitoring of the monetary developments should allow for appropriate adjustments in the financial program, as necessary, to ensure the achievement of program targets.

20. The policy of relying on voluntary conversions of FCDs into rupees (at the official exchange rate of PRs 46 per U.S. dollar) or into U.S. dollar government bonds will be continued until June 1999. At the time of the next review under the extended arrangement, a precise understanding will be reached on the "exit policy" with regard to these deposits. Two aspects of this "exit policy" have already been put in place. First, to encourage the conversion of FCDs to the newly announced foreign currency bonds, the interest rates on these bonds have been increased and their other features have been made more attractive.[3] Second, the fee for exchange rate cover on individuals' FCDs has been increased from 7 percent to 8 percent. Furthermore, the SBP has already issued a circular to eliminate the use of FCDs as collateral with effect from December 1, 1998. No later than by end-June 1999, the government will implement appropriate measures to convert the remaining resident FCDs into rupees or medium-term U.S. dollar government bonds. Based on the assessment of the prevailing situation, the exit strategy for nonresident individuals' FCDs, to be implemented starting in July 1999, would be agreed with the Fund in the context of the next review under the extended arrangement. At the same time, the State Bank is in the process of negotiating rollover of swap funds of banks and nonbank financial institutions.

21. The government is fully committed to move formally to a unified exchange rate system with effect from July 1, 1999 under which the exchange rate will be determined by market forces. In the interim, all transactions except for imports of wheat and petroleum products and conversions of FCDs and related instruments will be carried out at the composite rate determined by the weighted average of the floating rate in the interbank market and the official rate; until end-March, 1999, payments for travel and education abroad will continue to be settled outside the official market. The weights, which are currently 50 percent for both the FIBR and the official rate, will be changed to 75 percent and 25 percent, respectively, prior to the Fund approval of the program. The official exchange rate of PRs 46 per U.S. dollar would remain until the *de jure* unification of the exchange rate on July 1, 1999, at which time the requirement of the surrender of foreign exchange receipts to the SBP will be eliminated. The monetary authorities will undertake foreign exchange operations consistent with the objectives for the NFA of the SBP.

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[3] Initially, the bonds carried spreads over LIBOR of 100 basis points (for the 7-year bonds) and 200 basis points (for the 10-year bonds).The new bonds offer more attractive interest rates: the rates over LIBOR at 2 percentage points on 3-year bonds, 3 percentage points on 5-year bonds, and 4 percentage points on 7-year bonds.

Structural policies

22. In 1998/99 and 1999/2000, the government will continue to pursue vigorously the broad-based structural reforms outlined in the Policy Framework Paper. This would include, inter alia, a substantial broadening of the GST base; moving forward with the implementation of a meaningful agricultural taxation; the strengthening of tax administration through the restructuring of the CBR; implementation of the restructuring plan for WAPDA; privatization of financial institutions; trade liberalization; and consolidation, widening and deepening of the interbank foreign exchange market.

Fiscal reforms

23. The government conducted a comprehensive review of ways to broaden the tax base by streamlining the existing exemptions under the GST. In the context of the 1999/2000 budget, the GST will be extended to the services sector; to this end, the provincial governments will submit legislation empowering the federal government to collect GST on services on their behalf. As regards other major exemptions, the government intends to remove the exemption for petroleum products and electricity by end-September 1999 and for agricultural inputs by end-December 1999. With respect to petroleum and electricity, the GST will be imposed in a manner that is revenue neutral relative to revenue raised on these products. These actions are ahead of schedule of the original ESAF/EFF framework, and will constitute a major broadening of the GST base and will promote a much larger degree of documentation of the economy, with beneficial effects for other taxes. Furthermore, the government will, as a prior action, promulgate ordinances amending relevant Acts to abolish its discretionary power to grant exemptions from the GST as well as from import duties. Appropriate legislation to amend the Sales Tax Act will be submitted to parliament before the ordinances expire.

24. In support of the recently enacted extension of the GST to the retail stage, and in anticipation of the inclusion of services next year, the program would incorporate the following: (i) a commitment not to introduce any fixed tax schemes; (ii) improved administration of the GST in the textiles sector; and (iii) an improvement in the refund systems for exporters. A review of measures to strengthen the GST refund system will be undertaken in early 1999. A Fund technical assistance mission with participation from the AsDB will assist with this review. The recommendations of this review will be implemented by March 1999. SRO 826 and section 60 of the Sales Tax Act, which provide the basis to exempt exporters from the payment of GST on their inputs, will remain in place pending the completion of the above review, but operations under these provisions will be suspended.

25. The program also includes the following measures to strengthen tax administration: (i) the adoption of a unique tax identifier number; (ii) the development of a comprehensive joint tax audit program, the institution of a formal mechanism for information exchange between tax departments (based on the new tax identifier number); and (iii) strengthening of tax adjudication and appeal process. These improvements would be facilitated by the ongoing

restructuring, with World Bank technical assistance, of the CBR into an autonomous agency, the Pakistan Revenue Service. To this end, the budgetary support for the CBR has been increased and additional staff will be allocated in support of the GST reform, which constitutes the principal potential source of resource mobilization over the medium term. It is envisaged that about 500 officers (including about 400 auditors) will be recruited for assignment to the GST administration by end-March 1999.

26. At the provincial level, the government will take steps to increase substantially revenue from the agricultural taxation. To this end, it is committed to increasing the revenue target for agricultural income tax revenue from PRs 2.5 billion (0.1 percent of GDP) in 1998/99 to PRs 3.5-4 billion in 1999/2000, an increase of about 50 percent. Furthermore, the government will reach agreement by March 1999 with the provinces, in consultation with the World Bank, on a package of measures to achieve these targets; these measures will include a widening of the base and/or increases in rates. In addition, the government will seek agreement with the provinces, in consultation with the World Bank, on a strategy to rehabilitate and upgrade the system of land recordation, land assessment, district courts, and tax collection. These reform efforts will aim at raising steadily the level of revenue from agricultural taxation to 0.3 percent of GDP over the medium term.

27. The government intends to maintain a high rate of petroleum development surcharge (PDS) tax in 1998/99. Given the importance of this tax, there is a need to reduce the vulnerability of the budget to the current fluctuations in the rate of petroleum surcharge tax. Accordingly, the government has established a fixed PDS rate (in rupees per unit volume) for major petroleum products and will henceforth manage petroleum retail prices in a manner such that these PDS rates remain within a band of plus or minus 5 percent and that the aggregate level of PDS refunds stays within a ceiling established under the program. The rates for the third and fourth quarters of 1998/99 that have been set in accordance with the revenue targets for the PDS are PRs 15.65 per liter for motor spirit; PRs 4.37 per liter for high speed diesel; and PRs 1.50 per liter for fuel oil.

28. The program incorporates policies aimed at improving the composition and effectiveness of budgetary expenditure. In this context, the government has, with technical assistance from the World Bank, recently completed a comprehensive review of public expenditure. The program takes into account the need to safeguard the SAP from expenditure cuts in order to protect the poor, to strengthen institutional capacity, and to overcome implementation problems. The government attaches importance to enhancing the quality of the budgetary and nonbudgetary PSDP, intends protecting the high-priority projects even in the current difficult economic circumstances, and has reached an understanding with the World Bank on the prioritization of the PSDP. In view of the continuing fiscal constraints, any new projects will be carefully scrutinized.

29. Civil service reform is a critical element of the government's broader expenditure policy. Based on the recommendations of the Commission on Administrative Restructuring, and drawing on the recently completed study by the World Bank, the government will begin

implementing a program of civil service reform. Currently, the government is taking steps to improve civil service management and exercise control over establishment costs as recommended by the Commission on Administrative Restructuring.

Public sector enterprises and power sector

30. In line with the government policy statement on power sector reforms announced in November 1998, the restructuring plan for WAPDA and KESC will be implemented in an orderly framework (developed in consultation with the World Bank) which will be adhered to for resolution of disputes between the government and the independent power producers. The key financial elements of the restructuring plan for WAPDA and KESC for 1998/99 include reductions in cross-subsidies and operating costs, tariff adjustments, improvements in tariff collection and measures to reduce electricity theft. As a result of these measures, the deficit of the KESC would be nearly eliminated. The operating surplus of WAPDA will also record a substantial improvement in the last quarter of 1998/99. However, due to large investment needs, WAPDA's overall deficit would be broadly unchanged at 0.6 percent of GDP. Moreover, both KESC and WAPDA currently have unacceptably high levels of both payables and receivables outstanding. In view of the limited availability of financing, WAPDA is preparing, in collaboration with the World Bank, a set of measures to close the remaining financing gap. In this context, WAPDA will file in December 1998 with NEPRA for a tariff adjustment to strengthen its financial position in order to make it consistent with the macroeconomic framework. The government is committed to implementing the tariff decision of NEPRA by end-March 1999. It also intends to formulate by that date a comprehensive plan for the elimination of outstanding stocks of payables and receivables in the context of the ongoing restructuring program for WAPDA and KESC.

31. To ensure a healthy climate for private power investors, the government has already made major progress in resolving its dispute with the IPPs in an orderly framework. The government has re-emphasized its commitment to meet all its international obligations. In this regard, all IPPs which were served Notices of Intention to Terminate (NITs) as well as one IPP that was served a Notice of Termination (NT) reached agreement with the government. As a result, the NITs and the NT have been withdrawn and those IPPs are now allowed to resume their normal operations. Three other IPPs have voluntarily decided to terminate their projects since they had never completed construction or started operations. The government has also undertaken to resolve its dispute with Hubco and Kapco within the agreed orderly framework.

Financial sector reforms

32. Following the significant progress achieved thus far in consolidating the autonomy of the SBP, bringing prudential regulations to international standards, and rescuing from distress key financial institutions in the public sector, the authorities are now focusing on upgrading the SBP's supervisory capacity and enhancing the financial integrity of the public sector financial institutions, which should provide the basis for their privatization. In this regard, the

SBP expects to have its first off-site surveillance report in September 1999 and will start its inspection schedule under upgraded procedures in June 1999. The SBP agreed in July 1998 with public sector banks and development nonfinancial institutions on targets for a phased cash recovery from the stock of nonperforming loans. In particular, these institutions will collect on a cumulative basis PRs 11-12 billion by end-December 1998, PRs 19-20 billion by end-May 1999. Furthermore, the SBP has entered into a performance agreement with UBL following its recapitalization, whereby the bank will freeze expenditure and employment at the 1997 level, achieve a deposit growth of about 15 percent during 1998/99, and recover nonperforming loans to achieve their stock reduction by 25 percent annually over the next 3 years. A similar arrangement was agreed with HBL. More generally, revised regulations and tax rules governing provisioning of nonperforming loans will be implemented by end-June 1999.

33. The SBP is engaged in an exercise of financial restructuring of development financial institutions (DFIs) and consolidation/merger of investment banks, DFIs, smaller private commercial banks, and other financial institutions. Also several other measures, principally bona fide privatization of the nationalized commercial banks and larger DFIs, are being completed for further deepening the financial sector reforms, in consultation with the World Bank, with an expectation of a second Banking Sector Adjustment loan from the World Bank and other co-financiers. The schedule for future privatization will be reviewed in the context of the mid-tem review for the second annual program under the ESAF.

34. Concurrently with the reform of financial institutions and the consolidation of regulatory and supervisory improvements, the SBP is taking measures to develop the secondary market for government securities. In this context, and with a view to facilitating the conduct of monetary policy and improving public debt management, the authorities began to issue, in June 1998, three-month, six-month, and one-year treasury bills in discount form to replace the existing six-month short-term federal bonds, which could not be easily traded in the secondary market. The SBP will review the functioning of its primary dealer system, which at present includes all banks, nonbank financial institutions, and some members of the stock exchange. Specifically, a new tier of specialized primary dealers will be established by December 1999 with stricter obligations and certain privileges compared with the standard primary dealers; and the operational procedure for open market operations will be refined to promote interbank market activities and reduce short-term volatility of the interbank rate. A centralized system of registering bank securities will be operational in 1999/2000. Reforms of the capital market are being undertaken with financial and technical assistance from the AsDB.

35. Under the Prime Minister's National Agenda, the government has launched two major initiatives to enhance opportunities for self-employment and for development of small and medium-size enterprises in Pakistan. The major thrust of these initiatives is to facilitate access of small businesses to bank credit, in particular focusing on neglected geographical areas and small trade and industry. Cognizant of the need to further enhance the capital strength and the quality of loan portfolio of the banking system, the government is committed to ensure that credit extension under such schemes will be left to the lending institutions, to be implemented

in a professional manner consistent with the prescribed prudential standards and subject to usual loan evaluation procedures of these institutions. No lending quotas will be set under these schemes and any related subsidies will be borne in the government budget. Lending under these schemes will be assessed at the time of the next review under the extended arrangement. Furthermore, introduction of new special or subsidized credit schemes will be avoided and the existing concessional export refinance scheme will be abolished by a date to be agreed by end-June 1999.

Privatization

36. The government is committed to revitalizing and restoring the momentum of the privatization program. While the pace of privatization may have to be modest until market confidence is restored, the government recognizes the importance of pressing ahead with all the necessary steps up to the point of sale, which would allow a re-acceleration of the privatization process as the confidence is rebuilt. Over the next three years, all remaining public sector banks and nonbank financial institutions, six power generating facilities and six area electricity boards, and 28 industrial units (a number of them large facilities), as well as major public enterprises, such as PTCL and Pakistan Railways, will be privatized. The schedule of privatization will be established by the time of the ESAF mid-term review. Certain preconditions must be met in order to achieve these ambitious privatization targets, including strengthening the regulatory framework, removing labor-related impediments to privatization, further enhancing the technical and administrative capacity of the Privatization Commission to handle complex transactions, and maintaining full transparency in the privatization process. The Government is taking necessary actions in all of these areas, and remains committed to using privatization proceeds largely to reduce public debt.

External sector reforms

37. In the area of trade liberalization, the government remains fully committed to removing the remaining restrictions on exports and imports (subject to qualifications) and to further lowering import tariffs. More specifically, the maximum tariff rate will be reduced from 45 percent to 35 percent, and the number of nonzero tariff bands will be reduced from five to four by end-March 1999. The government is committed to a further reduction by end-June 2000 in the maximum import tariff to the range of 25–30 percent. Regarding nontariff barriers, the number of export bans was reduced from 24 to 9 in July 1998. The remaining export bans, and export minimum price and quota restrictions will be withdrawn in July 1999. A timetable for the elimination of import bans on textile products is being developed in the context of bilateral negotiations between Pakistan and its main trading partners. The remaining restrictions on imports subject to procedural restrictions will be eliminated in July 1999, except those based on health, safety, religious, and environmental reasons, and those applying to automobile imports, which will remain in effect for balance of payments reasons.

38. The government will also eliminate the exchange restrictions on payments for travel and education, and the 30 percent import margin requirement by March 1999. The program

also includes a schedule for the elimination of external payments arrears by end-June 1999, which constitutes a performance criterion under the program. As a first step toward normalization of external financial relations, the government will regularize its payments position with respect to multilateral institutions prior to the Executive Board meeting of the IMF. In addition, the authorities will make available foreign exchange to allow all deferred private sector obligations to multilateral institutions to be settled prior to the Board meeting, provided that the local borrower has been able to mobilize the domestic currency counterpart. The stock of deferred payments accumulated so far will also be eliminated by end-June 1999 in line with the availability of external financing and the achievement of official reserve targets. There will be no restriction on the provision of foreign exchange for current international payments after end-March 1999.

39. The government is determined to build on the experience with the interbank exchange market and to enhance the role of market forces in the process of determining the exchange rate by developing the spot and forward interbank markets. The next steps of the reform will include development of a suitably staffed and well-equipped foreign exchange trading room at the SBP, upgrade of information systems and market practices in the foreign exchange market, and the integration of foreign exchange and money market operations of the SBP by end-June 1999. The time schedule for the implementation of an increase in the nostro account limit of the banking system, adoption of a foreign exchange position limit (for prudential purposes) that is linked to banks' capital will be determined in the context of the next review. In the meantime, technical assistance from the Fund will be obtained for these improvements.

III. Balance of Payments Outlook and External Financing Issues

40. The external current account deficit (excluding official transfers) is projected to narrow further in 1998/99 to 3.0 percent of GDP as a substantial improvement in the trade balance would more than offset a drop in private transfers. Excluding inflows of worker remittances and FCDs, the improvement in the current account deficit will be 2.9 percentage points of GDP reflecting a virtually balanced position in the trade account. The improvement in the trade balance, despite a small decline in exports, would result from the projected decline of about 18 percent in imports, reflecting the combined effect of the slowdown in growth, temporary exchange restrictions, the exchange rate depreciation, and the tightening of financial policies. In 1999/2000, the external current account deficit is projected to decline to 2.4 percent of GDP.

41. Notwithstanding a substantial contraction in the current account deficit, and fairly modest external reserve targets, large exceptional financing will be required to close Pakistan's financing gaps in 1998/99 (about US$5.6 billion) and in 1999/2000 (currently estimated at about US$5.2 billion). In the current economic circumstances, new loans from bilateral creditors or any significant borrowing from commercial sources are unlikely in the near future. The government is expected to receive in the current fiscal year at least US$550 million from the World Bank, US$300 million from the AsDB in the form of adjustment loans, and US$400 million from bilateral sources, and in the next fiscal year, some US$450 million from the World Bank and US$400 million from the AsDB.

42. After accounting for balance of payments support expected from multilateral and bilateral sources, the remaining financing gap in 1998/99 is estimated at about US$3.5 billion, and in 1999/2000 is projected at about US$3.6 billion. To close these gaps, the government intends to explore all potential financing options, including a comprehensive rescheduling of public and publicly guaranteed debt owed to Paris Club and other bilateral creditors, as well as to commercial creditors. In addition to the restructuring of medium-term debt, the Government will seek restructuring or refinancing of short-term debt owed to public and private creditors. The government has already contacted creditors to inform them about Pakistan's payments difficulties and explained how the underlying problems are being addressed. The SBP has also initiated discussions with the financial institutions for the rollover of their swap funds (FE 45). Firmer indications of debt restructuring should start to emerge before the consideration of the program by the Fund's Executive Board.

IV. Program Monitoring

43. The program period for the second annual ESAF arrangement will cover October 1998–September 1999. The Government is aware that purchases under the extended arrangement are contingent on the implementation of prior actions and observance of quantitative and structural performance criteria, and that the monitoring of the program by the Fund staff will also take into account indicative targets and structural benchmarks (Tables 3 and 4).

44. The prior actions for completion of the second review under the EFF and the approval of the second ESAF annual arrangement are: (i) regularization of payments to multilateral institutions by the government; (ii) increase in the GST rate from 12.5 percent to 15 percent; (iii) an assurance that provinces have agreed to empower the federal government to collect GST on services; (iv) promulgation of ordinances to repeal the government's discretionary power to grant exemptions from the GST and import duties; (v) in the determination of the composite exchange rate, a change in the weights of the official exchange rate and the interbank rate to 25 percent and 75 percent, respectively, and application of this composite rate to all transactions except for wheat and petroleum product imports and FCD conversions; (vi) suspension of operations under SRO 826 and Section 60 of the Sales Tax Act, which enables exporters to purchase inputs free of GST; (vii) initiation of negotiations with commercial creditors on a debt restructuring plan; (viii) agreement on WAPDA finances and submission of a tariff filing to NEPRA; and (ix) adoption of an orderly framework for resolution of IPP disputes.

45. For program monitoring purposes, quantitative performance criteria and quantitative indicative targets that have been agreed are presented in Table 3, and structural performance criteria and benchmarks that have been established are presented in Table 4. Furthermore, purchases under the extended arrangement shall be subject to reviews to be completed in mid-March 1999, mid-June 1999, mid-September 1999, mid-December 1999, mid-March 2000, and mid-June 2000. Disbursements under the second annual ESAF arrangement shall also be subject to reviews to be completed by mid-June and mid-December 1999. Quarterly financing assurances reviews will also apply.

46. The government believes that the above-described policies are adequate to achieve the objectives of the program and, on this basis, hereby requests completion of the second review under the extended arrangement and approval of the second ESAF annual arrangement. Moreover, the government stands ready to take any additional steps that may be necessary and will consult with the Fund on this matter in accordance with the Fund procedures on such consultations.

Attachments (4):

1. Table 1: Quantitative Performance Criteria, and Indicative Targets Under the First Annual ESAF Arrangement and the Extended Arrangement, 1997/98.
2. Table 2: Structural Performance Criteria and Benchmarks Under the First Annual ESAF Arrangement and the Extended Arrangement, 1997/98
3. Table 3: Quantitative Performance Criteria, and Indicative Targets Under the Second Annual ESAF Arrangement and the Extended Arrangement, December 1998-September 1999
4. Table 4: Prior Actions, Structural Performance Criteria and Benchmarks Under the Second Annual ESAF Arrangement and the Extended Arrangement, December 1998-September 1999

Table 1. Pakistan: Quantitative Performance Criteria, and Indicative Targets Under the First Annual ESAF Arrangement and the Extended Arrangement, 1997/98 1/

(Cumulative flows from July 1, 1997 unless otherwise specified)

	End-September 1997			End-December 1997			End-March 1998			End-June 1998		
	Orig.	Adj.	Actual	Orig.	Adj.	Actual	Orig.	Adj.	Actual	Orig.	Adj.	Actual
Performance Criteria												
	(In billions of Pakistan rupees)											
Net domestic assets of the SBP 2/ 3/ 4/	24.8	16.2	-15.3	31.2	31.2	10.1	43.1	42.6	2.1	49.6	49.0	43.1
Of which: Budgetary support 2/ 5/ 6/	19.1	10.5	-18.5	24.7	24.7	-15.5	29.7	29.7	-1.3	30.0	30.0	-4.5
Overall budget deficit	43.1	43.1	40.7	83.3	83.3	80.2	123.3	123.3	122.4	148.0	148.0	147.3
Of which: Bank budgetary support 2/ 5/ 6/	37.0	0.6	13.6	47.8	47.8	22.3	57.4	57.4	39.5	58.0	58.0	49.2
Credit to the seven major public enterprises 7/	0.6	0.6	0.0	1.3	1.3	-0.2	1.9	1.9	-1.9	2.5	2.5	-2.9
Net foreign assets of the SBP 2/ 3/ 4/ 8/	-12.0	-3.4	0.6	-8.1	-25.7	9.9	-3.3	-3.9	4.1	10.6	-0.9	-20.7
Accumulation of budgetary arrears to WAPDA	0.0	0.0	0.0	0.0	0.0	11.5	0.0	0.0	15.8	0.0	0.0	13.3
	(In millions of U.S. dollars)											
Stock of public and publicly guaranteed short-term external debt	1,000	1,000	913	1,000	1,00(	881	1,000	1,000	837	1,000	1,000	880
Contraction of nonconcessional medium- and long-term public and publicly guaranteed external debt	1,500	1,500	457	2,800	2,800	1,419	4,000	4,000	1,973	5,000	5,000	2,083
Of which: External debt with an initial maturity of over one year and up to five years	600	600	434	1,100	1,100	1,125	1,500	1,500	1,178	1,800	1,800	1,178
Indicative Targets												
	(In billions of Pakistan rupees)											
Net domestic assets of the banking system 2/ 3/ 4/	37.1	28.5	-2.6	81.5	81.5	93.4	121.0	120.5	124.7	150.0	149.4	145.3
Federal tax revenue 9/	68.2	68.2	71.5	160.1	160.1	155.3	244.7	244.7	231.6	354.8	354.8	345.2
Memorandum items:												
Net external financing of the budget	-4.1	-4.1	4.5	10.1	10.1	9.6	21.3	21.3	17.7	29.5	29.5	22.2
Net inflows of nonresidents foreign currency deposits (In millions of U.S. dollars)	110	110	-240	135	135	-171	150	150	-309	150	150	-611
Inflows of program financing (in millions of U.S. dollars)	0.0	0.0	0.0	650	650	250	650	650	625	900	900	625

Source: Quarterly macroeconomic projections for 1997/98 agreed between the Pakistan authorities and the Fund staff.

1/ The performance criteria are only applicable under the extended arrangement. The end-June targets serve as indicators under the ESAF arrangement.

2/ These ceilings (floors) will be adjusted downward (upward) by the excess of net external financing of the budget relative to the programmed levels.

3/ These ceilings (floors) will be adjusted downward (upward) by the full amount of new privatization proceeds from abroad received during the fiscal year.

4/ These ceilings (floors) will be adjusted downward (upward) by the extent to which the net inflows of nonresident foreign curency deposits with SBP forward exchange cover exceed the programed levels.

5/ Continuous ceilings of PRs 30 billion on SBP budgetary support, and of PRs 58 billion on total budgetary support, will apply during the fiscal year.

6/ These ceilings will be adjusted downward by the amount of privatization proceeds used by the budget, except for amounts used on an exceptional basis as specified in paragraph 31of the Policy Framework Paper.

7/ Pakistan Railways, the Water and Power Development Authority, the Karachi Electricity Supply Corporation, Ltd., Sui Northern Gas Pipelines Ltd., Sui Southern Gas Company Ltd., the Pakistan Telecommunication Corporation Ltd., and the Oil and Gas Development Corporation.

8/ These floors will be adjusted downward by the extent to which inflows of program financing fall short of the programmed amount.

9/ Refers to the taxes collected by the Central Board of Revenue (CBR), plus gas and petroleum development surcharges and the foreign travel tax.

Table 2. Pakistan: Structural Performance Criteria and Benchmarks Under the First Annual ESAF Arrangement and the Extended Arrangement, 1997/98

Measures	Timing	Status
I. Structural Performance Criteria		
Measures relating to development of the interbank foreign exchange market and exit from the forward cover scheme:		
• Increasing banks' nostro account limits by at least 15 percent	By end-March 1998	Met.
• Issuing a marketable foreign currency bond	By end-June 1998	Met.
Removing the GST exemptions for sugar and edible oils.	By end-June 1998	Met. Exemption for sugar removed in March 1998 (prior action for completion of first review); exemptions on imported edible oils removed in June 1998.
Adopting legislation extending the GST to the retail stage.	By end-June 1998	Met.
Harmonizing provincial taxation of agricultural income with that prevailing in the province of Punjab.	By end-June 1998	Not met (one province met, while two others have not met). Rescheduled and waiver requested.
Establishing the Gas Regulatory Authority.	By end-June 1998	Met.
Introducing three-month, six-month, and one year treasury bills.	By end-June 1998	Met.
Implementing the automatic petroleum pricing mehanism.	Program period	Not applicable. To be reinstated in the context of the second review under the EFF.
II. Structural Benchmarks		
Achieving the revenue targets for 1997/98 under the audit program for the GST:		Not observed.
Collecting a minimum of PRs 3.0 billion	By end-March 1998	
Collecting a minimum of PRs 4.5 billion	By end-June 1998	

Table 2. Pakistan: Structural Performance Criteria and Benchmarks Under the First Annual ESAF Arrangement and the Extended Arrangement, 1997/98

Measures	Timing	Status
Widening the SBP's buy/sell spread for the U.S. dollar from 0.5 percent to 1 percent and allowing banks to quote their own rupee/U.S. dollar spot exchange rates for transactions with their customers within this band.	By end-March 1998	Observed.
Preparing a plan to extend the GST to the retail stage and establishing a project implementation team.	By end-June 1998	Not applicable as GST was extended to retail stage in June 1998.
Divesting the government's remaining ownership interest in Muslim Commercial Bank, Allied Bank Ltd., Pakistan Industrial Credit and Investment Corporation (PICIC), and Bankers' Equity Ltd (BEL).	By end-March 1998	Partially observed; divestment of PICIC and BEL completed.
Establishing an information exchange program encompassing the income tax, GST, and customs administration.	By end-June 1998	Delayed pending the finalization of the restructuring of the CBR into the PRS.
Selling at least 18 industrial units.	By end-June 1998.	Not observed.
Making the Pakistan Telecommunications Authority fully operational, and strengthening the National Electric Power Regulatory Authority.	By end-June 1998.	Observed.
Bringing Sui Northern Gas Pipeline Ltd., and Sui Southern Gas Company to point of sale.	By end-June 1998	Not observed.
Preparing operational plans for restructuring government ministries and divisions, attached departments and autonomous bodies.	By end-June 1998	Observed.
Developing action plans for restructuring the seven major public enterprises.	By end-June 1998	Restructuring plan for WAPDA agreed with the World Bank. Plan for the other enterprises being prepared.
Setting the per-currency and overall open position limits at 10 percent of bank capital.	By end-September 1998	Not observed.
Satisfactory implementation of the Social Action Program.	Program period.	Not observed.

Table 3. Pakistan: Quantitative Performance Criteria, and Indicative Targets Under the Second Annual ESAF Arrangement and the Extended Arrangement, December 1998–June 1999 1/

(Cumulative flows from July 1, 1998 unless otherwise specified)

	Est.	Performance criteria		
	End-Sep. 1998	End-Dec. 1998	End-March 1999	End-June 1999
Performance Criteria				
		(In billions of Pakistan rupees)		
Net foreign assets of the SBP 2/	-22.8	-52.1	-45.4	-37.8
Net domestic assets of the SBP 3/	17.3	86.8	79.1	71.5
Overall budget deficit	55.7	89.6	112.9	136.0
Of which : budget support 4/ 5/	24.0	45.8	6.0	-41.2
Credit to the seven major public enterprises 6/	-3.7	1.8	14.2	20.0
Accumulation of budgetary arrears to WAPDA 7/	6.9	0.0	0.0	0.0
		(In millions of U.S. dollars)		
Stock of public and publicly guaranteed short-term external debt	879	1,000	1,000	1,200
Contraction of nonconcessional medium- and long-term public and publicly guaranteed external debt	50	750	2,800	3,400
Of which: External debt with an initial maturity of over one year and up to five years	50	400	800	1,000
Stock of arrears on current account transactions (excluding interest payments)	306	396	198	0
Stock of arrears on private external debt service payments	152	234	156	0
Indicative Targets				
		(In billions of Pakistan rupees)		
Net domestic assets of the banking system 8/	19.2	147.1	119.3	100.3
Federal tax revenue 9/	76.6	177.8	280.7	407.1
Memorandum items:				
Net external budget financing 10/	-0.2	10.8	56.3	97.5
		(In millions of U.S. dollars)		
Stock of non-resident institutional foreign currency deposits	1,488	...	...	...
Program financing	204	595	1,536	2,277
Of which: BOP support loans 11/	-111	-149	316	571
Debt rescheduling and arrears 12/	315	744	1,220	1,706
External financing counted as SBP liability 13/	184	358	781	875

Source: Quarterly macroeconomic projections for 1998/99 agreed between the Pakistan authorities and the Fund staff.

1/ The performance criteria for end-December 1998, end-March and end-June 1999 are applicable under the extended arrangement; only the performance criteria for end-March 1999 are applicable for the second annual ESAF arrangement. The ceiling on net domestic assets of the SBP at end-June 1999, the ceiling on the stock of arrears on private current account transactions at end-December 1998, and the ceiling on the stock of arrears on private external debt payments at end-December 1998 are indicative targets.

2/ These floors will be adjusted (i) upward by the rupee equivalent of the excess program financing (see footnote 11; (ii) downward by the rupee equivalent of the shortfall program financing provided that the SBP net foreign assets (before the adjustment for the composition of external financing, see (vi) below) remain above PRs -56.4 billion at end-March 1999, and above PRs -54.9 billion at end-June 1999; (iii) upward by the rupee equivalent of the full amount of new privatization proceeds from abroad and receipts (cash or in kind) from the refund from the purchase of war planes from the United States that were not delivered; (iv) upward by the rupee equivalent of the excess in foreign currency deposits with SBP forward exchange cover above the end-September level (US$1,488 million); (v) upward by the rupee equivalent of special government dollar bonds issued in excess of foreign currency deposits converted into these bonds; and (vi) for changes in the composition of external financing (program financing versus financing counted as SBP liability) from that assumed under memorandum items; in the event of a shift in the structure of external financing from loans not counted as a reserve liability of the SBP to loans counted as a reserve liability, these floors will be adjusted downward by the rupee equivalent of the amount of this shift in the financing mix relative to the program baseline, and vice versa.

3/ These ceilings will be adjusted (i) downward by the rupee equivalent of the excess in program financing; (ii) downward by the rupee equivalent of the full amount of new privatization proceeds from abroad used by the budget and any receipts (cash or in kind) from the refund from the purchase of war planes from the United States that were not delivered; (iii) downward by the rupee equivalent of the excess in foreign currency deposits with SBP forward exchange cover above the end-September level; (iv) upward up to 40 percent of the amount of credits disbursed to KESC and WAPDA related to their financial restructuring agreed with AsDB and the World Bank, respectively; and (v) for changes in the composition of external financing (program financing versus financing counted as SBP liability) from that assumed under memorandum items; in the event of a shift in the structure of external financing from loans not counted as a reserve liability of the SBP to loans counted as a reserve liability, these ceilings will be adjusted upward by the rupee equivalent of the amount of this shift in the financing mix relative to the program baseline, and vice versa.

4/ These ceilings will be adjusted (i) downward by the rupee equivalent of the excess of net external budget financing (see footnote 10); and (ii) downward by the rupee equivalent of the amount of new privatization proceeds used by the budget.

5/ Continuous ceilings of PRs 45.8 billion on total budgetary support effective from January 1, 1999.

6/ The seven major enterprises include Pakistan Railways, the Water and Power Development Authority, the Karachi Electricity Supply Corporation, Ltd., Sui Northern Gas Pipelines Ltd., Sui Southern Gas Company Ltd., the Pakistan Telecommunications Corporation Ltd., and the Oil and Gas Development Corporation. These ceilings for end-March 1999 and end-June 1999 will be adjusted downward by the difference between program and actual amounts of credits to KESC and to WAPDA related to their financial restructurings agreed with AsDB and the World Bank; the program amounts are PRs 11.5 billion for KESC and PRs 5.0 billion for WAPDA.

7/ Cumulative flows from July 1, 1998.

8/ These ceilings include the rupee counterpart of external debt service due on government and government guaranteed debt. These indicative ceilings will be adjusted (i) downward by the rupee equivalent of the excess in program financing; (ii) downward by the rupee equivalent of the full amount of new privatization proceeds from abroad and any receipts (cash or in kind) from the refund from the purchase of war planes from the United States that were not delivered; (iii) downward by the rupee equivalent of the full amount of special government dollar bonds issued above their program levels; (iv) downward by the rupee equivalent of the excess in foreign currency deposits with SBP forward exchange cover above the end-September level; (v) downward at end-March 1999 and end-June 1999 by the difference between program and actual amounts of credits to KESC and to WAPDA related to their financial restructurings agreed with AsDB and the World Bank; the program amounts are PRs 11.5 billion for KESC and PRs 5.0 billion for WAPDA; and (vi) for changes in the composition of external financing (program financing versus financing counted as SBP liability) from that assumed under memorandum items; in the event of a shift in the structure of external financing from loans not counted as a reserve liability of the SBP to loans counted as a reserve liability, these ceilings will be adjusted upward by the rupee equivalent of the amount of this shift in the financing mix relative to the program baseline, and vice versa.

9/ Consists of the taxes collected by the Central Board of Revenue, gas and petroleum surcharges and the foreign travel tax.

10/ Includes all receipts from foreign currency government debt (including net amount of special dollar bonds issued), except for Non-Plan resources; receipts (cash or in kind) from the refund from the purchase of war planes from the United States that were not delivered; the accumulation of arrears on foreign currency government debt (including arrears on military debt); and the rescheduling of foreign currency government debt (including military debt); **less** the repayment of principal on foreign currency government debt (excluding military debt).

11/ Include adjustment loans from the World Bank and the AsDB net of principal payments due to the World Bank, AsDB, IsDB, IFAD, and OPEC Development Fund; and bilateral grants and loans for balance of payments support.

12/ Deviations in the amount of rescheduling of medium- and long-term public and publicly guaranteed debt compared with the program level will be corrected for revisions in data on debt service schedule from the figures presented below and payments on this debt in excess of the amounts presented below. Debt service due includes total principal and interest on medium- and long-term public and publicly guaranteed debt owed to bilateral, suppliers and commercial creditors.

Cumulative amounts in US$ since July 1, 1998	**Debt rescheduling + arrears (1)**	**Debt service due, excluding non-reschedulable debt (2)**	**Payments on debt other than non-reschedulable debt (3)**
End-September 1998	315	596	281
End-December 1998	744	1,135	391
End-March 1999	1,220	1,641	421
End-June 1999	1,706	2,157	451

The deviation taken into account in the calculation of shortfall/excess in program financing is equal to the deviation in (1) minus deviation in (2) plus deviation in (3) compared with the above Table.

13/ Includes net purchases and disbursements from the Fund as well as from other sources that affect the liabilities of the SBP.

Table 4. Pakistan: Prior Actions, Structural Performance Criteria and Benchmarks Under the Second Annual ESAF Arrangement and the Extended Arrangement, December 1998–September 1999

Measures	Timing
I. Prior Actions	
Raising the GST rate from 12½ percent to 15 percent.	
An assurance that provinces have agreed to empower the federal government to collect GST on services.	
Promulgation of ordinances to repeal government's discretionary power to grant exemptions from the GST and customs duties.	
Suspend operations under SR0 826 and Section 60 of the Sales Tax Act, which enable exporters to purchase inputs free of GST.	
Application of the composite exchange rate (with weights of 25 percent to the official exchange rate and 75 percent to the free interbank rate) to all external transactions, except for wheat and petroleum imports and FCD conversions.	
Agreement on WAPDA finances and submission of tariff filing to NEPRA.	
Adoption of an orderly framework for the resolution of disputes between the government and the independent power producers.	
Regularization of payments by the government to multilateral institutions.	
Initiation of negotiations with commercial creditors on debt restructuring.	
II. Structural Performance Criteria	
Extension of the GST to services.	By end-June 1999
Removal of GST exemptions for petroleum products and electricity.	By end-September 1999
Adoption of a unique tax-payer identification number.	By end-March 1999
Harmonizing provincial taxation of agricultural income with that prevailing in the province of Punjab and strengthening of collection mechanisms to reach a collection target of PRs 2.5 billion.	By end-June 1999
Implementation of power sector restructuring program:	
• Implementation of power tariff decision as approved by NEPRA based on WAPDA filing	By end-March 1999
• Corporate restructuring of WAPDA's power wing into 12 independent and autonomous companies which are regulated by NEPRA.	By end-March 1999
Reduction of the maximum tariff to 35 percent and the number of non-zero rates to four.	By end-March 1999
Elimination of the recently imposed exchange restrictions for travel and education abroad.	By end-March 1999
Phased elimination of electricity subsidy—	
• Reducing by 50 percent the subsidy for households with monthly bills larger than PRs 5,000	By end-March 1999
• Eliminating subsidy for households with monthly bills larger than Prs 5,000 and reducing by 50 percent the subsidy bill for all other households.	By end-June 1999
• Eliminating subsidy for all remaining households	By end-Sept. 1999

Table 4. Pakistan: Prior Actions, Structural Performance Criteria and Benchmarks Under the Second Annual ESAF Arrangement and the Extended Arrangement, December 1998–September 1999

Measures	Timing
Unification of exchange rates.	July 1, 1999
Maintain petroleum development surcharge rate within the bands established in the program.	Program period
III. Structural Benchmarks	
Elimination of the 30 percent import margin requirement and payment restrictions on travel and education abroad.	By end-March 1999
Divesting the government's remaining ownership interest in Muslim Commercial Bank and Allied Bank Ltd.	By end-March 1999
Bringing Sui Northern Gas Pipeline Ltd., and Sui Southern Gas Company to point of sale.	By end-March 1999
Bringing Habib Bank to the point of Sale.	By end-June 1999
Implementation of revised regulations and tax rules governing provisioning for nonperforming loans.	By end-June 1999
Recovery of nonperforming loans by:	
• PRs 11-12 million	By end-December 1998
• PRs 19-20 million	By end-May 1999
Time table and action plan for abolishing concessional credit scheme for exporters.	By end-June 1999
Submit to Parliament amendments to Loan Recovery Act of 1997 facilitating execution of Banking Court decisions.	By end-June 1999
Ban on introduction of new fixed tax schemes under the GST.	Program period.
Implementing a comprehensive GST audit program.	By end-June 1999
Strengthening the appeal process for tax assessments.	By end-June 1999
Restructuring and integrating the Central Board of Revenue into the Pakistan Revenue Service.	By end-June 1999
Preparation of an action plan for a medium-term civil service reform.	By end-June 1999
Satisfactory implementation of the Social Action Program.	Program period.