FOR AGENDA

EBS/97/185

CONFIDENTIAL

October 3, 1997

To: Members of the Executive Board

From: The Acting Secretary

Subject: **Pakistan—Staff Report for the 1997 Article IV Consultation and Request for Arrangements Under the Enhanced Structural Adjustment Facility and the Extended Fund Facility**

Attached for consideration by the Executive Directors is the staff report for the 1997 Article IV consultation with Pakistan and Pakistan's request for arrangements under the Enhanced Structural Adjustment Facility and the Extended Fund Facility. Draft decisions appear on page 47.

This subject, together with the policy framework paper for Pakistan (EBD/97/110, 10/3/97), will be brought to the agenda for discussion on a date to be announced.

Mr. Furtado (ext. 38423) or Mrs. Moalla-Fetini (ext. 34987) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Unless the Documents Preparation 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 Wednesday, October 15, 1997; 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.

Att: (1)

Other Distribution:
Department Heads

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

PAKISTAN

Staff Report for the 1997 Article IV Consultation and Request for Arrangements Under the Enhanced Structural Adjustment Facility and the Extended Fund Facility

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

(In consultation with other departments)

Approved by P. Chabrier and Susan M. Schadler

October 2, 1997

Contents **Page**

Text Box

Text Tables

Charts

Appendices

Attachment

EXECUTIVE SUMMARY

Recent developments—A large budget deficit and rapid net domestic asset expansion contributed to a sharp deterioration in the external current account to the range of 6–7 percent of GDP in 1995/96–1996/97. This was accompanied by a large build-up of short-term external liabilities, mainly nonresidents' foreign currency deposits. The 12-month inflation rate reached 13.8 percent in February 1997, concurrently with a deterioration in the external reserve position to the US$500–600 million range (about two weeks of imports), and a premium in the kerb foreign exchange market in excess of 10 percent. Real GDP growth weakened to 3.1 percent in 1996/97, reflecting a poor cotton crop and a decline in manufacturing output. The government that assumed office last February has emphasized tax and tariff reforms, government and public enterprise restructuring and downsizing, financial sector reform (including bank privatization), and exchange market reform. The government's stabilization and structural policies are being monitored by the staff under an SMP covering the period April–September 1997. Most of the targets for June 1996/97 under the SMP (which replaced those under the inoperative stand-by arrangement) were observed.

Macroeconomic objectives and policies—The macroeconomic objectives for the three-year period 1997/98–1999/2000 would be to reduce the external current deficit (excluding official transfers) to the range of 4.0–4.5 percent of GDP which would provide for a substantial strengthening of the external reserve position; to raise the annual growth rate of real GDP to the 5–6 percent range; and to progressively reduce annual inflation to about 7 percent. The key intermediate policy target would be a reduction in the overall budget deficit from 6.1 percent of GDP in 1996/97 to 5.0 percent of GDP in 1997/98 and to 4.0 percent of GDP by the third year of the program.

Structural policies—To be sustained, the macroeconomic adjustment is based on a strengthening of the structural aspects of the economy. The key structural elements in the fiscal area would be the extension of the GST to the retail sector; strengthening of the recently enacted provincial agricultural income taxes; overhaul of the tax collection machinery; return to an automatic petroleum pricing mechanism; and restructuring of government ministries/divisions and attached departments and autonomous bodies. Reduction in defense spending is significant and front-loaded. The budgetary adjustment is to be supplemented by major improvements in the operations of the public enterprises. In the banking sector, the program incorporates an enhancement of the central bank's autonomy and of its regulatory and supervisory role; an improvement of the legal and judiciary processes for enforcing financial contracts; privatization of the state-owned banks and financial institutions; and loan recovery efforts. As regards the external sector, customs tariffs would be lowered and simplified; and exchange market reforms will be implemented with a view to develop private forward cover and enable the central bank to gradually phase out its forward cover scheme for foreign currency deposits.

Staff appraisal—The staff supports the government's strategy while noting the risks associated with the demands which the wide range of reforms will place on Pakistan's limited implementation capacity, and those arising from the still fragile macroeconomic situation.

I. INTRODUCTION

1. Discussions for the 1997 Article IV consultation and use of Fund resources were held in Islamabad during July 9–24 and in Washington during July 30–August 11.[1] The 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 1997/98–1999/2000 (July/June fiscal years).[2] In support of its three-year adjustment and reform program, the Government of Pakistan is requesting financial support from the Fund in an amount of SDR 1,137.30 million (equivalent to 150 percent of quota), of which SDR 682.38 million (90 percent of quota) under the Enhanced Structural Adjustment Facility and SDR 454.92 million (60 percent of quota) under the Extended Fund Facility.[3]

2. The last Article IV consultation with Pakistan was concluded on December 13, 1995, at which time the Executive Board approved a 15-month stand-by arrangement (SBA) in an amount of SDR 401.85 billion (53 percent of quota).[4] On that occasion, Directors emphasized the importance of reducing the budget deficit, strengthening the external reserve position, and resuming structural reforms—in particular, those aimed at improving the structure of the budget, addressing the weaknesses in the banking system, and liberalizing import tariffs.[5] In December 1996, at the completion of the second review, the SBA was extended by six months, through September 1997, and the total access was augmented to SDR 562.59 million (74.2 percent of quota).[6] However, large deviations in relation to the program re-emerged in early 1997, as a result of which the third review could not be completed and the arrangement became inoperative, with an undrawn balance of SDR 267.90 million. Since April 1997, policy implementation has been monitored under a Staff Monitored Program and the Board has been

---

[1]The staff team consisted of Mr. Furtado (Head), Mmes. Liu and Moalla-Fetini (MED), Ms. Anulova (FAD), Mr. Le Dem (PDR), and Ms. Ochoa (Assistant, MED). World Bank staff participated in the work of the mission. Mr. Chabrier participated in the policy discussions.

[2]The Policy Framework Paper has been issued as EBD/97/110, October 3, 1997.

[3]The proposed schedule of disbursements and purchases is shown in Appendix I and the draft texts of the proposed arrangements are presented in Appendices II and III. The authorities' letter of transmittal and Memorandum on Economic and Financial Policies are presented in Attachment I.

[4]See EBS/95/208, December 5, 1995 and Correction 1, December 12, 1995.

[5]Pakistan initiated wide ranging structural reforms during the 1993/94 fiscal year, with Fund financial support under an SBA which was replaced by ESAF and extended arrangements. These arrangements, approved in February 1994, became inoperative in early 1995 as policy implementation slipped after initial successes.

[6]See EBS/96/185, December 2, 1996, and Supplement 1, December 12, 1996.

kept informed of developments in Pakistan on occasion of the country matter meetings. Pakistan accepted the obligations under Article VIII with effect from July 1994, and has since maintained an exchange system which is free from restrictions on current international payments. As of end-August 1997, total Fund credit and loans outstanding to Pakistan amounted to SDR 881.84 million (116.3 percent of quota).[7]

3. The composition of the World Bank Group's lending to Pakistan has shifted significantly in recent years, reflecting an increasing emphasis on human development and a declining, albeit still dominant, share of commitments to agriculture and infrastructure. Meanwhile, market-friendly reforms pursued over the past few years have allowed IFC to increase significantly its investments and participate in a more diversified range of activities. The World Bank at present is working closely with Pakistan, including in the context of an ongoing banking sector reform program which is expected to be supported through adjustment lending.[8]

II. BACKGROUND

4. In recent years, Pakistan has made several attempts to address its macroeconomic imbalances and deep-rooted structural problems. However, slippages in policy implementation and policy reversals have muted the supply response and frustrated any lasting improvements in the fiscal and external positions, in several instances bringing the economy to the verge of foreign exchange crises. The cost to Pakistan has been very high in terms of chronic double-digit inflation, weak exports, rising borrowing costs, and reduced policy credibility.
In addition, economic growth over the past five years has averaged 4 percent per year, significantly slower than in past decades, and has continued to come mainly from the agricultural sector. Growth in the industrial sector has been weak in recent years, with large-scale manufacturing contracting in 1996/97. This performance has been the result of lagging competitiveness, inadequate investment, and the impact of several poor cotton crops; also, civil strife in Karachi has impacted adversely on investment and production.

5. The budget deficit has fluctuated around 6 percent of GDP since 1993/94 while the structure of the budget and the composition of its financing has worsened. The tax to GDP ratio has remained flat over the last three years, despite significant revenue measures introduced in successive budgets, the impact of which has been diffused by distortions in the tax system and poor administration and enforcement. Nontax revenues have declined in relation to GDP reflecting a worsening of the financial position of public enterprises. This, together with rising interest payments, has led to a compression of development expenditure and of the nonwage component of operations and maintenance outlays. Bank borrowing for budgetary support increased sharply over the last three years, which hampered credit availability to the private sector.

---

[7]Pakistan's relations with the Fund are described in Appendix IV.

[8]Pakistan's relation with the World Bank group are described in Appendix V.

6. The weaknesses in the fiscal system have had a range of adverse effects on financial intermediation. Restrictions on the lending regime (including excessively high liquid asset ratios as a means of maintaining a captive market for government securities) have seriously undermined the soundness of the banking sector and contributed to inordinately high spreads between lending and deposit rates. Moreover, high rates of domestic credit expansion (reflecting, in large measure, the financing requirements of the government) have contributed to double-digit inflation, thereby weakening the demand for real rupee balances. In turn, there has been a shift into foreign currency deposits, whose rupee equivalent grew at an average annual rate of 35 percent over the last three years, compared with only 10 percent for rupee deposits.

7. The fiscal imbalances and associated monetary injections contributed to a sharp deterioration in the external current account in 1995/96 which was only slightly reversed in 1996/97. In view of the difficulties in mobilizing medium- and long-term financing for the widening current account deficit, Pakistan has accumulated a large stock of short-term external liabilities, mainly in the form of nonresidents' foreign currency deposits (which amounted to US$4.3 billion as of June 1997). This, combined with the increasing holdings of residents mentioned above, raised the total stock of foreign currency deposits to US$9.8 billion as of end-June 1997 (about 50 percent of the deposit base and eight times the level of gross reserves), giving rise to significant risks and rigidities. In particular, given the forward cover scheme under which the SBP provides exchange rate guarantees for these deposits, any exchange rate movement in excess of the fee charged for the cover gives rise to quasi-fiscal foreign exchange losses.

8. In recent years, these macroeconomic imbalances and structural problems have been compounded by increasing weaknesses in the area of governance. Such weaknesses have, inter alia, constrained tax collection (through tax evasion and granting of widespread tax exemptions and concessions), undermined tax administration, hampered the effectiveness of public expenditure, opened the way for massive waste in public enterprises, and contributed to the build up of the nonperforming loan portfolio of the banking system.

III. Recent Economic and Financial Developments

9. The present government assumed office in February of this year in the context of a delicate economic situation. The caretaker administration (November 1996–February 1997) gave impulse to important structural reforms but did not succeed in redressing the macroeconomic imbalances. This, together with political uncertainties, contributed to an acceleration in inflation (with the 12-month rate peaking at 13.8 percent in February 1997), a deterioration in the external reserve position to the US$500–600 million range (about two weeks of imports), and a premium in the kerb foreign exchange market in excess of 10 percent. Moreover, the economic picture was complicated by the weak growth of real GDP in 1996/97 (Table 1 and Chart 1), reflecting a poor cotton crop and a decline in large-scale manufacturing output.

Table 1. Pakistan: Key Economic Indicators, 1993/94–1999/2000

	1993/94	1994/95	1995/96	Prel. 1996/97	Prog. 1997/98	Prog. 1998/99	Prog. 1999/2000
				(In percentage change)			
Output and prices							
Real GDP at factor cost	4.5	5.2	4.6	3.1	5.5	5.8	6.0
GDP deflator at factor cost	12.6	13.6	10.9	11.3	11.0	9.5	7.0
Consumer price index (annual average)	11.3	13.0	10.8	11.8	10.5	9.0	7.0
Consumer price index (end-of-period)	11.8	12.1	10.3	12.5	9.0	7.5	7.0
Nominal GDP at market prices	17.2	19.7	15.4	15.3	17.1	15.9	13.4
				(In percent of GDP)			
Investment and savings							
Total investment	19.4	18.4	18.6	18.2	17.8	18.8	19.4
Public	7.7	6.9	7.0	5.6	4.9	5.2	5.5
Private	11.7	11.5	11.6	12.6	12.8	13.0	13.3
Gross national savings	15.8	14.5	11.8	11.8	12.6	14.0	15.2
Public	0.1	0.3	-1.1	-2.0	-1.2	-0.4	0.4
Private	15.7	14.2	12.9	13.9	13.8	14.4	14.8
Savings/Investment balances	-3.6	-3.9	-6.8	-6.4	-5.1	-4.8	-4.2
Public	-7.6	-6.6	-8.1	-7.6	-6.2	-5.6	-5.1
Private	4.0	2.7	1.3	1.2	1.0	1.4	1.5
Budgetary operations							
Budgetary revenue	17.2	17.0	17.0	15.3	15.7	16.4	16.8
Budgetary expenditure	23.2	22.6	23.8	21.5	20.8	20.9	20.8
Budgetary balance	-6.0	-5.6	-6.9	-6.1	-5.0	-4.5	-4.0
Domestic debt	45.2	42.9	42.3	41.4	39.3	38.9	37.0
				(Changes in beginning-of-period domestic liquidity)			
Monetary sector							
Net foreign assets	5.6	3.8	-4.7	-3.6	1.3	2.5	2.7
Net domestic assets	12.4	13.4	18.5	14.4	14.4	13.2	11.9
Domestic liquidity	18.0	17.2	13.8	10.8	15.7	15.6	14.6
				(In percent of GDP)			
External sector							
Exports	12.9	13.2	13.3	12.7	13.5	14.2	14.4
Imports	16.6	16.8	18.5	17.7	17.1	17.2	16.7
Current account excluding official transfers	-3.6	-3.9	-6.8	-6.4	-5.1	-4.8	-4.2
Current account including official transfers	-3.0	-3.4	-6.5	-6.0	-4.9	-4.5	-4.0
External public debt 1/	48.2	44.5	42.5	43.8	45.3	46.7	46.2
				(In millions of U.S. dollars)			
Current account, excluding official transfers	-1,904	-2,413	-4,409	-4,092	-3,418	-3,328	-3,148
Current account balance	-1,590	-2,101	-4,195	-3,837	-3,283	-3,140	-2,960
Gross reserves 2/	2,302	2,741	2,053	1,238	1,673	2,483	3,383
Gross reserves 2/ (in weeks of imports)	12.6	12.7	8.2	5.2	7.0	10.0	13.0
External debt service ratio 3/	22.6	22.0	24.7	27.9	24.9	24.0	23.8

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

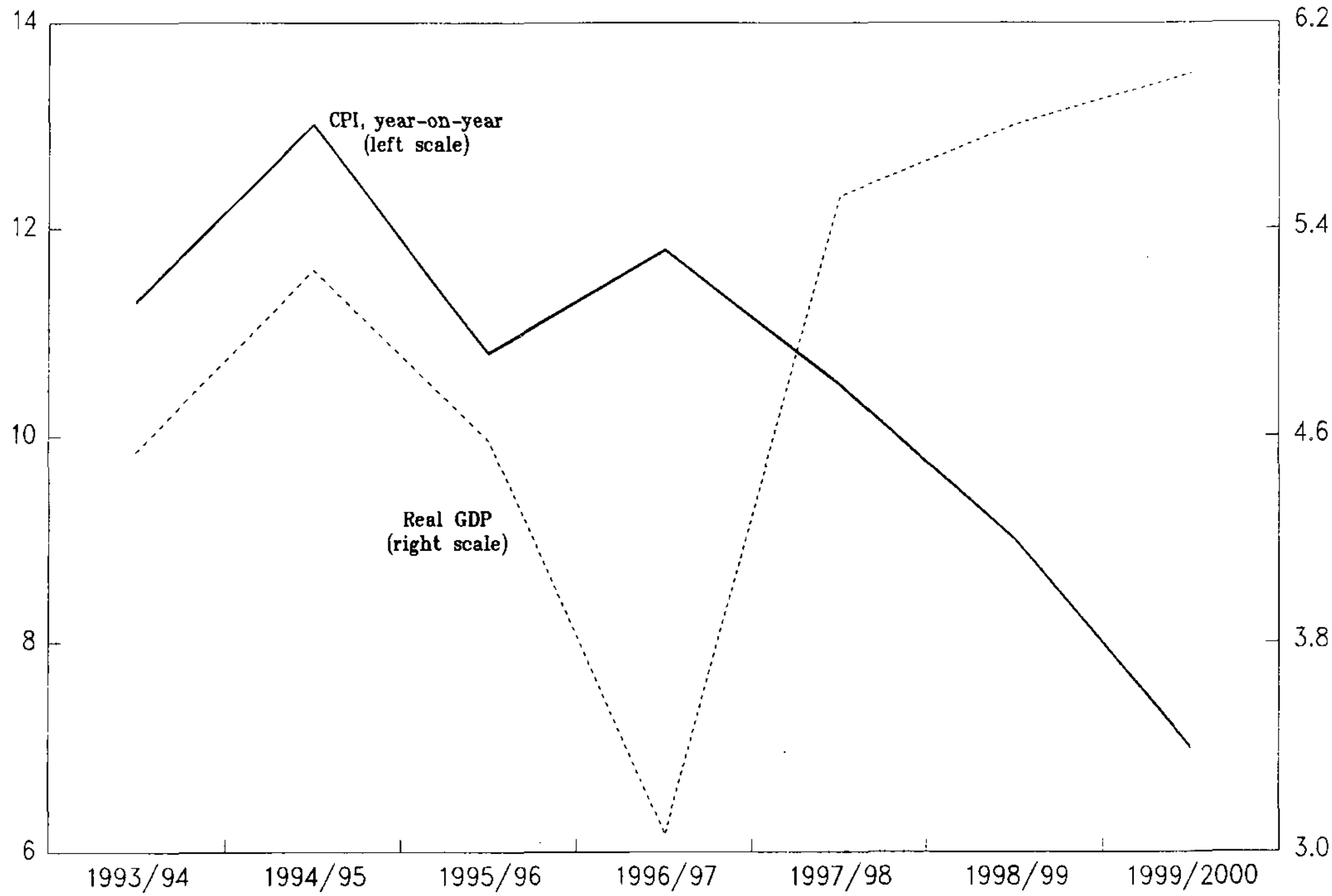
1/ Excludes foreign currency deposit liabilities.
2/ Excluding gold.
3/ Medium- and long-term debt service in percent of exports of goods and services and receipts of private transfers.

CHART 1

PAKISTAN

REAL GDP GROWTH AND CONSUMER PRICE INFLATION, 1993/94-1999/2000

(In percent)



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

10. In developing their economic strategy, the new authorities emphasized an acceleration and broadening of the structural reform agenda; to that effect, they constituted special committees to formulate a package of reforms covering the areas of agricultural policy, tax administration and tax policy, government and public enterprise restructuring, and export promotion. In addition, they felt that it was crucial for Pakistan to remain engaged in a close policy dialogue with the Fund in order to forestall a confidence crisis and to better develop and monitor policies. Accordingly, they requested that the staff monitor implementation of their macroeconomic and structural policies under a Staff Monitored Program (SMP) covering the six-month period ending in September 1997.

11. In the structural area, the authorities have endorsed and consolidated under the SMP the ongoing reform efforts while combining them with a new range of initiatives. Specifically, they secured parliamentary approval for key *ordinances* introduced during the tenure of the caretaker government providing for taxation of agricultural income by the provinces[9] and introducing financial sector reforms. These included enhancing the autonomy of the State Bank of Pakistan (SBP) to formulate and implement monetary policy targets; making the SBP the sole regulatory and supervisory entity for financial institutions; and strengthening the mechanisms for appointing the managements of the public sector financial institutions. These financial sector reform measures were complemented by the enactment, in June 1997, of a new law aimed at simplifying the legal processes for loan recovery and foreclosure/sale of collaterals.

12. As regards new structural reform initiatives, the government launched tax and tariff reforms which, taking advantage of the new revenue sharing arrangement adopted in early 1997, are designed to shift the revenue base from imports to consumption and income over the medium-term while improving the efficiency of the economy.[10] At end-March, the maximum import tariff was brought down to 45 percent (from 65 percent), the 10 percent regulatory duty that had been introduced in October 1995 was eliminated for most imports, and the tariff structure was simplified by reducing the number of slabs from 14 to 6.[11] On domestic taxes, the authorities took the position that the existing relatively high rate structure was adversely affecting production, investment, and tax compliance. Thus, with

---

[9]Under Pakistan's constitution taxation of agricultural income is an exclusive prerogative of the provinces but this had never been reflected in the provinces' tax laws as a result of which income from the sector remained exempt.

[10]In contrast with the preceding arrangement, which assigned the bulk of import-based taxes to the federal government and the major share of domestic taxes to the provinces (thereby limiting the incentive of the federal government to raise domestic taxes and reduce tariffs), the new arrangement includes all federally collected taxes in the divisible pool under a uniform sharing ratio.

[11]Namely, zero, 10, 15, 25, 35, and 45 percent.

effect from April 1997, the government reduced the standard rate of the General Sales Tax (GST) to 12 ½ percent (from 18 percent) while eliminating the 23 percent rate. At the same time, personal and corporate income tax rates were reduced with effect from the assessments beginning in July 1998.

13. In the macroeconomic area, most of the targets established for 1996/97 under the SMP were observed (Table 2). The budget deficit was reduced to 6.1 percent of GDP (from 6.9 percent in 1995/96) reflecting a decline in budgetary expenditure (by more than 2 GDP percentage points) which more than offset a drop in the revenue-to-GDP ratio (Table 3 and Chart 2). The latter reflected a decline in both tax and nontax revenue at the federal level, as tax revenue was affected by higher GST refunds in the beginning of the year and the lowering of tax rates in the last quarter; and nontax revenue was depressed by a deterioration in the financial position of key public enterprises and lower SBP profits. On the expenditure side, the sources of containment were defense expenditure, current provincial expenditure, and low-priority outlays under the Public Sector Development Program (PSDP). Reflecting the deterioration in the performance of major public enterprises, the overall deficit of the consolidated public sector[12] amounted to the equivalent of 7.6 percent of GDP in 1996/97, compared with 8.0 percent in 1995/96.[13]

14. In the monetary sector, net domestic asset growth decelerated to 14.4 percent of initial stock of domestic liquidity—a marked slowdown in relation to 1995/96, when NDA grew at a rate of 18.5 percent of initial domestic liquidity (Table 4 and Chart 3). The deceleration in the growth of net domestic assets was partly due to lower expansion in credit to the private sector under government-sponsored schemes. However, in the face of a weaker demand for money (as reflected in an overall liquidity growth of only 10.8 percent), these credit trends were consistent with an increase in average CPI inflation to 11.8 percent (compared with 10.8 percent in 1995/96) and a loss in net foreign assets equivalent to 3.6 percent of the initial stock of domestic liquidity. Reflecting continuing weaknesses in the banking system which limit the responsiveness to interest rate policy impulses (see Box 1), the three percentage

---

[12]Comprising the federal and provincial budgets and the seven public enterprises: Pakistan Railways, the Water and Power Development Authority (WAPDA), the Karachi Electricity Supply Corporation (KESC), Sui Northern Gas Pipelines Ltd., Sui Southern Gas Company, the Pakistan Telecommunications Corporation Ltd., and the Oil and Gas Development Corporation.

[13]The combined current balance of these enterprises weakened to 0.7 percent of GDP in 1996/97 (from 1.4 percent of GDP in 1995/96), while their capital outlays declined by only 0.5 percent of GDP (to 2.8 percent). In particular, the current balance of WAPDA is estimated to have deteriorated by 0.6 percent of GDP in 1996/97 as significant cuts in distribution losses and a 10.2 percent increase in the average electricity tariff fell far short of matching a more than doubling of its average cost.

Table 2. Pakistan: Quantitative Targets Under the Staff Monitored Program

	1996/97		1997/98 (First Quarter)	
	Target	Actual	Original target	Revised target 1/
	(In billions of Pakistan rupees)			
Domestic sector				
Total federal tax revenue	313	308	74	68
Overall budget deficit	155	153	39	43
Bank borrowing for budgetary support	102	69	37	37
Change in net domestic assets of the State Bank of Pakistan	110	65	25	25
Change in banking system credit to the non-government sector	73	57	2	5
	(In millions of U.S. dollars)			
External sector				
Stock of gross official reserves (excluding gold)	1,000	1,238	1,000	1,000
Stock of public and publicly guaranteed short-term external debt	1,000	832	1,000	1,000
Contraction of non-concessional medium- and long-term public and publicly guaranteed external debt	2,200	1,892	1,000	1,500
Of which				
External debt with an initial maturity of over one year and up to five years	800	788	350	600

1/ The revisions in the end-September SMP targets reflect mainly a more refined quarterlization of the annual program. The annual targets for 1997/98 have been maintained.

Table 3. Pakistan: Summary of Consolidated Federal and Provincial Budgetary Operations, 1993/94-1999/2000

	1993/94	1994/95	1995/96	Prel. 1996/97	Prog. 1997/98	Prog. 1998/99	Prog. 1999/2000
	(In billions of Pakistan rupees)						
Total revenue	271.0	320.1	368.6	383.7	461.3	557.6	649.0
Tax	208.7	259.6	305.6	322.0	372.9	458.5	536.2
Nontax	62.3	60.5	63.0	61.7	88.5	99.1	112.8
Total expenditure	364.7	426.2	517.4	537.1	609.3	710.4	803.1
Current	293.1	343.9	423.1	451.9	519.2	598.3	644.4
Of which: Interest 1/	86.2	94.2	128.0	145.6	185.4	212.0	231.0
Defense	91.8	104.5	119.7	127.4	134.0	155.3	176.1
Development 2/	71.5	82.3	94.2	85.2	90.1	112.1	138.7
Budget deficit	-93.7	-106.1	-148.8	-153.4	-148.0	-152.8	-154.1
Financing	93.7	106.1	148.8	153.4	148.0	152.8	154.1
External	25.2	28.9	27.0	21.4	29.5	49.0	49.6
Domestic	66.5	66.1	109.7	130.5	118.5	103.8	104.5
Bank	27.8	36.2	49.5	68.7	58.0	46.7	55.5
Nonbank	38.6	30.0	60.2	61.8	60.5	57.1	49.0
Privatization proceeds	2.0	11.1	12.0	1.5	0.0	0.0	0.0
	(In percent of GDP)						
Total revenue	17.2	17.0	17.0	15.3	15.7	16.4	16.8
Tax	13.3	13.8	14.1	12.9	12.7	13.5	13.9
Nontax	4.0	3.2	2.9	2.5	3.0	2.5	2.9
Total expenditure	23.2	22.6	23.8	21.5	20.8	20.9	20.8
Current	18.6	18.3	19.5	18.1	17.7	17.6	17.6
Of which: Interest 1/	5.5	5.0	5.9	5.8	6.3	6.2	6.0
Defense	5.8	5.6	5.5	5.1	4.6	4.6	4.6
Development 2/	4.5	4.4	4.3	3.4	3.1	3.3	3.6
Budget deficit	-6.0	-5.6	-6.9	-6.1	-5.0	-4.5	-4.0
Memorandum items:							
Current balance	-1.4	-1.3	-2.5	-2.7	-2.0	-1.2	-0.4
Total domestic debt	44.2	42.0	41.6	41.3	39.3	38.9	37.0
Current balance of the seven major public enterprises	1.5	1.5	1.4	0.7	0.8	0.8	0.8
Extra-budgetary capital outlay of the seven major public enterprises	3.2	2.5	2.6	2.2	1.9	1.9	1.9
Overal balance of the consolidated public sector 3/	-7.6	-6.6	-8.1	-7.6	-6.2	-5.6	-5.1

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

1/ In 1998/99 onwards, includes the interest on government bonds related to bank restructuring operations in an estimated amount of PRs 60 billion.

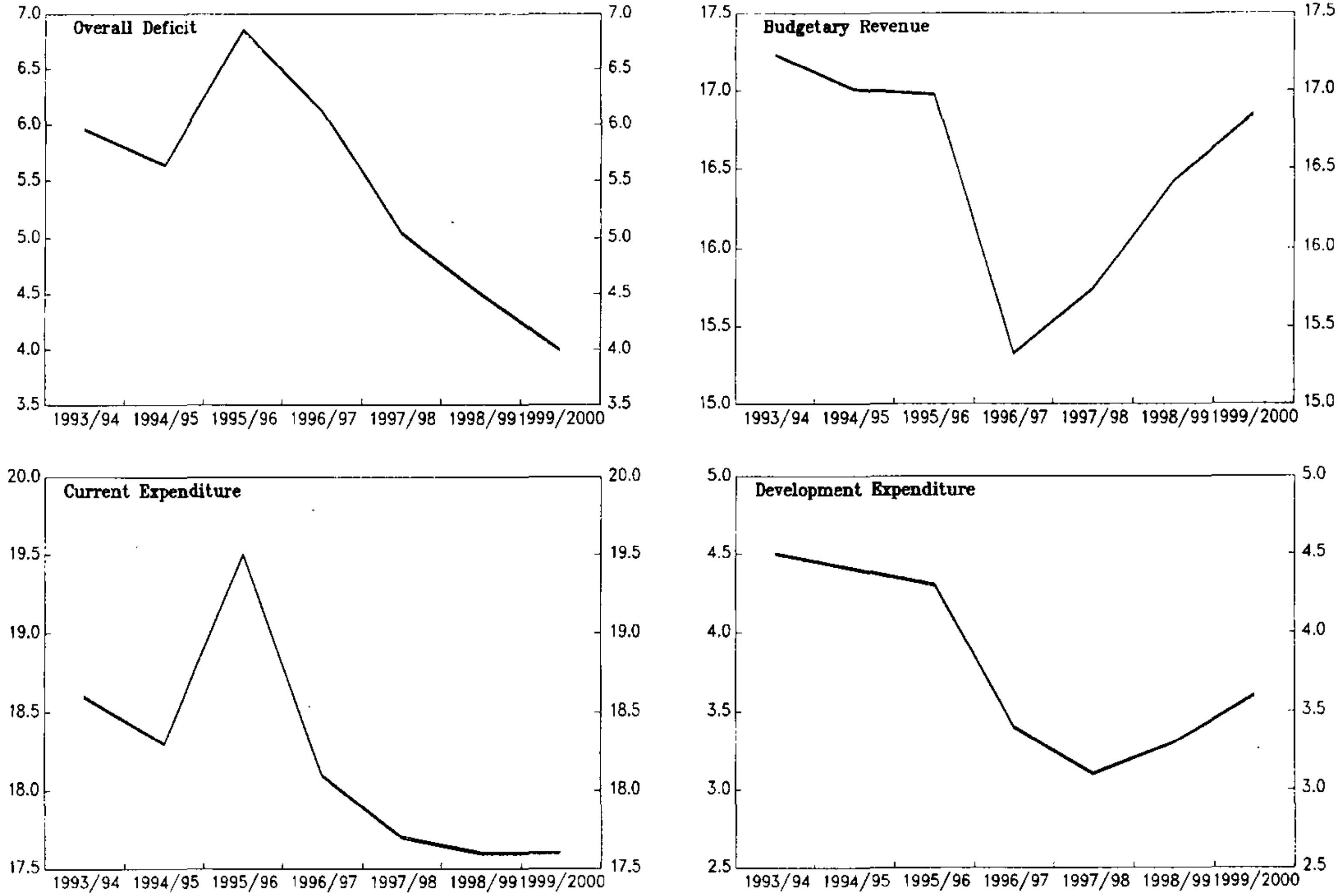
2/ Includes capital expenditure, net lending, and certain current outlays under the public sector development program.

3/ Includes the federal/provincial consolidated budget and the operations of Pakistan Railways, the Water and Power Development Authority, the Karachi Electricity Supply Corporation, Sui Northern Gas Pipeline Ltd., Sui Southern Gas company, the Pakistan Telecommunication Corporation Ltd., and the Oil and Gas Development Corporation.

CHART 2

PAKISTAN

BUDGETARY DEVELOPMENTS AND PROSPECTS, 1993/94-1999/2000
(In percent of GDP)



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

Table 4. Pakistan: Factors Affecting Changes in Domestic Liquidity, 1993/94-1999/2000

	1993/94	1994/95	1995/96	Prel. 1996/97	Proj. 1997/98	Proj. 1998/99	Proj. 1999/2000
	(Changes in millions of Pakistan rupees)						
Net foreign assets	33,409	26,957	-38,998	-33,438	13,200	29,565	37,589
Net domestic assets	73,863	94,376	152,900	135,139	150,000	158,741	165,538
Net claims on government	27,963	38,696	54,297	70,572	63,500	52,161	61,000
Of which:							
Budgetary support	22,842	36,158	49,497	68,709	58,000	46,661	55,500
Commodity operations	6,582	4,733	5,858	4,726	5,500	5,500	5,500
Claims on non-government sectors	39,425	69,977	68,707	56,823	84,500	106,580	104,537
Other items net 1/	6,475	-14,298	29,896	7,744	2,000	0	0
Domestic liquidity	107,272	121,333	113,902	101,701	163,200	188,306	203,127
	(Changes in percent of initial stock of domestic liquidity)						
Net foreign assets	5.6	3.8	-4.7	-3.6	1.3	2.5	2.7
Net domestic assets	12.4	13.4	18.5	14.4	14.4	13.2	11.9
Of which:							
Budgetary support	3.8	5.1	6.0	7.3	5.6	3.9	4.0
Claims on non-government sectors	6.6	9.9	8.3	6.1	8.1	8.9	7.5
Domestic liquidity	18.0	17.2	13.8	10.8	15.7	15.6	14.6
Memorandum item:							
Velocity of domestic liquidity	2.24	2.28	2.31	2.41	2.44	2.44	2.42

Source: State Bank of Pakistan, and Fund staff projections.

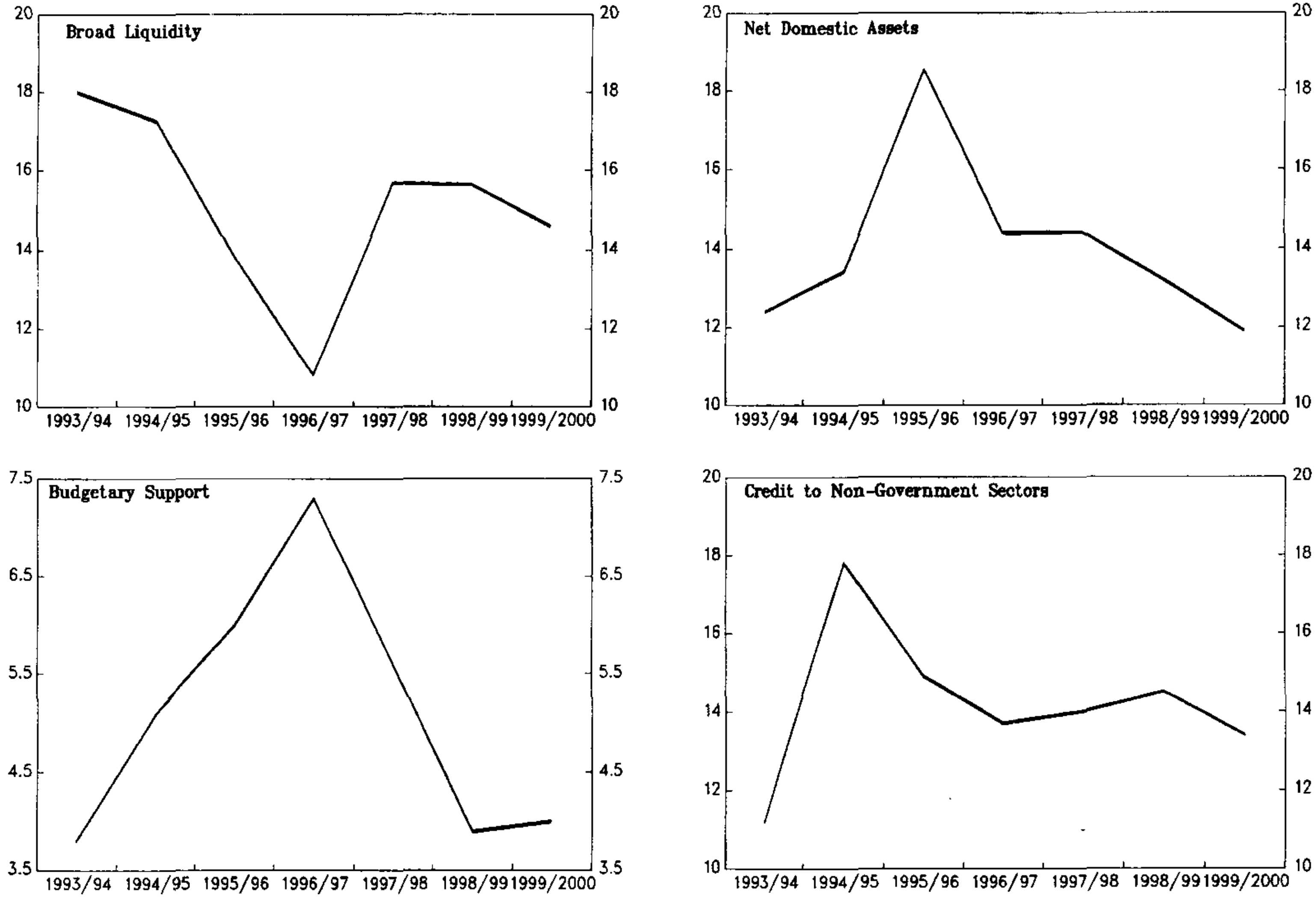
1/ Includes the impact of inflows and use of privatization proceeds.

CHART 3

PAKISTAN

MONETARY DEVELOPMENTS AND PROSPECTS, 1993/94-1999/2000

(Changes in beginning-of-period domestic liquidity)



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

Box 1. The Banking Sector

In 1975, the banking system was fully nationalized, with a number of private banks merged into fewer larger institutions. Since the early 1990s the government sought private sector participation in the banking system through privatization of the nationalized commercial banks (NCBs) and the establishment of new privately owned banks. Despite some progress in this area, the three largest commercial banks (National Bank of Pakistan (NBP), Habib Bank Limited (HBL), and United Bank Limited (UBL)) remain in public hands and continue to hold over 45 percent of bank deposits, while the two other large nationalized banks (Muslim Commercial Bank (MCB), and Allied Bank Limited (ABL)) have been only partially privatized and continue to hold 18 percent of deposits.[1] In early 1996, the government made an attempt to privatize UBL which failed, in part, due to the bank's large non-performing loan portfolio and to significant over staffing.

In recent years, the NCBs have experienced declining profitability, increasing operating costs, a weakening capital base, and a build up of nonperforming assets amounting to some 18 to 20 percent of outstanding loans (equivalent to 4 percent of GDP). Recent analysis undertaken by the World Bank found that the negative net worth of the three NCBs was of the order of PRs 60 billion (the equivalent of 2 percent of GDP), and that the cost of recapitalizing these banks according to BIS standards could be as high as US$6 billion (PRs 240 billion, equivalent to 8 percent of GDP).

Several factors have been at play in producing these negative trends. NCBs have generally not operated on sound commercial principles. In addition they have been burdened with the task of fulfilling several social objectives such as employment creation, servicing of remote areas at high cost, and providing subsidized and mandatory credit under an array of government sponsored credit schemes. Moreover the profitability of all banks continues to suffer from remaining forms of financial repression (indicative credit ceilings and high reserve and liquidity requirements).

The immediate negative impact of these trends has been the widening spread between lending and deposits rates, which averaged 5–6 percentage points during the last two years. The depressed level at which deposit rates have been kept (minus 1 to minus 2 percent in real terms) has led to a growing tendency towards disintermediation in rupee deposits. In real terms, rupee deposits remained flat in 1995/96 and declined by 13 percent in 1996/97. This tendency has been further aggravated by growing direct borrowing by the government through the national saving schemes, increasing lack of confidence of savers in the NCBs, and dollarization.

---

[1] In addition, the sector comprises 19 foreign commercial bank branches (holding 23 percent of deposits), 13 private domestic banks (12 percent of deposits), four small specialized state owned banks, and two provincial banks.

point increase in the SBP's repo rate to 20 percent implemented in October 1996 to tighten monetary conditions—and commensurate increase in money market rates and in the yield on short-term government bonds—did not trickle down to deposits rates, nor did they have any significant impact on lending rates, both of which remained virtually constant in nominal terms. Thus, the main effect of the increase in the key official interest rates has been to avoid outflows of nonresidents' foreign currency deposits. In this regard, the interest rate actions were supplemented by a temporary special deposit facility at the SBP where banks could deposit the rupee counterpart of foreign currency deposits at an after tax return of 17 percent.[14]

15. The reduction in the budget deficit and the deceleration in net domestic asset growth contributed to a narrowing of the external current account deficit (before official transfers) to 6.4 percent of GDP in 1996/97, from 6.8 percent in 1995/96 (Chart 4). This reflected a decline in imports[15] and a strengthening in private transfers, which more than offset a 5.3 percent drop in exports, associated in part with the poor cotton crop (Table 5). Pakistan's disbursed public and publicly guaranteed external debt rose to US$28.1 billion (43.7 percent of GDP) at end-June 1997, from US$27.6 billion (42.5 percent of GDP) in 1995/96 (Table 5). Gross official reserves declined by about US$900 million during 1996/97 to US$1.2 billion (5.2 weeks of imports), compared with a projected US$1 billion under the SMP. During the first four months of the fiscal year, gross official reserves fell sharply to a low of about US$500 million in November. Subsequently, they recovered markedly to above US$1.5 billion by end-August 1997 as corrective policies were put in place and access to foreign financing became more forthcoming. This was accompanied by a substantial reduction of the premium in the kerb foreign exchange market and recovery in the index of the Karachi Stock Exchange. Nevertheless, Pakistan's external position remained highly vulnerable in view of the large exposure on account of foreign currency deposits.

16. The official exchange rate of the rupee has been managed by the SBP on the basis of various criteria, including maintenance of competitiveness of the tradeable goods sector. Following slight depreciations in 1994/95–1995/96, the average real effective exchange rate of the Pakistani rupee depreciated further by 1 percent in 1996/97 (Chart 5). The REER index fell by 9.6 percent from June to November 1996 as the result of two devaluations (by 3.8 percent in September and by 8.5 percent in October); subsequently, it increased by 11.5 percent by June 1997. About half of the recent appreciation was due to the strengthening of the U.S. dollar against which the bilateral exchange rate of the rupee has been virtually unchanged over the last several months.

---

[14]The normal avenue for investing the rupee counterpart funds to foreign currency deposits is investment in short-term federal bonds. The rate of return on this type of investment averaged 17 percent in 1996/97, before a withholding tax of 35 percent.

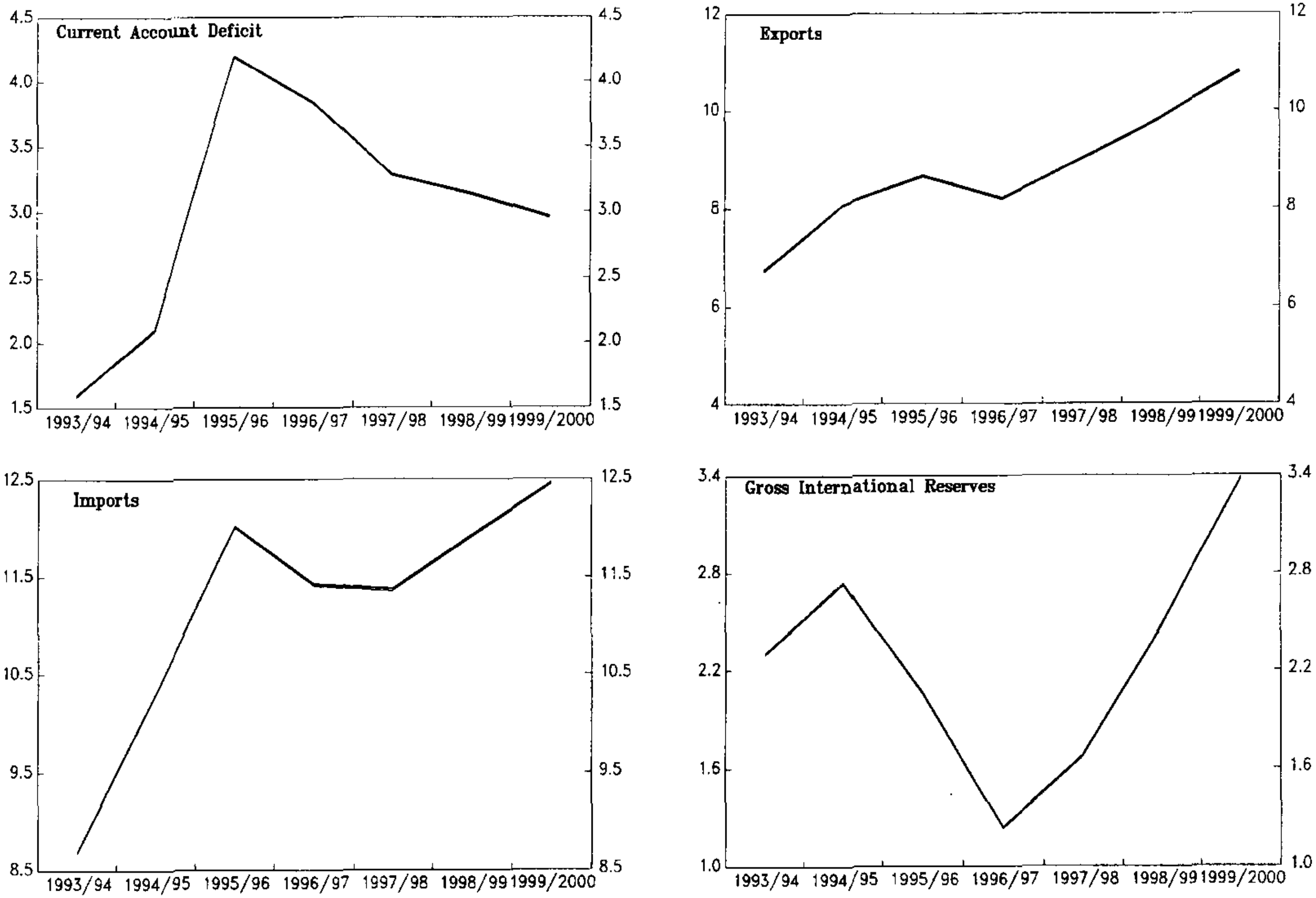
[15]Food imports declined by more than 12 percent in U.S. dollar terms reflecting a sharp reduction in imports of palm oil. Import volumes of raw materials and intermediate goods also declined, owing to sluggish activity in manufacturing and delays in import orders in anticipation of the customs tariff reform.

CHART 4

PAKISTAN

EXTERNAL SECTOR DEVELOPMENTS AND PROSPECTS, 1993/94-1999/2000

(In billions of U.S. dollars)



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

Table 5. Pakistan: Summary Balance of Payments, 1993/94–1997/98

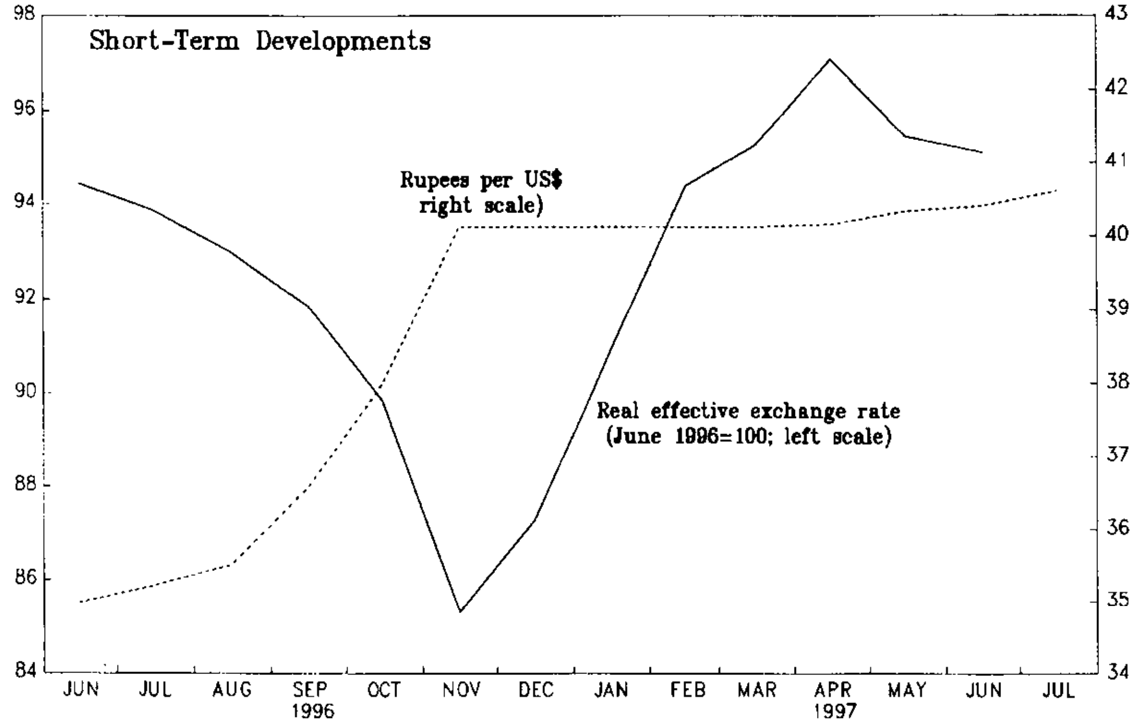
	1993/94	1994/95	1995/96	Prel. 1996/97	Prog. 1997/98
	(In millions of U.S. dollars)				
Current account before official transfers	-1,904	-2,413	-4,409	-4,092	-3,418
Trade balance	-1,940	-2,223	-3,363	-3,223	-2,364
Exports f.o.b.	6,745	8,074	8,652	8,195	9,004
Imports f.o.b.	-8,685	-10,296	-12,015	-11,418	-11,368
Services (net)	-2,354	-2,587	-3,437	-3,820	-3,649
Of which: interest payments	-1,270	-1,466	-1,624	-1,754	-1,849
Private transfers (net)	2,390	2,397	2,391	2,951	2,596
Of which: Workers' remittances	1,446	1,866	1,461	1,409	1,400
Official transfers (net)	314	312	214	255	135
Current account balance	-1,590	-2,101	-4,195	-3,837	-3,283
Capital account	3,173	2,348	3,746	2,813	3,523
Medium- and long-term capital	915	1,068	1,071	1,119	1,724
Project and nonproject loans	793	658	808	561	971
Commercial banks 1/	132	284	256	368	444
Other official capital	-10	126	7	190	309
Public sector short-term (net)	214	-471	135	26	104
Private medium- and long-term	1,438	1,844	1,683	1,347	1,745
Private short-term (including errors and omissions)	606	-93	857	321	-50
Overall balance	1,583	247	-450	-1,024	240
Financing	-1,583	-247	450	1,024	-240
Net international reserves (increase -)	-1,880	-349	414	1,189	-435
Use of Fund credit	297	102	36	-165	194
Memorandum items					
End-year gross official reserves 2/	2,302	2,741	2,053	1,238	1,673
(In weeks of c.i.f. imports)	12.6	12.7	8.2	5.2	7.0
	(In percent of GDP)				
Current account before official transfers	-3.6	-3.9	-6.8	-6.4	-5.1
Current account balance	-3.0	-3.4	-6.5	-6.0	-4.9
Exports f.o.b.	12.9	13.2	13.3	12.7	13.5
Imports f.o.b.	-16.6	-16.8	-18.5	-17.7	-17.1
External public debt	48.2	44.5	42.5	43.8	45.3
	(Annual percentage changes)				
Exports f.o.b.	-0.6	19.6	7.2	-5.3	9.9
Imports f.o.b.	-13.6	18.6	16.7	-5.0	-0.4
Export volume	-4.3	11.2	4.2	-0.8	10.2
Import volume	-10.3	6.1	11.3	-6.3	2.4
External terms of trade	6.6	-3.6	-1.7	-5.8	2.5

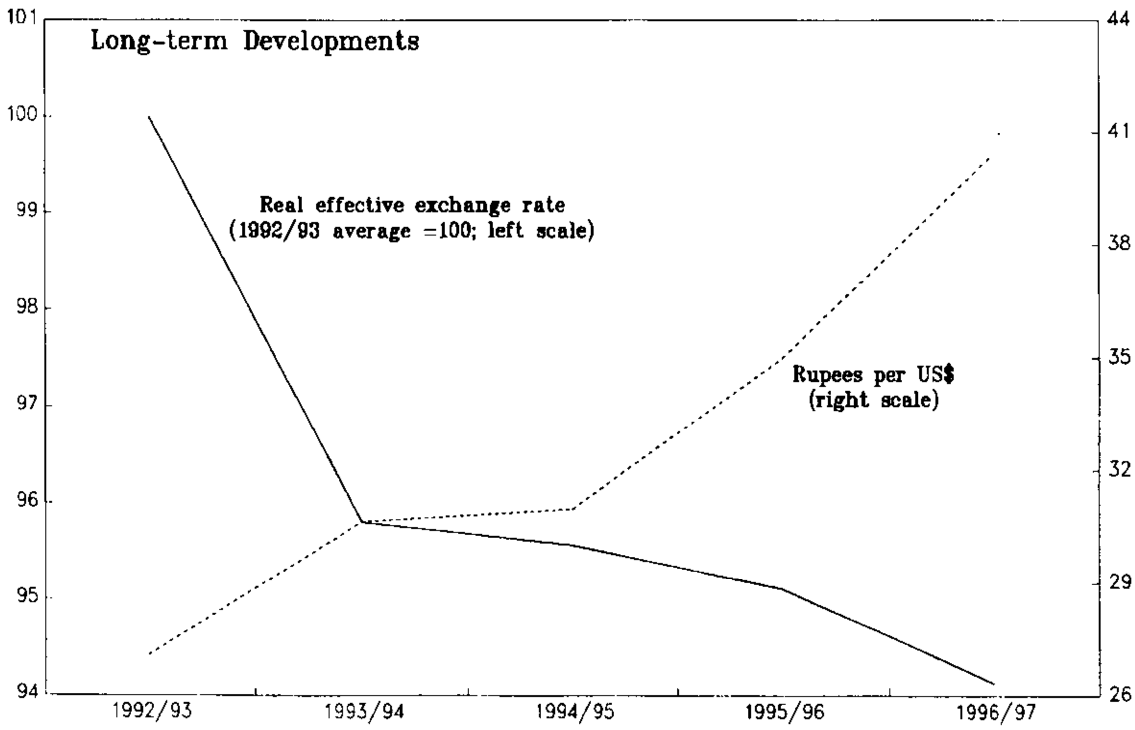
Sources: State Bank of Pakistan; Ministry of Finance, and Fund staff estimates.

1/ Includes loans from the Islamic Development Bank.
2/ Excluding gold.

CHART 5

PAKISTAN
EXCHANGE RATE DEVELOPMENTS, 1992/93-1996/97





Sources: International Monetary Fund, Information System; International Financial Statistics; and staff estimates.
An increase in the real effective exchange rate indicates an appreciation of the rupee.

IV. THE PROPOSED MEDIUM-TERM ADJUSTMENT AND REFORM PROGRAM

17. The proposed medium-term program incorporates a significant adjustment effort and progress on a broad range of structural reforms. Notwithstanding the relatively gradual improvement in financial balances, the adjustment effort is considerable as certain components of the structural reform program entail significant up-front costs. As regards the coverage of reforms, the program both builds on existing initiatives (such as the furthering of the tax reform process and banking sector reform) and breaks new ground, most notably in the areas of tax administration, government downsizing, public enterprise reform, and liberalization of the foreign exchange market.

A. Macroeconomic Framework

18. The macroeconomic program for the three-year period 1997/98–1999/2000 would seek to: (i) raise the annual growth rate of real GDP to the 5–6 percent range, reflecting initially the recovery of agricultural growth and industrial production, which would be subsequently reinforced by the impact of structural reform; (ii) progressively reduce annual inflation to about 7 percent; and (iii) reduce the external current deficit (excluding official transfers) to the range of 4.0–4.5 percent of GDP. The targeted reduction in the current account deficit, combined with the outlook for the capital account associated with multi-year Fund arrangements, would provide for a substantial strengthening of the external reserve position during the program period.

19. The key intermediate policy target would be a reduction in the overall budget deficit to 4.0 percent of GDP by the third year of the program, supplemented by improvements in the operating position of the major public enterprises. Annual monetary expansion would slow down within the 14–16 percent range, which would be consistent with a conservative assumption about the recovery in the demand for money that would result from declining inflation and regained confidence in the banking system. The recovery in money demand, together with further reductions in the domestic financing requirements of the budget, would create room for credit to the private sector to expand in line with the growth in nominal GDP. The structure of the budget and the composition of credit expansion would be consistent with a substantial increase in domestic investment, from about 18 percent of GDP in 1996/97–1997/98 to 19½ percent by 1999/2000, similar to the rates recorded during 1990/91–1993/94. Given the programmed current account path, this would imply a strengthening of national savings, particularly on account of higher public savings, from about 12 percent of GDP in 1996/97 to about 15 percent by 1999/2000. These policies would be supported by external sector policies directed mainly at diversifying Pakistan's tradeable goods sector and enhancing competitiveness.

20. In line with the understandings under the SMP, and consistent with the above macroeconomic strategy, the program for 1997/98 would seek to raise the growth rate of real GDP to 5.5 percent; reduce year-on-year inflation to 10.5 percent; and bring down the external current account deficit to 5.1 percent of GDP. The outlook for the capital account of the

balance of payments would allow for maintenance of gross official reserves (before disbursements and purchases from the Fund) at their end-June 1997 level of US$1.2 billion. To achieve these objectives, the budget deficit would be contained at PRs 148 billion (5.0 percent of GDP), the composition of net domestic asset expansion will be redressed in favor of the private sector, and the competitiveness of the tradeable goods sector would be enhanced. The end-September targets under the SMP have been incorporated as prior actions and end-September indicative targets under the 1997/98 economic program.

B. Fiscal Policy

21. Underlying the envisaged path for the overall budget deficit is a reduction in the current account deficit of the consolidated federal-provincial budget, from 2.7 percent of GDP in 1996/97 to 2.0 percent of GDP in 1997/98, and to 0.4 percent by 1999/2000. In 1997/98, the improvement in the current balance would be supplemented by a reduction in low-priority development expenditure (by 0.3 percent of GDP). The subsequent further strengthening in the current account would allow for a recovery in development expenditure to 3.6 percent of GDP by the third year of the program (compared with 3.4 percent of GDP in 1996/97). The fiscal path would imply a drop in the ratio of public debt to GDP to 65 percent by 1999/2000 (from 76 percent in 1996/97).

22. The improvement in the budgetary current account would result primarily from a containment of current expenditure, particularly in 1997/98, and a substantial strengthening in tax revenue in the second and third years of the program. The latter would reflect: (i) introduction of a transitional 3 percent turnover tax on traders in January 1998, with an option to pay the standard GST; (ii) removal of the exemptions for sugar and edible oils from the GST by end-June 1998;[16] (iii) phasing out the turnover tax and full extension of the standard GST to the retail stage by June 1999 for outlets beyond a minimum turnover threshold; (iv) expansion of the base of direct taxes, including to agriculture; and (v) improvements in tax administration. These measures would raise GST revenue by about 1 percent of GDP and direct tax revenue by about 0.7 percent of GDP over the program period, which would more than offset a projected decline in customs revenue to 3.1 percent of GDP in 1997/98 (from 3.4 percent in 1996/97) and to 2.7 percent of GDP by the third year. Nontax revenue would also increase, reflecting a projected strengthening in the financial position of public enterprises which would allow them to fully discharge their debt service obligations to the budget.[17]

23. Structural policy elements, relating mainly to the GST and income taxation, would play a key role in the above-described revenue scenario. With regard to the GST, important

---

[16]The government will consider further reductions in the coverage of exemptions from the GST with the 1998/99 and 1999/2000 budgets, including those for fertilizers and electricity.

[17]As of end-June 1997, the accumulated stock of debt service arrears vis-à-vis the federal budget had reached PRs 24 billion.

improvements were introduced in the 1997/98 budget, including unification of the rates into a single standard rate of 12.5 percent; compulsory registration of importers, wholesalers, and distributors; abolition of replacement invoices; effective extension of the GST to two major industries (textiles and steel); improved refund procedures; and strengthening of the legal provisions to deal with delinquent taxpayers, curb tax fraud, and minimize evasion. Looking ahead, key aspects relate to the extension of the GST to the retail sector; and to the possible inclusion of fertilizers and electricity in the GST net. On these points, the authorities explained that: (i) the transitional 3 percent turnover tax was necessary given the remaining "breaks in the invoicing chain" associated with the large and pervasive informal sector; the timing of its elimination by June 1999 (i.e., possible implementation at an earlier date) will depend on the evolution of revenue under the transitional regime as well as on dissemination of the use of invoicing;[18] and (ii) the exemptions for fertilizers and electricity will be reviewed in light of, respectively, the broader policy for the agricultural sector and the overall tax incidence on electricity (and the legal implications of its inclusion under the GST).[19]

24. With regard to income taxation, the concept of taxable income has been redefined to include prerequisites in kind, and certain deductions have been reduced; the recent reduction in personal and corporate income tax rates is expected to improve compliance. Looking ahead, the government will undertake a comprehensive review of the income tax system with a view to specifying steps aimed at increasing the yield and imparting simplification and neutrality; the recommendations emanating from this review, for which the government intends to request technical assistance from the Fund, would be implemented with the 1998/99–1999/2000 budgets. In addition, as detailed in the PFP, the recently enacted provincial agricultural income taxes will be harmonized by end-June 1998; and tax rates and exemptions will be adjusted by end-June 1999 to achieve a significant improvement in revenues in 1999/2000. However, the projected revenue contribution from this tax has been kept at a modest level for the program period given difficulties in assessing high enforcement costs and large numbers of low-income producers.

25. The revenue outlook also depends importantly on the ongoing efforts to strengthen tax administration. With regard to the GST, a registration enforcement program is being implemented which aims to reduce the number of nonfilers, from 30 percent currently to 15 percent by July 1998, and to 10 percent by July 1999. Moreover, 10–15 percent of the GST payers will be audited during 1997/98 and 20–25 percent will be audited during 1998/99 and subsequent fiscal years. Collection of a minimum amount of PRs 4.5 billion during 1997/98 under this audit program would constitute one of the structural benchmarks of the

---

[18]It is believed that the 3 percent turnover tax may create a strong incentive for retailers to voluntarily pay the standard GST depending on the provision of invoices by suppliers.

[19]According to a constitutional provision in Pakistan, services cannot be taxed under the VAT. Whether electricity can be classified as a good and be subject to the GST will require a clarification of the relevant constitutional provision.

proposed program. With regard to income tax, a Tax Audit and Investigation Unit will be established by December 1997. To promote integration of the tax system, an information exchange system encompassing the income tax, GST, and customs administrations is being designed and will be put in place shortly.

26. In the context of the SBA-supported program, the government adopted an automatic petroleum pricing mechanism in December 1995 whereby domestic prices were reviewed monthly and adjusted whenever the cumulative change in the rupee landed cost of imported oil since the last adjustment exceeded 3 percent. The purpose of the mechanism was to protect the budgetary revenue target for the petroleum development surcharge (which depends on the difference between the domestic price and the landed cost); to impart flexibility to domestic petroleum prices so that they more closely reflect changes in world oil prices; and to reduce the discretionary role of the government in the price-setting mechanism. Application of the mechanism for *declines* in the landed cost was suspended temporarily for revenue reasons (i.e., to raise the target for the development surcharge) in the context of the second review under the SBA (December 1996). More recently, the present government has imposed a temporary freeze on the domestic prices of petroleum products. However, under the proposed program, the Government is committed to reinstating the automatic pricing mechanism by December 1997 following a revision in which the possibility of moving to quarterly (rather than monthly) reviews will be considered. The first automatic adjustment will take place by March 1998 (if called for by the revised formula); in the interim, the government is committed to taking any action that may be necessary to protect the budgetary target for the petroleum development surcharge in 1997/98.

27. On the expenditure side of the budget, the decline in current outlays in relation to GDP would initially reflect a virtual freeze of all federal expenditure during 1997/98 at the nominal levels of 1996/97, except for interest payments and mandatory transfers to provinces. In particular, defense expenditure would decline to 4.6 percent of GDP (from 5.1 percent in 1996/97). Current expenditure would decline further in the second and third years of the program, albeit at a slower pace, as the result of restructuring of government ministries/ divisions and attached departments and autonomous bodies, reform of the civil service, further containment of unproductive expenditure, and better planning and monitoring of budgetary outlays.[20] Within the fiscal envelope, however, provincial current expenditure would increase from 4.3 percent of GDP in 1996/97–1997/98 to 4.5 percent of GDP by 1999/2000, thereby providing room for an increase in the outlays under the second phase of the Social Action

[20]Plans for restructuring the government will be prepared by June 1998 and phased in during 1998/99–1999/2000. A medium-term expenditure framework will be developed by March 1998 for use in preparing future budgets; and an action plan will be developed by June 1998, and implemented during 1998/99–1999/2000, to improve the quality and timeliness of information flows relating to public expenditures at both federal and provincial levels. An action plan for reforming the civil service will be prepared by June 1999, on the basis of which initial reform steps will be taken in 1999/2000.

Program to 2.4 percent of GDP a year during the program period (from 2.2 percent in 1996/97).[21] In order to ensure the effectiveness of the Public Sector Development Program (PSDP), a Core Development Program (CDP) of high-priority projects, developed in consultation with the World Bank and other donors, would be protected from any cuts in development spending that might become necessary during the course of the program.

28. Immediately upon taking office, the new government initiated a downsizing exercise to identify redundant organizations and staff, and devise a strategy to tackle the problem of surplus labor in the public sector in an economically viable and socially acceptable way. Failure in the past to design and implement such a strategy stood in the way of making further progress in the privatization agenda, and prevented an increase in pay and recruitment of more qualified staff for the civil service.[22] In the federal government, overstaffing equivalent to about 16 percent of existing employment has been identified.[23] The government announced in mid-August a scheme for downsizing federal ministries, attached departments, and public sector corporations. Under the scheme, employees have been offered golden handshakes or early retirement benefits on a voluntary basis.[24] It is expected that these packages will elicit a substantial response shortly. As detailed in Section IV.D, privatization proceeds will be used, on an exceptional basis and in consultation with the staff, to cover the cost of downsizing.[25]

29. The authorities' strategy is to supplement the budgetary adjustment with major improvements in the operations of the public enterprises. Consistent with this emphasis, a set of measures amounting to PRs 23.5 billion (0.8 percent of GDP) is being implemented, which

---

[21]Total public sector spending on health and education in Pakistan has averaged about 3.3 percent of GDP in recent years, of which about 2 percent of GDP fall under the SAP (which also includes outlays on the population program and on rural water supply and sanitation).

[22]The wage bill of the civil service amounts to less than 17 percent of current federal expenditure, and to 25 percent of provincial governments' current expenditure.

[23]The corresponding figures for public corporations and the three nationalized banks are 20 percent and 25 percent, respectively.

[24]Golden handshakes are offered to employees with service of up to ten years (three months' basic salary for each year of service). Early retirement schemes, including commutation benefits are offered to employees with more than ten years' service.

[25]The possibility of additional external financing for this purpose will also be explored; the authorities have requested technical assistance in this area from the World Bank.

is expected to reduce the enterprises' overall deficit to 1.8 percent of GDP in 1997/98.[26] These measures include: (i) capital expenditure cuts (PRs 8.7 billion); (ii) the increase in WAPDA's electricity tariffs implemented in late 1996/97, resulting in an average tariff 6.6 percent higher in 1997/98 than in 1996/97 (yield: PRs 4.6 billion); (iii) increase in the bulk rate of electricity tariff to the Federally Administered Tribal Areas (FATA) and to Azad-Jammu Kashmir (AJK), and metering of tubewells (with a combined yield of PRs 4 billion); (iv) a cut in generation and transmission losses in WAPDA and KESC (total yield: of PRs 4.2 billion); (v) increase in PTCL's installation fee and line rents (yield: PRs 1 billion); and (vi) increase in security deposits by customers for KESC (yield: PRs 1 billion). As part of the efforts to improve management, performance improvement arrangements between the government and WAPDA will be introduced by December 1997. The government will pursue further financial strengthening during the course of the program through expenditure containment, rationalization of tariff structures, and stepped-up efforts to collect overdue receivables. These policies, combined with the development and implementation of a strategy to rationalize employment, are expected to set the stage for privatization of several public enterprises during the program period.

C. Financial Sector Policies

30. The monetary program for 1997/98 envisages an increase in domestic liquidity amounting to 15.7 percent (compared with a projected nominal GDP growth of 17.1 percent). The implied continuation, in the period immediately ahead, of the trend towards higher velocity observed over the last three years (despite the programmed reduction in inflation and improvements in the banking sector) was felt to be warranted to provide an extra safeguard to the program's targets. Bank borrowing for budgetary support would be reduced to PRs 58 billion (from PRs 68.7 billion in 1996/97), of which no more than PRs 30 billion would come directly from the central bank (PRs 43.2 billion in 1996/97). This much lower pressure from the budget would facilitate the SBP's task of keeping net domestic credit expansion at 14.4 percent of the initial stock of domestic liquidity. Availability of credit to the private sector on a commercial basis is likely to be adequate as the authorities would continue to persevere with containment of credit under government-sponsored schemes. Also, the lower pressure from the budget would help the SBP reduce its recourse to various forms of moral suasion used in the past and to rely primarily on open market operations (and associated movements in interest rates) to control domestic liquidity expansion.[27] This will be facilitated by actions to improve the environment for the use of indirect instruments for monetary control. In this context, the government has started to reform the primary dealer system for government securities and it will expand the maturity structure of government papers by

---

[26]Under existing tariff structures and with an unchanged ratio of capital expenditure to GDP, the overall deficit of the seven key public enterprises would have widened to 2.6 percent of GDP in 1997/98 (from 2.1 percent in 1996/97).

[27]To signal this intention, the SBP has recently lowered the Statutory Liquidity ratio from 25 percent to 20 percent for banks; and from 19 percent to 14 percent for nonbank financial institutions.

introducing a three-month and a one-year treasury bills.[28] The operational procedures for open-market operations will be improved with a view to, inter alia, reducing short-term interest rate volatility in the interbank market.

31. One of the cornerstones of the structural reform program is financial sector reform. Deteriorating governance, lack of credit discipline, and overstaffing in the state-owned banks (which continue to dominate the market) have aggravated the financial problems in this sector. Specifically, they have led to rapidly eroding profitability, a weakening capital base, and a buildup of nonperforming loans to some 18 to 20 percent of outstanding bank credit, mainly to large defaulters.[29] In view of the crisis in the banking sector, the government has embarked on a far-reaching structural reform program encompassing enhancement of the authority and the ability of the SBP to regulate and supervise banks; improvement of the legal and judiciary processes for enforcing financial contracts; and privatization of the state-owned banks and financial institutions. In this context, as mentioned above, the government has already secured the enactment of legislation making the SBP the sole regulator and supervisory authority and—following the adoption of new mechanisms for appointing the management of the public sector banks—new managers have been appointed to head Habib Bank Limited and the National Bank of Pakistan. Also, important actions have been taken to deal with the nonperforming portfolio of banks. These include the above-noted enactment of a foreclosure law and an incentive package offered to defaulters to voluntarily repay their overdue loans without facing legal action under the new law, and with partial forgiveness of overdue interest.

32. Looking forward, the major challenge is to successfully restructure and privatize state-owned institutions within a strengthened supervisory and regulatory environment. Prior to privatization, loss-making branches will be closed, and staff reduced through voluntary separation in the context of a severance payment program.[30] The nonperforming assets that remain after vigorous recovery efforts will be removed by the government at the time of sale

---

[28]These securities will be issued on a discount basis to promote the development of the secondary market. The existing six-month government bond will be replaced by a discount-based paper of the same maturity.

[29] The largest 250 defaulters accounting for some 70 percent of the total amount of defaults.

[30]The downsizing of the state-owned banks and nonbank financial institutions is expected to be financed by a US$200 million banking sector adjustment loan from the World Bank, with co-financing from the Japanese Government (OECF).

so as to restore the net worth of these institutions to zero.[31] The SBP will reach an understanding with the private investors purchasing these banks on a timeframe for bringing their capital to BIS standards. Also, in order to increase competition in the banking system, the *government is considering splitting the nationalized commercial banks, especially* Habib Bank Limited, rather than selling them as single banks. Moreover, prudential regulations will be made consistent with international norms;[32] and an early warning system and on-site and off-site supervision mechanisms will be strengthened. A comprehensive technical assistance program focusing on banking regulation/supervision and bank privatization is being provided under an ongoing World Bank project. Moreover, the government would implement during the course of the program, with the technical and financial assistance from the Asian Development Bank, capital market reforms directed at eliminating market distortions, strengthening market regulation and supervision, modernizing and upgrading the securities market infrastructure, and improving investment alternatives and efficiency of market participants.

D. External Sector Policies

33. The above-described fiscal and monetary policies, the structural and sectoral policies discussed below, and an exchange rate policy directed at ensuring competitiveness for Pakistan's tradeable goods sector would reduce the external current account deficit to 5.1 percent of GDP (before official transfers) in 1997/98, and further to 4.2 percent of GDP by 1999/2000. Annual export growth is projected to average 9 percent in U.S. dollar terms during the program period, faster than in the last two years but in line with the export growth trend of the early 1990s. This would be driven by an expected recovery of traditional exports such as raw cotton, cotton yarn, and textile products and a rapid expansion of nontraditional exports. By contrast, import growth will be contained in the first year of the program, in spite of the reduction in effective protection in the economy, as buoyant imports by the private sector will be offset by a strong downward adjustment in the volume of public sector imports; following this correction, imports are projected to grow broadly in line with real GDP growth.

34. The current account deficit will be covered mainly by multilateral and bilateral financing in support of the structural reforms, as well as substantial amounts of medium- and long-term

---

[31]The medium-term macroeconomic projections have been prepared on the assumption that PRs 60 billion in government securities would be issued to banks in 1998/99 for this purpose. The agreement with the World Bank under the proposed banking sector loan contemplates that modalities of financial restructuring, which would replace bad assets net of reserves and capital with good assets by the government, will be consistent with the agreed macroeconomic framework. The current medium-term fiscal projections have been prepared assuming the upper bound of a range for the expected restructuring costs.

[32]Compliance by banks and nonbank financial institutions with the new capital adequacy standards will be phased in starting by December 1997 and ending by June 2000.

capital inflows. In 1997/98, official financing would increase substantially with the envisaged disbursement of US$900 million in balance of payments support from multilateral and bilateral sources. Gross private inflows would total US$7.1 billion over the program period, compared with US$6 billion in the last three years. This figure includes a number of foreign direct investment projects such as power plants, chemical plants, and petroleum refineries, and privately operated highways; such investments would total US$3.8 billion over the program period. Private inflows over the three-year period also include US$1.2 billion of net portfolio investment, a realistic assumption in view of the renewed interest of foreign investors in Pakistan over the last six months (as indicated by the recent performance in the Karachi Stock Exchange).[33] In 1997/98, short-term external financing would contribute at positive but modest levels, reflecting an additional net inflow of nonresidents' foreign currency deposits which would be reversed by the third year of the program.

35. The proposed program includes important reforms in the external sector policy area, comprising trade liberalization, exchange market reforms, and reduced reliance on exchange rate guarantees for foreign currency deposits. As regards trade liberalization, the government has already taken, as noted, the important step of lowering the maximum tariff rate to 45 percent, simplifying the tariff structure, and eliminating the 10 percent regulatory duty for most imports. This has led to a reduction in the average tariff rate, from 18.2 percent to 16.6 percent, which is projected to result in a revenue loss equivalent to 0.5 percent of GDP per year. The authorities are committed to moving further along the path of tariff reduction during the course of the program by lowering the maximum tariff rate to the range of 30–35 percent by June 1999. During the discussions, the authorities explained that the decision as to the precise timing for achieving this objective and the number of tariff reform steps (whether one or two) would take into account the evolution of budgetary revenue, in particular the need for synchronization with progress on the GST front.[34] The reduction in the maximum tariff would be implemented along with further simplification in the tariff structure to four or five slabs (from six currently). Furthermore, in the context of the first review, agreement would be reached on a timetable for phasing out remaining quantitative restrictions on imports which are not attributable to health, safety, social, national security, religious, or environmental considerations.

36. The envisaged exchange market reform is designed to sharply increase the volume of transactions among banks and to de-emphasize the role of the SBP in the foreign exchange

---

[33]The balance of payments projections do not include the proceeds from sales of public enterprises and financial institutions to foreign investors.

[34] Specifically, while a single-step reduction in the maximum tariff to the targeted range would minimize the administrative costs of the tariff reform, the accompanying large loss of revenue would pose a challenge from the standpoint of fiscal management; accordingly, the authorities will consider an intermediate step in 1998 which would smooth out the required response on the domestic tax side.

market. Such a deepening of the interbank market is envisioned to enhance banks' ability to provide forward cover, thereby opening the way for a gradual exit from the official forward cover scheme for foreign currency deposits—a top priority in view of the large stock (about US$10 billion) under official cover and the constraints on exchange rate policy created by the exchange rate guarantees under the scheme. The authorities have endorsed the recommendations of the Fund technical assistance mission which recently reviewed these issues and, in the context of the first review, they will agree on a timetable for implementing the following recommendations aimed at imparting depth to the interbank market: (i) phasing out the surrender requirement for export earnings (while maintaining the repatriation requirement); (ii) widening the buy/sell margin for SBP operations; (iii) ending the practice of fixing daily buy/sell spot market prices of banks; and (iv) increasing banks' uncovered position limits for foreign exchange.[35] Concurrently with the development of the market infrastructure, incentives will be created for banks to rely increasingly on alternatives to the official forward cover scheme, including: (i) authorizing banks to provide forward cover for nontrade transactions; (ii) issuing, by March 1998, a marketable foreign currency bond, while allowing banks to cover a portion of their foreign currency deposit liabilities by investing in the new foreign currency bond; and (iii) progressively raising the SBP's forward cover fee (currently 5 percent per annum for U.S. dollar deposits) during the course of the program.

37. The development of the interbank market will provide for an increasing role of market forces in the determination of the exchange rate. The authorities have provided assurances that, in the interim period until this reform takes root, they will manage the exchange rate in a manner that enhances the competitiveness of Pakistan's tradeable goods sector. In addition to ensuring a competitive exchange rate, the authorities are developing a targeted export promotion strategy, including improvements in the duty drawback mechanism, as well as in the temporary importation and bonded manufacturing schemes.[36] In their discussion with the staff, the authorities also emphasized their belief that export growth would depend, as well, on the opening of foreign markets in terms of quotas and other nontariff barriers.[37] In this regard, they noted that a more efficient system of quota management would be gradually

---

[35]In preparation for these steps, banks' nostro account limits will be increased by at least 15 percent by March 1998.

[36]Under such schemes, exporters are allowed to hold tax and duties on imported inputs in suspense until the associated exports have taken place. The eligibility and operating requirements for such schemes will be simplified to encourage their greater use.

[37]With respect to textile products, the agreement on Textile and Clothing (ATC) provides for the phasing out of quotas by 2004 in Pakistan's main markets (the United States and the European Union). Implementation of the ATC is also expected to lead to a reduction in antidumping and safeguard actions by industrialized countries; such actions are believed to have substantially affected Pakistan's export performance over the last two years.

implemented, with a view to fostering an increase in the proportion of high value-added exports under the existing quantitative restrictions in Pakistan's export markets.

38. Pakistan's large foreign exchange exposure on account of uncovered *foreign currency deposits* (FCDs) remains a major concern. Even assuming full implementation of the above-described adjustment and reform measures, it will take some time for Pakistan to work itself out of a vulnerable position. As noted, the program seeks to achieve progress through: (i) the strengthening of monetary conditions to shift resident portfolio preferences toward domestic currency instruments; (ii) a reduction in the need to attract nonresident FCDs (or what the authorities have viewed as a convenient form of short-term borrowing) through a reduction in the financing requirement; (iii) the development of private provision of forward cover as the State Bank of Pakistan prices itself out of this function (which currently involves large quasi-fiscal costs). In the interim, the vulnerability would be countered somewhat by the programmed increase in foreign exchange reserves and attempts to gradually lengthen maturities. Notwithstanding all these factors, and given the magnitude of the problem, the stock of foreign currency deposits will pose a risk for Pakistan for the coming period.

E. Supply Side, Social, and Environmental Policies

39. To expand the role of the private sector, the government is fully committed to accelerating the privatization program during 1997/98–1999/2000. The next phase of the program is ambitious, covering the industrial and financial sectors, power and gas, railways, and telecommunication. The authorities are of the view that the program targets are necessary for promoting efficiency, improving governance, insulating the financial system from political interference, deepening financial intermediation, and encouraging competition. Nevertheless, the authorities recognize the downside risks associated with the market's limited absorptive capacity given the large number of transactions and the overall size of the assets.[38] As an appropriate regulatory framework is viewed as essential for moving to a larger scale of privatization, the government will work to strengthen the core infrastructure regulatory bodies with technical assistance from the World Bank. Attention is also being devoted to addressing the labor-related aspects of privatization in a manner that protects the marketability of assets. Privatization proceeds will continue to be deposited in special (extrabudgetary) government accounts with the SBP and, under the program, they will be subject to a regime aimed at avoiding expenditure levels that would be inconsistent with the underlying budgetary trends;

[38]The bulk of privatization proceeds is expected to come from abroad. Preliminary estimates indicate that the potential net inflows could reach up to US$2.5 billion during the program period. As discussed below, the program design seeks to ensure that privatization proceeds are used to build up additional official reserves, which would facilitate the envisaged liberalization of the foreign exchange rate market and the exit from the forward cover scheme for foreign currency deposits.

protecting the monetary program; and ensuring that external privatization inflows do not lead to a relaxation of the efforts at strengthening the external accounts.[39]

40. The PFP details the government's policies with respect to agriculture, energy, transportation, and water supply and sewerage. Broadly, the government's strategy is to limit the role of the public sector, shift management responsibility to the private sector, and strengthen local capacity. In the agricultural sector, management of the provincial irrigation and drainage systems will be decentralized; and the government control over imports of fertilizers, the subsidy on wheat imports, and the remaining restrictions on imports and exports of agricultural commodities will be phased out. In the energy sector, the reform agenda would focus on accelerating the restructuring and privatization program of the power and gas utilities in the context of an effective regulatory regime; adopting more appropriate pricing policies; and continuing to encourage private sector participation in new energy supply facilities. In the transportation sector, an institutional framework is being developed to encourage greater private sector investment and establishment of an adequate source of funding for road maintenance, based primarily on enhanced road user charges; with respect to railways, institutional changes will be implemented with a view to preparing the ground for privatization. Foreign investment will be encouraged in the area of water supply and sewerage systems.

41. Public expenditures on social sectors under the second phase of the Social Action Program (SAP) are projected to rise from an annual average of 2 percent of GDP over the last three years to at least 2.4 percent of GDP a year during the program period. This admittedly modest increase reflects an emphasis on ensuring adequate quality of the basic services and maximum effectiveness of the budgetary allocations. The highlights of the program are: (i) in the education sector, development and implementation of a teacher redeployment plan with the objective of reducing the inequality of teacher-student ratios within each province/federal area and achieving efficiency gains and reductions in unit costs; and provision of incentives for greater community, NGO, and private sector participation; (ii) in the health area, strengthening of basic health care services at the community level, including an increase of female staff in family planning services; and (iii) in the population area, the management and effectiveness of the Population Welfare Program will be improved; budgetary allocations will be increased

---

[39]Specifically: (i) privatization proceeds will continue to be excluded from the concept of budgetary revenue; (ii) any use (withdrawal) of privatization proceeds would trigger a downward adjustment to the ceiling on bank budgetary support (and to the subceiling on direct budgetary support from the SBP); and (iii) external inflows on account of privatization would trigger commensurate upward adjustments to the floors on the SBP's net foreign assets (with a corresponding downward adjustment to the ceilings on net domestic assets). However, the program provides for an exception to (i) and (ii) when privatization proceeds are used, in consultation with the staff, to finance the costs associated with the restructuring/downsizing of the government and public enterprises.

significantly in real terms; and the private sector and NGO's roles in provision of family planning services will be facilitated and expanded. Satisfactory implementation of the SAP will constitute a structural benchmark under the program, to be monitored on the basis of an indicator that has been developed specifically for this purpose by World Bank staff.

42. A multifaceted strategy will be undertaken by the government to minimize potential social costs of reforms in the shortrun and strengthen the social safety net. First, by insulating SAP and high-priority public investments from expenditure cutbacks, the government expects to maintain the level of basic social services provided to the poor. Second, the government has established the Pakistan Poverty Alleviation Fund to mobilize and assist poor communities in developing income-generating activities through human resource development and micro-credit programs. Third, the government has carried out a review of existing public sector safety nets, based on which it will ensure more adequate and better targeting of the most vulnerable groups among the poor. The government will seek technical and financial assistance from the donor community to finance severance packages for compensation and retraining of workers affected by the restructuring exercises.

43. One of the key enabling conditions for a sustainable increase in the pace of economic growth in Pakistan is improved environmental protection. The major sources of concern are the limited capacity of the provincial Environmental Protection Agencies to enforce the National Environmental Quality Standards and other provisions of the Environmental Protection Ordinance; and the absence of a pollution control scheme at the national level. Against this background, the following steps will be taken over the program period: (i) enactment of the Environmental Protection Law; (ii) development of provincial capabilities for enforcement, including development of systems for enforcing pollution controls and assessing pollution's environmental impact; and (iii) implementation of popular environmental awareness programs.

F. Governance

44. As noted, governance has emerged as an increasingly important policy issue for Pakistan. The actions taken in recent months to address this issue have included: (i) strengthening of the accountability process; (ii) abolition of block budgetary allocations at the federal and provincial levels; (iii) termination of quotas such as those for public sector employment, plots of land, and access to educational institutions; and (iv) tax reforms which promote documentation and reduce the scope for discretion by tax officials. Looking ahead, the government will implement the following steps designed specifically to improve governance: (i) ensuring effective law and order; (ii) strengthening transparent and competitive procurement practices to promote competition; (iii) promoting greater accountability of public service providers to the beneficiaries and communities by involving NGOs and encouraging community participation; (iv) enhancing the efficiency of the civil service; and (v) strengthening the legal and judicial system. In addition, the planned management improvements and restructuring of the government, public enterprises, and public financial institutions—along with the privatization program and accompanying development of

Table 6. Pakistan: Medium-Term Balance of Payments,1996/97-2001/02

	Prel. 1996/97	Prog. 1997/98	Prog. 1998/99	Prog. 999/2000	Proj. 2000/01	Proj. 2001/02
	(In millions of U.S. dollars)					
Current account before official transfers	-4,092	-3,418	-3,327	-3,147	-3,063	-2,974
Trade balance	-3,223	-2,364	-2,072	-1,663	-1,357	-1,118
Exports f.o.b.	8,195	9,004	9,844	10,796	11,815	12,915
Imports f.o.b.	-11,418	-11,368	-11,917	-12,458	-13,172	-14,033
Services (net)	-3,820	-3,649	-3,853	-4,076	-4,281	-4,461
Of which : interest payments	-1,754	-1,849	-1,991	-2,179	-2,308	-2,376
Private transfers (net)	2,951	2,596	2,598	2,591	2,574	2,606
Of which : Workers' remittances	1,409	1,400	1,600	2,000	2,400	2,800
Official transfers (net)	255	135	188	188	188	188
Current account balance	-3,837	-3,283	-3,139	-2,959	-2,875	-2,786
Capital account	2,813	3,523	3,612	3,493	3,589	3,544
Medium- and long-term capital	1,119	1,724	1,901	1,856	1,885	1,901
Project and nonproject loans	561	971	1,168	1,230	1,254	1,257
Commercial banks 1/	368	444	383	226	181	145
Other official capital	190	309	350	400	450	500
Public sector short-term (net)	26	104	0	0	0	0
Private medium- and long-term	1,347	1,745	1,873	1,956	2,222	2,361
Private short-term (including errors and omissions)	321	-50	-162	-320	-519	-719
Overall balance	-1,024	240	473	534	714	758
Financing	1,024	-240	-473	-534	-714	-758
Net international reserves (increase -)	1,189	-435	-810	-900	-450	-600
Use of Fund credit	-165	194	336	366	-264	-158
Memorandum items						
End-year gross official reserves 2/	1,238	1,673	2,483	3,383	3,833	4,433
(In weeks of c.i.f. imports)	5.2	7.0	10.0	13.0	13.9	15.1
	(In percent of GDP)					
Current account before official transfers	-6.4	-5.1	-4.8	-4.2	-3.8	-3.4
Current account balance	-6.0	-4.9	-4.5	-4.0	-3.5	-3.1
Exports f.o.b.	12.7	13.5	14.2	14.4	14.5	14.6
Imports f.o.b.	-17.7	-17.1	-17.2	-16.7	-16.2	-15.8
External public debt	43.8	45.3	46.7	46.2	44.4	42.8
	(Annual percentage changes)					
Exports f.o.b.	-5.3	9.9	9.3	9.7	9.4	9.3
Imports f.o.b.	-5.0	-0.4	4.8	4.5	5.7	6.5
Export volume	-0.8	10.2	7.5	7.8	7.8	7.9
Import volume	-6.3	2.4	6.4	3.6	4.5	5.2
External term trade	-5.8	2.5	3.3	0.8	0.3	0.0

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

1/ Includes loans from the Islamic Development Bank.

2/ Excluding gold.

appropriate regulatory frameworks—are expected to contribute significantly to improvements in governance.

V. MEDIUM-TERM OUTLOOK AND CAPACITY TO REPAY THE FUND

45. The baseline balance of payments scenario for the next five years (Table 6) has been developed on the basis of the following macroeconomic assumptions beyond the program period: further strengthening in real GDP in the 6–7 percent range and decline in inflation to the 5–6 percent range; continued fiscal adjustment; maintenance of a competitive exchange rate; and consolidation of the structural reform achievements envisaged in the PFP. The scenario shows a further steady improvement of Pakistan's external position and progress toward external viability. Export volume growth would be sustained in excess of 8 percent per year (9 percent in U.S. dollars terms) while the path of import volume would be in line with real GDP growth. Private transfers are projected to increase only marginally. Reflecting these trends, the current account deficit before official transfers would narrow, from 6.4 percent of GDP in 1996/97 to 4.2 percent in 1999/2000 and 3.4 percent by 2001/02.

46. Annual net capital inflows would be in the range of US$3.4–3.6 billion over the six-year period. It is assumed that close to US$2 billion per year will come from net official assistance, including some balance of payment support (albeit at a declining rate) during the three years following the program period. Concerning private flows, the stabilization program, and the implementation of reforms aimed at providing an environment conducive to private sector development, would provide the basis for an increase in foreign direct and portfolio investment. At the same time, the gradual phasing out of the SBP forward cover scheme would discourage inflows of nonresidents' foreign currency deposits. Reflecting these trends, gross official reserves would increase to the vicinity of 15 weeks of imports by 2001/02. The scenario suggests that after reaching a peak in 1998/99 at 46.7 percent of GDP, Pakistan's stock of public and publicly guaranteed external debt would gradually decline to 42.8 percent of GDP by 2001/02 (Table 7).

47. Pakistan's external prospects nevertheless remain vulnerable to the high concentration of export earnings in cotton manufactures (some 60 percent in 1996/97). To illustrate the vulnerability of the balance of payments outlook to less favorable external developments, the staff has developed an alternative scenario based on lower growth for exports of cotton manufactures (by 1 percent each year), which might arise from reduced world demand for textile products or continued protectionist measures in major markets. Under these conditions, the current account deficit would narrow to 3.8 percent of GDP by 2001/02 which, on the assumption of an invariant outcome in the capital account, would imply a smaller increase in gross official reserves, to the range of 11–12 weeks of imports.

48. As noted, the authorities are requesting a total access to Fund resources of about SDR 1.14 billion (150 percent of Pakistan's quota), of which SDR 682.38 million (90 percent of quota) would be provided under ESAF arrangements and SDR 454.92 million (60 percent) under an extended arrangement (Table 8). The proposed access, which is about the average of

Table 7. Pakistan: Summary of External Debt and Debt Service, 1993/94–2001/02

	1993/94	1994/95	1995/96	Prel. 1996/97	Prog. 1997/98	Prog. 1998/99	Prog. 1999/2000	Proj. 2000/01	Proj. 2001/02
				(In millions of U.S. dollars)					
Total public and publicly guaranteed external debt	25,210	27,214	27,557	28,205	30,155	32,378	34,587	36,194	37,924
Long-term	22,568	24,448	24,552	25,625	27,276	29,164	31,007	32,878	34,765
Project and nonproject aid	20,333	22,117	22,275	23,096	24,277	25,596	26,926	28,230	29,516
Commercial banks and IDB	260	543	799	1,167	1,611	1,994	2,220	2,401	2,546
Other	1,975	1,788	1,478	1,362	1,388	1,574	1,861	2,247	2,703
Short-term	1,235	1,256	1,466	1,260	1,364	1,364	1,364	1,364	1,364
Commercial banks and IDB	724	716	990	832	995	1,054	1,113	1,172	1,231
FEBCs and DBCs	511	540	476	428	369	310	251	192	133
Use of Fund resources	1,408	1,510	1,539	1,320	1,514	1,850	2,216	1,952	1,794
Service of medium- and long-term public and publicly guaranteed debt	2,461	2,758	3,192	3,617	3,378	3,490	3,736	3,845	3,870
Of which : to the Fund	120	163	289	367	285	253	337	318	209
Amortization	1,627	1,854	2,217	2,641	2,417	2,455	2,603	2,608	2,552
Of which : to the Fund	79	113	241	317	241	208	287	264	158
Interest	834	905	975	976	961	1,035	1,133	1,237	1,318
Of which : to the Fund	41	50	48	50	44	45	50	54	50
Interest on public and publicly guaranteed short-term debt	65	67	77	82	120	116	116	114	113
				(In percent of GDP)					
Total public and publicly guaranteed external debt	48.2	44.5	42.5	43.8	45.3	46.7	46.2	44.4	42.8
Long-term	43.2	40.0	37.9	39.8	40.9	42.1	41.5	40.3	39.2
Of which : project and nonproject aid	38.9	36.2	34.4	35.9	36.4	36.9	36.0	34.6	33.3
Short-term	2.4	2.1	2.3	2.0	2.0	2.0	1.8	1.7	1.5
Use of Fund resources	2.7	2.5	2.4	2.1	2.3	2.7	3.0	2.4	2.0
Service of medium- and long-term public and publicly guaranteed debt	4.7	4.5	4.9	5.6	5.1	5.0	5.0	4.7	4.4
Amortization	3.1	3.0	3.4	4.1	3.6	3.5	3.5	3.2	2.9
Interest	1.6	1.5	1.5	1.5	1.4	1.5	1.5	1.5	1.5
Interest on public and publicly guaranteed short-term debt	0.1	0.1	0.1	0.1	0.2	0.2	0.2	0.1	0.1
		(In percentage of exports of goods and services, and net private transfers) 1/							
Total public and publicly guaranteed external debt	231.8	217.4	213.5	217.8	222.7	222.4	220.3	214.1	207.9
Of which : Fund credits and loans	12.9	12.1	11.9	10.2	11.2	12.7	14.1	11.6	9.8
Service of medium- and long-term public and publicly guaranteed debt	22.6	22.0	24.7	27.9	24.9	24.0	23.8	22.7	21.2
Of which : to the Fund	1.1	1.3	2.2	2.8	2.1	1.7	2.1	1.9	1.1
Amortization	15.0	14.8	17.2	20.4	17.8	16.9	16.6	15.4	14.0
Of which : to the Fund	0.7	0.9	1.9	2.4	1.8	1.4	1.8	1.6	0.9
Interest	7.7	7.2	7.6	7.5	7.1	7.1	7.2	7.3	7.2
Of which : to the Fund	0.4	0.4	0.4	0.4	0.3	0.3	0.3	0.3	0.3
Interest on public and publicly guaranteed short-term debt	0.6	0.5	0.6	0.6	0.9	0.8	0.7	0.7	0.6

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

1/ Private transfers consists mainly of worker remittances.

Tabel 8. Pakistan: Fund Position, 1996/97–1999/2000

	Prel. 1996/97	Proj. 1997/98	Proj. 1998/99	Proj. 1999/2000	Total 1997/98– 1999/200
	(In millions of SDRs)				
Transactions under ESAF/EFF and Stand-by Arrangements (net)	36.3	104.6	203.1	220.2	527.9
Disbursements	294.7	303.3	379.1	454.9	1,137.30
ESAF arrangements	--	227.5	227.5	227.5	682.4
EFF arrangements	--	75.8	151.6	227.5	454.9
Stand-by arrangements	294.7	--	--	--	--
Repayments	258.4	198.7	176	234.7	609.4
Principal	223.9	167.9	144.6	200.0	512.5
Charges and interest	34.5	30.8	31.4	34.7	96.9
Total Fund credit outstanding at the end of period	946.5	1,081.9	1,316.4	1,571.3	1,571.3
Memorandum item					
Total Fund credit outstanding at the end of period (In millions of U.S. dollars)	1,320	1,553	1,889	2,255	2,255

Source: IMF, Treasurers' Department; and Fund staff estimates.

recent access by countries undertaking important reforms, would be justified in this particular case by the scope of the structural reform agenda; the financing requirements associated with certain structural elements of the program, including the tariff reform and the envisaged actions to restructure/downsize public enterprises and financial institutions; and the need to build up a cushion of gross official reserves in view of Pakistan's large uncovered foreign currency deposit liabilities. The need for a reserve cushion is accentuated by the fact that the authorities are about to embark on a strategy to exit from the provision of forward cover for foreign currency deposits (which might cause capital outflows) and to develop an interbank foreign exchange market (which will require greater capacity to intervene in the market to smooth out short-term volatility). The proposed blend of ESAF and EFF resources would be consistent with Pakistan's capacity to repay nonconcessional resources given the size of its economy and its relative large access to private capital markets.[40] The staff believes that Pakistan should not encounter difficulties in fulfilling its debt service obligations to the Fund, given the projected improvement in its external position and the low debt service to the Fund as a percentage of exports and reserves throughout the repayment period (Table 9). In addition, Pakistan has an excellent record in servicing its debt obligations, including those to the Fund.

VI. Statistical and Technical Assistance Issues

49. 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 assessments of economic developments and to form a perspective on medium-term prospects. The authorities are responsive to data requests and they report to the Fund, on a monthly basis, the monetary statistics 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 a one-day lag. Despite good provision of statistics, data deficiencies remain, notably long lags for data on the provincial budgetary operations and methodological shortcomings in estimating certain GDP components in the national accounts. The data provision and coverage can also be improved by compiling and reporting, on a regular basis, the financial positions of public enterprises.[41]

50. The Pakistan authorities expect to benefit from wide-ranging technical assistance from the Fund and other multilateral institutions during the program period. Technical assistance from the Fund will be requested for: (i) undertaking a comprehensive review of the income tax system; (ii) improving tax administration; (iii) developing a data base for monitoring public enterprises; (iv) reforming the primary dealer system for government securities and implementing exchange market reforms; (v) improving the compilation of, and reporting requirements for, the monetary statistics; and (vi) addressing remaining deficiencies in the

---

[40]It would also be consistent with the medium-term lending program of the World Bank, which includes both IBRD loans and IDA credits.

[41]Statistical issues are reviewed in greater detail in Appendix VI.

Table 9. Pakistan: Indicators of Fund Credit, 1996/97–2006/07

	1996/97	Program			Projections						
		1997/98	1998/99	1999/20000	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07
Outstanding Fund Credit											
In millions of U.S. dollars	1,320	1,553	1,889	2,255	1,991	1,833	1,740	1,646	1,436	1,148	843
In percent of:											
Quota	124.8	142.7	173.6	207.2	183.0	168.4	159.9	151.2	132.0	105.5	77.5
GDP	2.1	2.3	2.7	3.0	2.4	2.1	1.8	1.5	1.2	0.9	0.6
Exports 1/	10.2	11.5	13.0	14.4	11.8	10.0	8.8	8.8	7.1	5.2	3.5
Public and publicly guaranteed debt	4.7	5.1	5.8	6.5	5.5	4.8	4.4	4.0	3.4	2.7	1.9
Debt service to the Fund											
In millions of U.S. dollars	367	285	253	337	318	209	140	128	240	313	324
In percent of:											
Exports 1/	2.8	2.1	1.7	2.1	1.9	1.1	0.7	0.7	1.2	1.4	1.3
Gross official reserves	29.7	17.0	10.2	10.0	8.3	4.7	2.8	2.2	3.7	4.2	3.8

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

1/ Exports of goods, nonfactor services, and net private transfers.

economic data base of Pakistan, particularly in the area of national accounts. Technical assistance from the World Bank would focus on: (i) studying the various options for improving the agricultural income tax; (ii) developing operational plans to improve the quality and timeliness of information flows relating to public expenditure; (iii) preparing a program of civil service reform; (iv) developing safety net programs to address the effects of restructuring in the public sector; (v) developing management information systems for public enterprises; (vi) strengthening banking regulation and supervision; (vii) implementing the privatization program, including as regards financial institutions; (viii) strengthening the regulatory bodies for core infrastructure; and (ix) improving the institutional support for exporters. Technical assistance from the ADB would be directed at reforming pension and provident funds; reforming the insurance industry; and restructuring the public sector mutual funds.

VII. Developments in Early 1997/98 [42]

51. Developments in July–August 1997 were broadly consistent with the program. Specifically, gross official reserves have fluctuated within the range of US$1.2–1.5 billion, the premium in the kerb foreign exchange market has remained at about 2 percent, and the index of the Karachi Stock Exchange has remained broadly stable following a strong recovery in July. Monetary developments have also been in line with the program, with bank borrowing by the budget well below the September target under the SMP. However, concerns arose regarding the risks to the fiscal program. Specifically, while expenditure and total tax revenue were on track, customs duty and GST collections showed a shortfall of PRs 3 billion (0.1 percent of GDP) vis-à-vis the budgeted path. In view of the importance of these key taxes for meeting the overall fiscal target for 1997/98, the authorities have committed to taking the following corrective measures: (i) to reinforce a recent reduction in the duty drawback (in line with the reduction in customs tariffs) by a further reduction during the course of the second quarter (to correct certain anomalies in the structure of drawback rates); and (ii) to apply the GST at the retail stage beyond the 13 urban main centers for certain products (including automobiles, electronics, bicycles, and motorcycles). These incremental revenue measures (including the already implemented first phase of reduction in drawbacks) would yield PRs 5.5 billion for the remainder of the fiscal year. This, together with the overperformance of other taxes (mainly in petroleum surcharges) should be sufficient to ensure that the overall revenue target for 1997/98 is met. Moreover, the government has taken the decision to step up its tax administration effort by restructuring the Central Board of Revenue.

VIII. Staff Appraisal

52. Over the past several years, repeated attempts by the Pakistan authorities to address the country's macroeconomic imbalances and deep-rooted structural problems have been frustrated by slippages in policy implementation. These setbacks have entailed high costs in

[42] The staff will be providing additional information on developments in early 1997/98 in a supplement to this report to be issued prior to the Executive Board meeting.

terms of lower growth and employment, chronic double-digit inflation, and weak exports; and they brought the economy to the verge of foreign exchange crises in 1995 and 1996. Equally important, the policy credibility of the authorities was severely reduced. Against this background, the new government—which assumed power in the wake of a political and financial crisis—is to be commended for halting the deterioration in financial and macroeconomic balances, and for the commitment it has demonstrated to a wide range of reforms aimed at opening up the economy and raising its efficiency.

53. The announcement effect of a comprehensive "home-grown" and credible adjustment/reform program contributed importantly to the reduction in inflation in recent months and the favorable movements in the external reserve position, stock market prices, and premium in the parallel foreign exchange market notwithstanding the recent turmoil in Southeast Asian markets. More fundamentally, however, these developments reflect the fact that, under the program monitored by the staff, the macroeconomic policy fundamentals have started to move in the right direction. The macroeconomic targets for 1996/97 under the SMP were met in terms of containment in the budget deficit and in net domestic asset growth, which contributed to a small but much needed narrowing of the external current account deficit.

54. While the initial progress has been encouraging, the macroeconomic situation remains fragile, the structural deficiencies are pervasive, and the challenges facing the authorities will require unwavering determination in the adjustment and reform process. At 6.1 percent of GDP in 1996/97, the overall budget deficit was still too expansionary. Besides, the structure of taxation and revenue, and the composition of expenditure (with inadequate development and social outlays and a still high level of unproductive spending) are highly distorted. Moreover, there has been a severe deterioration in the finances of major public enterprises, which must be addressed urgently and decisively. The recent period has also been marked by a further weakening in the demand for money, constraints to the transmission mechanism of interest rate policy, and deep-rooted structural weaknesses in the banking system. In addition, continued high inflation has weakened the structure of rates of return and the demand for real rupee balances. The financial fragility of the banking system has also reflected serious governance deficiencies, including outside political interference in banking operations and an inadequate regulatory and supervisory framework.

55. In view of the above-mentioned fragilities in the budget, public enterprises, and banking system, the staff supports the authorities' emphasis on an acceleration and broadening of the structural reform agenda which addresses these key issues at the root. In this context, the fact that the new government fully endorsed the already ongoing reforms in the financial system supported by the World Bank will be of central importance in the period ahead. The staff welcomes, in particular, the clear commitment to banking reform as evidenced, inter alia, in the parliamentary approval for *ordinances* enhancing the autonomy of the State Bank of Pakistan to control its balance sheet and to regulate and supervise the financial system. Equally important is the range of new reform initiatives, which seeks to reduce the budget deficit in the context of a marked improvement in the structure of taxation and composition of

expenditure, and to restructure the federal government itself and the major public sector enterprises.

56. The extent of up-front implementation of long overdue structural reform steps, the ownership by the government of the reform policies, and the commitment of the authorities to a steady reduction in the budget deficit, are key factors underlying the staff's support for an early transition to multi-year arrangements. As noted, progress has been made in turning around—although still modestly and requiring consolidation and expansion—the policy fundamentals and important initial actions have been taken in the crucial area of banking reform. In addition, two policy areas deserve special credit for up-front implementation—tariff reform and public sector restructuring and downsizing. Under the new revenue-sharing arrangement, the rationalization of federal-provincial relations and has opened the way for a movement away from reliance on import duties on the part of the federal government. In this regard, the staff welcomes the reduction of the maximum import tariff to 45 percent, the elimination of the 10 percent regulatory duty that had been introduced in October 1995, and the simplification of tariff structure. The staff recognizes that these actions will involve an important up-front revenue loss and commends the authorities for their readiness to take offsetting fiscal adjustment measures if revenue trends deviate from the program targets. As regards public sector restructuring and downsizing, the government has already started to tackle the problem of surplus labor. Failure in the past to address this problem stood in the way of deficit reduction in the public sector, prevented an upgrading of the civil service, and delayed progress on privatization. The staff welcomes the government's efforts to minimize the potential social costs of reforms in the transition period by strengthening the social safety net and insulating the Social Action Program and high-priority public investments from expenditure cutbacks.

57. The staff is of the view that the envisaged path of adjustment strikes an appropriate balance between reduction of financial imbalances and progress on structural reforms where such a trade-off is operative. The key area of adjustment will be the steady reduction in the overall budget deficit to 4.0 percent of GDP by the third year of the program. While this fiscal path might, on the surface, appear to be too gradualistic, the underlying adjustment is in fact significant and will pose a major challenge to the authorities, in view of the fiscal cost associated with key elements of the structural reform program (such as tariff reform and bank restructuring) and of the challenges which lie ahead regarding both revenue mobilization and expenditure containment. Moreover, achievement of the macroeconomic objectives will depend on the government's success in supplementing the budgetary improvements with improvements in the financial position of the major public enterprises. Careful monitoring and timely implementation of additional stabilization measures, as needed, will be key to the success of the program.

58. Achievement of the targets for domestic tax revenues will require discipline and determination from the very start. Accordingly, the staff attaches great importance to the ongoing efforts to strengthen tax administration through, inter alia, a GST registration enforcement program, an income tax audit and investigation unit, and an information

exchange system among the major tax departments. Looking ahead, it will be essential to persevere with the structural reform elements, the most crucial of which is the extension of the GST to the retail sector. In this regard, the authorities have opted for a two-stage approach involving a temporary 3 percent turnover tax, a first stage which is deemed necessary because of difficulties in bringing into the tax net the large and pervasive informal sector. While appreciating the rationale for this approach, the staff urges the authorities to undertake all efforts to overcome the existing impediments and to move, as quickly as possible, to a full extension of the invoice-based GST to the retail level in order to capture the full revenue potential from this sector. The staff also attaches importance to the planned review of the income tax system—which should point to ways for increasing the yield and imparting simplification and neutrality—and to the ongoing efforts at the provincial level to consolidate, harmonize, and enhance the taxation of agricultural income.

59. As regards tariff reform, the authorities are committed to moving further along the path of tariff reduction during the course of the program by lowering the maximum tariff rate to the range of 30–35 percent by June 1999. The staff stresses the importance of moving to the proposed range or below and urges the authorities to consider an intermediate tariff reduction step in June 1998. The staff also underscores the benefits that may be expected from the planned further simplification in the tariff structure and the envisaged phasing out of remaining quantitative restrictions on imports.

60. The automatic petroleum pricing mechanism, which has been suspended temporarily for revenue reasons, fulfills the dual functions of protecting the budgetary revenue targets for the petroleum development surcharge and imparting flexibility to domestic petroleum prices. The staff welcomes the government's commitment to reinstating that mechanism by December 1997 and to take, in the interim, any action that may be necessary to protect the budgetary target for the petroleum development surcharge in 1997/98, and for revenue in general.

61. The expenditure plan for the current fiscal year, to be followed by further containment during the remainder of the program, represents a major adjustment effort as virtually all expenditure items in the federal budget have been frozen in nominal terms at last year's levels. Adherence to the expenditure plan will require heightened attention, effort, and ability to withstand pressures for a relaxation of the expenditure controls. The staff welcomes the further reduction in the ratio of defense expenditure to GDP in 1997/98, the protection of priority projects under the Public Sector Development Program and the Social Action Program, and the envisaged subsequent recovery in development expenditure from an inadequately low level. Equally important, the three-year fiscal envelope provides for an increase in *provincial* current expenditure, thereby allowing for the planned increase in social outlays under the second phase of the Social Action Program.

62. The authorities' strategy to supplement the budgetary adjustment with improvements in the operations of the public enterprises is appropriate as these entities have become a major source of macroeconomic imbalances. The staff wishes to stress the importance of expendi-

ture containment, rationalization of tariff structures, and stepped-up efforts to collect overdue receivables (especially by WAPDA). These policies, combined with the development and implementation of a strategy to rationalize employment, will be key in setting the stage for privatization of several public enterprises during the program period.

63. The envisaged recovery in the demand for money hinges on positive real rates of return on rupee assets to positive levels and on regained confidence in the banking system. Given these challenges, it is fitting that one of the cornerstones of the structural reform program is a frontal attack on deteriorating governance, lack of credit discipline, and overstaffing in the state-owned banks. The staff urges the authorities to implement this essential component of the program on a full and sustained basis in order to restore the profitability and capital base of banks, and reduce the stock of nonperforming loans. This will enable a reduction in the now excessive wedge between lending and deposit rates, which should facilitate the enhancement of deposit rates. Success in banking reform will ultimately be measured by progress in the privatization of the state-owned banks. The authorities are aware that, in order to attract suitable private investors, the banks must be operationally and financially restructured before they are offered for sale. Thus, prior to privatization, loss-making branches must be closed; surplus staff must be sharply reduced; and the remaining nonperforming assets must be replaced by an appropriate mix of government securities, as contemplated in the privatization plans which are being developed with assistance from the World Bank. The planned strengthening of prudential regulations in line with international norms, and establishment of an early warning system and enhanced supervision mechanisms, should be vigorously pursued.

64. As the above structural improvements take hold and the pressure from the budget on credit policy subsides, the SBP will be in a position to rely primarily on open market operations to control domestic liquidity expansion. Consistent with this outlook, the program incorporates significant actions to improve the environment for the use of indirect instruments for monetary control. In this context, the recently initiated reform of the primary dealer system for government securities and the programmed introduction of treasury bills covering a range of maturities will play a useful role, as will the planned improvement in the operational procedures for open-market operations.

65. The proposed fiscal, monetary, and structural policies will need to be supported by external policies that enhance the competitiveness of Pakistan's tradeable goods sector and that lead to a more efficient exchange system. In recent years, however, exchange rate policy has been constrained by an excessive accumulation of foreign currency deposits with SBP forward cover. Accordingly, one of the most important structural components of the program is the strategy to develop private provision of forward cover. In this regard, the staff welcomes the authorities' plan to implement enabling exchange market reforms designed to sharply increase the volume of transactions among banks, thereby enhancing banks' ability to provide forward cover. The staff also attaches importance to the incentives which will be created for banks to rely increasingly on alternatives to the official forward cover scheme, including the programmed issuance of a marketable foreign currency bond and the progressive increase in the SBP's forward cover fee during the course of the program. The staff welcomes

the authorities' assurances that, in the interim period until these reforms take root, they will manage the exchange rate in a manner that enhances Pakistan's external competitiveness.

66. *The proposed privatization program is ambitious and will contribute significantly to* promoting productive efficiency, insulating the financial system from political interference and deepening financial intermediation, and encouraging competition. There are, however, obvious risks associated with the market's limited absorptive capacity. As an appropriate regulatory framework is essential for moving to a larger scale of privatization, the government's emphasis on strengthening the core infrastructure regulatory bodies is well-placed. The attention that is being devoted to addressing the labor-related aspects of privatization is also warranted. The staff views the proposed restrictions on the use of privatization proceeds under the program as essential for avoiding unsustainable increases in expenditure, protecting the monetary program, and ensuring that external privatization inflows do not lead to a relaxation of the efforts at strengthening the fiscal and external current accounts.

67. The staff welcomes the recent actions aimed at improving governance, as shortcomings in this area have significantly hampered macroeconomic performance through their detrimental impact on the loan portfolio of the banking system, tax collection, the effectiveness of public expenditure, and performance of public enterprises. Looking ahead, the staff supports the government's plan to enhance law and order; promote transparent and competitive procurement practices; enhance the efficiency of the civil service; and strengthen the legal and judicial system. In addition, the planned management improvements and restructuring of the government, public enterprises, and public financial institutions may be expected to contribute significantly to improvements in governance.

68. 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 assessments of economic developments and to form a perspective on medium-term prospects. The staff appreciates the full collaboration on the part of the authorities for developing a set of accounts and projections for the seven key public enterprises. However, data deficiencies remain, notably long lags for data on the provincial budgetary operations and methodological shortcomings in estimating certain GDP components in the national accounts. The data provision and coverage can also be improved by compiling and reporting, on a regular basis, the financial positions of public enterprises.

69. In the staff's view, the proposed program merits support because it evidences a clearly defined strategy of economic liberalization anchored on encouragement of the private sector, significant adjustment efforts, wide-ranging structural reforms, and a high degree of ownership on the part of the authorities. However, the program does present downside risks associated, in large measure, with the demands which the wide range of reforms will place on Pakistan's limited implementation capacity and with the still weak macroeconomic situation. For these reasons, the program incorporates close monitoring provisions to ensure that deviations from targets and objectives are promptly corrected. The proposed level of access and the mix between ESAF and EFF resources would reflect support for the policy ingredients

of the program; recognition that the present constellation of political backing for the new government and reform momentum presents a unique opportunity for a frontal attack on longstanding structural weaknesses in the economy; and an appropriate balance between Pakistan's balance of payments needs and capacity to borrow on commercial terms. The staff also believes that the proposed backloading of purchases under the extended arrangement adequately addresses the concerns posed by the policy implementation setbacks and reversals which characterized Pakistan's track record in the past.

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

IX. Proposed Decisions

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

A. Request for Extended Arrangement

1. The Government of Pakistan has requested and extended arrangement for a period of three years.

2. The Fund approves the extended arrangement attached to EBS/97/185.

B. Request for Arrangements under the Enhanced Structural Adjustment Facility

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 of the Pakistan set forth in EBD/97/110.

3. The Fund approves the arrangements under the Enhanced Structural Adjustment Facility attached to EBS/97/185.

Pakistan: Reviews and Phasing of Disbursements and Purchases Under the Proposed ESAF and Extended Arrangements, 1997/98–1999/2000

(In millions of SDRs)

Timing of Purchase/ Disbursement	Conditions	ESAF	EFF
October 1997	Board approval of the First Annual and extended arrangements	113.73	37.91
March 15, 1998	ESAF/EFF review and end-December 1997 performance criteria	113.73	18.96
May 15, 1998	End-March1998 performance criteria	--	18.96
September 15, 1998	Board approval of the second annual ESAF arrangement, end-June 1998 performance criteria, and EFF review	113.73	37.91
November 15, 1998	End-September 1998 performance criteria	--	37.91
March 15, 1999	ESAF/EFF review end-December 1998 performance criteria	113.73	37.91
May 15, 1999	End-March 1999 performance criteria	--	37.91
September 15, 1999	Board approval of the third annual ESAF arrangement, end-June 1999 performance criteria, and EFF review	113.73	56.87
November 15, 1999	End-September 1999 performance criteria	--	56.86
March 15, 2000	ESAF/EFF review and end-December 1999 performance criteria	113.73	56.86
May 15, 2000	End-March 2000 performance criteria	--	56.86

Pakistan: Three-Year and First Annual Arrangement
Under the Enhanced Structural Adjustment Facility

Attached hereto is a letter, with the annexed Memorandum on Economic Policies dated September 8, 1997 from the Minister of Finance and the Governor of the State Bank of Pakistan, requesting from the International Monetary Fund a three-year arrangement under the Enhanced Structural Adjustment Facility, and the first annual arrangement thereunder, and setting forth

(i) the objectives and policies of the program to be supported by the three-year arrangement

and

(ii) the objectives and policies of the program to be supported by the first annual arrangement.

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

1. (a) For a period of three years from October 20, 1997 Pakistan will have the right to obtain loans from the Fund under the Enhanced Structural Adjustment Facility, in a total amount equivalent to SDR 682.38 million, which shall be provided from the Enhanced Structural Adjustment Facility Trust.

(b) The amount of each annual arrangement will be the equivalent of SDR 227.46 million for the first annual arrangement; the equivalent of SDR 227.46 million for the second annual arrangement; and the equivalent of SDR 227.46 million for the third annual arrangement.

(c) Under the first annual arrangement:

(i) the first loan, in an amount equivalent to SDR 113.73 million, will be available on October 10, 1997 at the request of Pakistan; and

(ii) the second loan, in an amount equivalent to SDR 113.73 million, will be available after February 15, 1997 at the request of Pakistan, subject to paragraph 2 below.

2. Pakistan will not request the disbursement of the second loan specified in paragraph 1(c)(ii) above

(a) if the Managing Director finds that the data at the end of December 1997 indicate that

(i) the limit on the overall budget deficit,

(ii) the limit on the bank borrowing for budgetary support or bank borrowing of the seven public enterprises specified in paragraph 13, or

(iii) the limit on net domestic assets of the State Bank of Pakistan or its lending to the federal and provincial governments, or

(iv) the floor on net foreign assets of the State Bank of Pakistan, or

(v) the limit on the outstanding stock of short-term public and publicly guaranteed external debt, or

(vi) the limit on the contraction of new nonconcessional public and publicly guaranteed external debt with initial maturity of over 1 year and up to and including 12 years, or the limit on debt with initial maturity of over 1 year and up to and including 5 years

described in paragraph 35 and as specified in Table 1, respectively, of the Memorandum on Economic Policies annexed to the attached letter, is not observed; or

(b) if the structural performance criteria specified in Table 2 of the Memorandum on Economic Policies annexed to the attached letter are not observed; or

(c) if Pakistan:

(i) imposes or intensifies restrictions on the making of payments and transfers for current international transactions, or

(ii) introduces or modifies multiple currency practices, or

(iii) concludes bilateral payments agreements which are inconsistent with Article VIII, or

(iv) imposes or intensifies import restrictions for balance of payments reasons, or

(v) accumulates external payments arrears, or

(d) until the Fund determines that the mid-term review of Pakistan's program referred to in paragraph 35 of the Memorandum on Economic Policies annexed to the attached letter has been 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 loan specified in paragraph 1(c)(ii) 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 the disbursement of that second loan.

3. Before approving the second annual arrangement, the Fund will appraise the progress of Pakistan in implementing the policies and reaching the objectives of the program supported by the first annual arrangement, taking into account primarily:

(a) the indicators specified in Tables 1 and 2 attached to the memorandum;

(b) imposition or intensification of restrictions on payments and transfers for current international transactions;

(c) introduction or modification of multiple currency practices;

(d) conclusion of bilateral payments agreements which are inconsistent with Article VIII; and

(e) imposition or intensification of import restrictions for balance of payments reasons.

4. 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 35 of the Memorandum on Economic Policies annexed to the attached letter, during the period of the first annual arrangement, Pakistan will consult with the Fund on the adoption of any measures that may be appropriate at the initiative of the government or whenever the Managing Director requests such consultation. Moreover, after the period of the first annual arrangement and while Pakistan has outstanding financial obligations to the Fund arising from loans under the 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.

Pakistan: Extended Arrangement

Attached hereto is a letter with annexed Memorandum on Economic Policies dated September 8, 1997 from the Minister of Finance and the Governor of the State Bank of Pakistan requesting an extended arrangement and setting forth:

(a) the objectives and policies that the authorities of Pakistan intend to pursue for the period of this extended arrangement;

(b) the policies and measures that the authorities of Pakistan intend to pursue during the first year of this extended arrangement; and

(c) understandings of Pakistan with the Fund regarding reviews that will be made of progress in realizing the objectives of the program and of the policies and measures that the authorities of Pakistan will pursue for the second and third year of this extended arrangement.

To support these objectives and policies, the International Monetary Fund grants this extended arrangement in accordance with the following provisions:

1. For a period of three years from October 20, 1997, Pakistan will have the right to make purchases from the Fund in an amount equivalent to SDR 454.92 million, subject to paragraphs 2, 3, 4, and 5 below, without further review by the Fund.

2. (a) Until November 15, 1998, purchases under this extended arrangement shall not, without the consent of the Fund, exceed the equivalent of SDR 113.73 million, provided that purchases shall not exceed the equivalent of SDR 37.91 million until February 15, 1998 the equivalent of SDR 56.86 million until May 15, 1998, and the equivalent of SDR 75.82 million until August 15, 1998.

(b) Until September 15, 1999, purchases under this extended arrangement shall not, without the consent of the Fund, exceed the equivalent of SDR 227.34 million.

(c) The right of Pakistan to make purchases during the second and third years shall be subject to such phasing as shall be determined.

3. Pakistan will not make purchases under this extended arrangement:

(a) during any period in which the data at the end of the preceding period indicate that

(i) the limit on the overall budget deficit,

(ii) the limit on the bank borrowing for budgetary support or bank borrowing of the seven public enterprises specified in paragraph 13, or

(iii) the limit on net domestic assets of the State Bank of Pakistan or its lending to the governments, or

(iv) the floor on net foreign assets of the State Bank of Pakistan, or

(v) the limit on the outstanding stock of short-term public and publicly guaranteed external debt, or

(vi) the limit on the contraction of new nonconcessional public and publicly guaranteed external debt with initial maturity of over 1 year and up to and including 12 years, or the limit on debt with initial maturity of over 1 year and up to and including 5 years

described in paragraph 35 and as specified in Table 1, respectively, of the Memorandum on Economic Policies annexed to the attached letter, is not observed; or

(b) if the structural performance criteria specified in Table 2 of the Memorandum on Economic Policies annexed to the attached letter is not observed; or

(c) after February 14, 1998, August 14, 1998, February 14, 1999, August 14, 1999, and February 28, 2000, respectively, until the reviews contemplated in paragraph 35 of the Memorandum on Economic Policies annexed to the attached letter are completed; or

(d) if at any time during the period of this extended arrangement Pakistan:

(i) imposes or intensifies restrictions on the making of payments and transfers for current international transactions, or

(ii) introduces or modifies multiple currency practices, or

(iii) concludes bilateral payments agreements which are inconsistent with Article VIII, or

(iv) imposes or intensifies import restrictions for balance of payments reasons, or

(v) accumulates external payments arrears.

When Pakistan is prevented from purchasing under this extended arrangement because of this paragraph 3, purchases will be resumed only after consultation has taken place between the Fund and Pakistan and understandings have been reached regarding the circumstances in which purchases can be resumed.

4. Pakistan will not make purchases under this extended arrangement during any period in which it has an overdue financial obligation to the Fund or is failing to meet a repurchase expectation (a) in respect of a noncomplying purchase pursuant to Decision No. 7842-(84/165) on the Guidelines on Corrective Action, or (b) in respect of a purchase in support of debt and debt service reduction operations pursuant to Decision No. 9331-(89/167), as amended, or (c) pursuant to subparagraph 16(a) or 33 (a) of Decision No. 8955-(88/126), as amended, on the Compensatory and Contingency Financing Facility.

5. Pakistan's right to engage in the transactions covered by this extended arrangement can be suspended only with respect to requests received by the Fund after (a) a formal ineligibility, or (b) a decision of the Executive Board to suspend transactions, either generally or in order to consider a proposal, made by an Executive Director or the Managing Director, formally to suppress or to limit the eligibility of Pakistan. When notice of a decision of formal ineligibility or a decision to consider a proposal is given pursuant to this paragraph 5, purchases under this arrangement will be resumed only after consultation has taken place between the Fund and Pakistan and understandings have been reached regarding the circumstances in which purchases can be resumed.

6. Purchases under this extended arrangement shall be made in the currencies of other members selected in accordance with the policies and procedures of the Fund, unless, at the request of Pakistan, the Fund agrees to provide SDRs at the time of the purchase.

7. Pakistan shall pay a charge for this extended arrangement in accordance with the decisions of the Fund.

8. (a) Pakistan shall repurchase the outstanding amount of its currency that results from a purchase under this extended arrangement in accordance with the provisions of the Articles of Agreement and decisions of the Fund, including those relating to repurchases as Pakistan's balance of payments and reserve position improves.

(b) Any reductions in Pakistan's currency held by the Fund shall reduce the amounts subject to repurchase under (a) above in accordance with the principles applied by the Fund for this purpose at the time of the reduction.

9. During the period of the extended arrangement Pakistan shall remain in close consultation with the Fund. These consultations may include correspondence and visits of officials of the Fund to Pakistan or of representatives of Pakistan to the Fund. Pakistan shall provide the Fund through reports, at intervals or dates requested by the Fund, with such information as the Fund requests in connection with the progress of Pakistan in achieving the objectives and policies set forth in the attached letter and annexed Memorandum.

10. In accordance with paragraph 35 of the Memorandum on Economic Policies annexed to the attached letter, Pakistan will consult with the Fund on the adoption of any measures that may be appropriate at the initiative of the government or whenever the Managing Director requests consultations because any of the performance criteria in paragraph 3 above have not been observed or because he considers that consultation on the program is desirable. In addition, after the period of the arrangement and while Pakistan has outstanding purchases under this arrangement, the government will consult with the Fund from time to time, at the initiative of the government or at the request of the Managing Director, concerning Pakistan's balance of payments policies.

Pakistan: Fund Relations
(As of September 30, 1997)

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	1,243.72	164.0
Reserve position in Fund	0.06	--

III. **SDR Department**:	**SDR Million**	**% Allocation**
Net cumulative allocation	169.99	100.0
Holdings	2.77	1.6

IV. **Outstanding Purchases and Loans**:	**SDR Million**	**% Quota**
Stand-by arrangements	362.38	47.8
Extended arrangements	123.20	16.2
SAF arrangements	213.06	28.1
ESAF arrangements	172.20	22.7

V. **Financial Arrangements**:

Type	**Approval Date**	**Expiration Date**	**Amount Approved (SDR Million)**	**Amount Drawn (SDR Million)**
Stand-by	12/13/95	9/30/97	562.59	294.69
EFF	2/22/94	12/13/95	379.10	123.20
ESAF	2/22/94	12/13/95	606.60	202.20

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

	Overdue	Forthcoming				
	9/30/97	1997	1998	1999	2000	2001
Principal	--	62.0	116.2	183.3	217.5	137.1
Charges/Interest	--	8.1	29.5	26.4	20.4	13.3
Total	--	70.1	145.7	209.7	237.9	150.4

B. Nonfinancial Relations

VII. Exchange System

Since January 1982, Pakistan has implemented a managed float exchange rate system with the U.S. dollar as the intervention currency. As of September 30, 1997, the State Bank of Pakistan's buying exchange rate was PRs 40.52 per U.S. dollar. Pakistan maintains an exchange system that is free of restrictions on the making of payments and transfers for current international transactions.

VIII. Last Article IV Consultation

The last Article IV consultation discussions were held in Islamabad during November 1994 and March 1995, and in Washington during July 1995. The staff report (SM/95/298) together with Pakistan's request for a stand-by arrangement (Supplement 1 to EBS/95/208) was discussed by the Executive Board on December 13, 1995 (EBM/95/118). In concluding the discussion on the 1995 Article IV consultation and the request for a stand-by arrangement, the Executive Board adopted the decision (Decision No. 11141-95/118) on December 13, 1995:

"Request for Stand-by Arrangement

1. The Government of Pakistan has requested a 15-month stand-by arrangement in an amount equivalent to SDR 401.85 million.

2. The Fund approves the stand-by arrangement set forth in EBS/95/208, Supplement 1.

3. The Fund notes the cancellation on December 4, 1995 of the arrangement under the enhanced structural adjustment facility and the extended arrangement approved by the Fund on February 22, 1994 (EBS/94/9, Supplement 2)."

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

IX. Recent Technical Assistance

a. The **Middle Eastern Department** stationed a staff member at the State Bank of Pakistan for a three-month period, beginning in February 1994, to assist in strengthening the macroeconomic framework for liquidity programming.

b. The **Fiscal Affairs Department** provided technical assistance on the broadening of the General Sales Tax in October 1993; follow-up missions visited Pakistan in July 1994 and in July 1995 to assist in the operational aspects of the GST broadening. A tax advisor to the Ministry of Finance was assigned for a period of nine months starting in March 1995.

In May 1995 a technical assistance mission made recommendations for the reform of the social safety net system. In November 1995, two technical assistance missions assisted the authorities in drafting a new GST law and in estimating the revenue impact of broadening the base of the GST. In May 1997, a mission reviewed the operation of the GST and assessed measures under consideration to increase income tax compliance. In May/June 1997, a mission conducted review of the public expenditure management system.

c. In July 1994, the **Monetary and Exchange Affairs Department** conducted a workshop on supervision and regulation of financial institutions at the State Bank of Pakistan. An advisor in monetary analysis and research was assigned for two years starting January 1995. In September 1995, a technical assistance mission helped establish a detailed action plan for strengthening bank supervision activities. In May/June 1996, MAE fielded a follow-up technical assistance mission on the transition to indirect monetary control. A technical assistance mission in June/July 1997, a technical assistance mission assisted authorities in developing a strategy to phase out subsidized forward cover for foreign currency deposits and identify key steps to liberalize the exchange system and to improve the institutional structure of the foreign exchange market.

d. A multitopic technical assistance mission of the Statistics Department—on monetary, balance of payments, national accounts and price statistics—visited Pakistan in November 1992. Two follow-up missions, in February 1993 and in May/June 1995, assisted in designing a plan for implementation of the recommendations of this mission on the compilation of monetary statistics.

e. The **Legal Department** provided technical assistance to the State Bank of Pakistan in reviewing the existing banking legislation with a view to proposing changes in the context of the undergoing reform of the financial sector and international practice (August 1992). In November 1995, a technical assistance mission helped in drafting the GST law.

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 87 loans and 118 credits to Pakistan since 1952, totaling US$5,581.8 million and US$4,549.4 million respectively (both net of cancellations). Of these amounts, US$2,033.5 million has been repaid and US$1,949.1 million remained undisbursed as of July 31, 1997. IFC's portfolio consists of 71 projects benefiting 51 Pakistani companies totaling $649 million, $505 million of which was disbursed as of July 31, 1997. IFC's Pakistan portfolio, which is its fourth largest exposure in terms of commitments, is performing well. MIGA has been active in Pakistan since 1991. As of June 30, 1997, Pakistan accounted for 6 percent of MIGA's portfolio with a total of sixteen contracts of guarantee for an outstanding maximum contingent liability of US$156 million.

2. IBRD and IDA assistance to Pakistan steadily increased over the last decade, 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 over the past year, IDA commitments during FY97 totaled US$85 million. No commitments of IBRD resouirces were made in FY97.

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 four years, by contrast, commitments to the social sectors averaged 21 percent while commitments to agriculture and infrastructure (mainly energy) projects averaged 11 and 33 percent, respectively.

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 so that people see improvements in their living standards quickly and permanently. 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 just 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. The Bank has worked with Pakistan to develop a banking sector reform program. Negotiations of possible adjustment assistance to banking reforms is scheduled for mid-September, 1997.

6. 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.

7. 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, which constitute the bulk of economic activity and infrastructure. 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

8. 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 FY97 level.

9. Total new IBRD and IDA commitments (including guarantees) for FY 1998-00 could reach 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. IFC's expected net approval volume in FY 1998 is expected to be about $100 million, though its actual commitment levels will be determined by market demand, which itself depends on the pace of economic reform. MIGA's assistance is not easily projected, since it depends both on private investors' view of the political and investment climate in Pakistan, and on capacity constraints.

Technical assistance by the World Bank

10. The World Bank provides technical assistance in agriculture, public sector management, 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 FY97 Pakistan portfolio have explicit technical assistance components or can be categorized as stand-alone technical assistance projects. The total amount of this TA is 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.

11. 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, 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 July 31, 1997

(In millions of U.S. dollars)

	IBRD	IDA	TOTAL
IBRD / IDA lending operations			
1. Fully disbursed operations	3,722.2	2,748.7	6,470.9
2. Ongoing operations			
Agriculture	0.0	377.8	377.8
Public sector management	0.0	75.6	75.6
Telecommunications	35.0	0.0	35.0
Education	0.0	483.5	483.5
Social Action Program	0.0	200.0	200.0
Finance	214.5	0.0	214.5
Oil & Gas	351.4	0.0	351.4
Population, health & nutrition	0.0	184.8	184.8
Industry	26.0	0.0	26.0
Multisector	0.0	100.0	100.0
Electric, power & energy	980.0	0.0	980.0
Transportation	252.7	0.0	252.7
Urban development	0.0	111.5	111.5
Environment	0.0	67.2	67.2
Water supply & sanitation	0.0	200.2	200.2
3. Total (1 + 2)	5,581.8	4,549.4	10,131.2
4. Repayments	1,705.5	328.0	2,033.5
5. Undisbursed	965.5	983.6	1,949.1
6. Total outstanding (3 - 4 - 5)	2,910.8	3,237.8	6,148.6

Source: World Bank

Note: Ongoing operations are commitments less cancellations

Pakistan: Statistical Issues

1. In general, the economic and financial data in Pakistan are of sufficient coverage, quality, frequency, and timeliness to enable the staff to undertake timely and adequate assessment of economic developments, and to form a perspective 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 indexes within 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 stock market index with a one day lag. The main areas for improvement in data quality are provincial government finance statistics (particularly as regards provincial government expenditures); national income accounts; and the financial positions of public enterprises.

2. At the 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 addition, data on wage and employment are not reported; and systems for the compilation of quarterly GDP are not yet well developed. These deficiencies are being partly addressed through the project on the Improvement of National Account Statistics in Pakistan (INAS) sponsored by the Dutch Government.

3. 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.

4. The data on government finances continue to suffer from a lack of information on functional classification of government outlays; and inadequate reporting by provinces on their fiscal operations.

5. In the monetary area, the quality of statistics would benefit from implementation of the STA (money and banking statistics) mission of February 1993. That mission recommended the introduction of a new consolidated balance sheet for the State Bank of Pakistan to coincide with the introduction of the new monthly call report forms for banks. In May/June 1995, a follow-up mission found that, due to an insufficient number of personal computers, the Statistics Department of the State Bank of Pakistan had stopped using the new monthly reporting forms for the compilation of the monetary survey in July 1994. Because of the quality of the monetary statistics can be significantly improved from the new monthly reporting system, the 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. The authorities have not yet officially adopted the new monthly reporting

system and monetary statistics continued to be compiled based on the old weekly reporting forms.

6. 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. In addition, the compilation of trade statistics (currently on the base year of 1980/81) should be rebased to 1990/91.

Table 1. Pakistan: Survey of Reporting of Main Statistical Indicators
(as of end-August 1997)

	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	8/26/97	8/26/97	6/97	6/97	6/97	6/97	6/97	6/97	6/97	6/97	6/97	6/97	6/97
Date received	8/27/97	8/27/97	7/97 Mission	7/97 Mission	7/97 Mission	7/97 Mission	7/97	7/97	6/97 Mission	6/97 Mission	6/97 Mission	6/97 Mission	6/97 Missio n
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	Missio n
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	Ministr y of Financ e and Econo mic 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	Unrestr icted

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.

September 8, 1997

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

Dear Mr. Camdessus:

The attached Memorandum on Economic and Financial Policies sets out the Pakistan Government's medium-term economic and financial program, in support of which the Government of Pakistan is requesting multi-year financial assistance from the Fund under the Enhanced Structural Adjustment Facility (in an amount of SDR 682.38 million, equivalent to 90 percent of quota) and the Extended Fund Facility (in an amount of SDR 454.92 million, equivalent to 60 percent of quota). The Government asks that the request for these two arrangements be considered by the Executive Board of the Fund after confirmation is received that the prior actions specified in paragraph 35 of the Memorandum on Economic and Financial Policies have been observed.

The government believes that the polices set out in the attached Memorandum on Economic Policies 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,

Sartaj Aziz
Minister of Finance and Economic Affairs
Ministry of Finance and Economic Affairs

Muhammad Yaqub
Governor
State Bank of Pakistan

Attachment:
Memorandum on Economic and Financial Policies

INTERNATIONAL MONETARY FUND
PAKISTAN

Memorandum on Economic and Financial Policies, 1997/98–1999/2000

I. INTRODUCTION

1. The Government of Pakistan has held discussions with the Fund staff for the 1997 Article IV consultation and with respect to the transition from the current Staff Monitored Program (SMP) to an ESAF/EFF-supported medium-term program. The discussions provided the basis for the Policy Framework Paper (PFP) which the government has prepared with assistance from the Fund and World Bank staffs setting forth the macroeconomic, structural, sectoral, and social policies which it intends to pursue during the three-year period 1997/98–999/2000. The present Memorandum reviews performance under the SMP and, consistent with the PFP, further specifies the macroeconomic policies and commitments in the structural area for the first year of the program.

2. As described in the April 28, 1997 Memorandum of Understanding for the SMP and its Supplement of May 22, 1997 the government launched an ambitious economic policy package soon after taking office in February 1997, aimed at reviving the growth of output and exports and addressing Pakistan's severe macroeconomic imbalances. The package involved a three-pronged approach comprising: (i) containment of the macroeconomic imbalances at manageable levels in 1996/97; (ii) consolidation of the initiatives of the caretaker administration regarding agricultural income taxation, revenue sharing, and financial sector reform; and (iii) major new reform initiatives aimed at reviving growth and exports and placing the economy on a path of progressively lower inflation and stronger balance of payments. These new initiatives are intended to promote the growth of private sector activities, encompassing reforms in the tax and tariff systems, rationalization of public expenditure, banking and capital market reforms, liberalization of the foreign exchange market, and privatization.

II. ECONOMIC AND FINANCIAL PERFORMANCE DURING THE STAFF MONITORED PROGRAM

3. In recent months, the government has succeeded in containing the macroeconomic imbalances and has implemented major structural reforms which are more comprehensive in coverage and have been implemented at a faster pace than had been envisaged in the SMP. On the macroeconomic front, as described below, the SMP targets for end-June were fully met. On the structural front, the following actions have already been taken: (i) reduction in the maximum tariff rate to 45 percent (from 65 percent) concurrent with simplification of the tariff structure and elimination of the regulatory duty on most imports; (ii) rationalization of the rate structures of the income and sales taxes; (iii) approval by both houses of parliament of the ordinances relating to the autonomy of the SBP and banking sector reform; (iv) enactment

of a new comprehensive law for loan recovery; and (v) adoption by the provincial assemblies of the ordinances relating to agricultural income tax.

4. The preliminary data on the consolidated federal-provincial budget indicate a deficit of 6.1 percent of GDP, as compared to 6.2 percent of GDP under the SMP. Total revenue fell short of the target by 0.2 percentage points of GDP due to some underperformance in both federal and provincial taxes, partly offset by higher federal nontax revenue. Expenditure, particularly at the provincial level, was compressed to offset the revenue shortfall. Among the major taxes, customs duties performed unexpectedly strongly, while income tax and federal excise duty collections were lower than expected. These taxes were affected, inter alia, by the slow growth of real GDP in 1996/97 (3.1 percent), which was due to poor crops and a decline in large-scale manufacturing output.

5. In the monetary sector, net domestic asset growth decelerated to 14.4 percent of initial stock of domestic liquidity, well below the projected growth of 19.3 percent and a marked slowdown in relation to 1995/96 (when they grew at a rate of 18.5 percent of initial domestic liquidity). However, in the face of a weaker demand for money, as reflected in an overall liquidity growth of only 10.8 percent, this was consistent with a loss in net foreign assets equivalent to 3.6 percent of the initial stock of domestic liquidity. The deceleration in the growth of net domestic assets was due to a contraction in credit to the autonomous bodies and lower expansion in credit to the private sector. The latter resulted from containment of credit under government-sponsored schemes, a better rate of loan recovery, and improved standards of prudence in lending.

6. The above fiscal and monetary developments were reflected in a lower inflation rate and better balance of payments performance than projected for 1996/97 under the SMP. The twelve-month rate of CPI inflation amounted to 12.5 percent (compared to a projection of 13.8 percent). On the external front, the external current account deficit before official transfers was contained at 6.4 percent of GDP in 1996/97, smaller than envisaged under the SMP, reflecting lower than projected imports and higher worker remittances and private transfers. This allowed the build-up of gross foreign reserves of the SBP to US$1.2 billion by end-June, compared to the SMP target of US$1 billion. Exports declined by 5.3 percent in relation to the 1995/96 level, mainly due to a poor cotton crop. The debt ceilings under the SMP were met.

III. MEDIUM-TERM MACROECONOMIC FRAMEWORK

7. The macroeconomic objectives for the three-year program period (1997/98–1999/2000) are: (i) to raise the growth rate of real GDP to the 5–6 percent range; (ii) to progressively reduce annual inflation to about 7 percent; and (iii) to reduce the external current deficit (excluding official transfers) to the range of 4.0–4.5 percent of GDP. The targeted improvement in growth performance would result from an increase in domestic investment from about 18 percent of GDP in 1996/97–1997/98 to 19½ percent by 1999/2000, and from gains in total factor productivity—a key objective of the structural reform package.

The targeted reduction in inflation and strengthening of the external reserve position would require that national savings increase from about 12 percent of GDP in 1996/97 to about 15 percent by 1999/2000. About two-thirds of this increase in national savings is projected to originate from higher budgetary savings.

8. Higher budgetary savings would result from an increase in revenue to 16.8 percent of GDP by 1999/2000 (from 15.3 percent in 1996/97) and a reduction of current expenditure to 17.2 percent of GDP (from 18.1 percent in 1996/97). Tax revenue would increase in the areas of the GST and direct taxes, which would more than offset lower customs revenues due to tariff reform. This would reflect further horizontal expansion of the GST and its extension to the trade sector; expansion of the base of direct taxes, including to agriculture; and improvements in tax administration and tax compliance. Nontax revenues would also increase, reflecting the strengthened financial position of public enterprises. On the expenditure side, the envisaged decline in current outlays would follow from restructuring of government ministries/divisions and attached departments and autonomous bodies, reform of the civil service designed to enhance the productivity of government employment, and better planning and monitoring of budgetary expenditure, particularly non-productive current expenditure. Enhanced budgetary savings would allow for a reduction in the overall budget deficit to 4.0 percent of GDP by the third year of the program. This fiscal path would enable the ratio of public debt to GDP to drop to 65 percent by 1999/2000 (from 76 percent in 1996/97). The strengthening of the budgetary accounts would be supported by improvements in the operating position of the major public enterprises which would provide for a reduction in their overall deficit, amounting to 0.3 percent of GDP in 1997/98, to be followed by further gains over the medium term as they are restructured and privatized. The sources of additional savings in the non-government sector would consist of improvements in the operations of the public enterprises and enhanced supply of financial assets to private savers associated with structural reforms in the financial sector.

9. Declining inflation, restructuring of the banking system, and the associated strengthening of confidence should raise the demand for money and lead to a gradual recovery in the ratio of domestic liquidity to GDP to its 1992/93–1993/94 level. Containment of credit to the government would create room for credit to the private sector to expand somewhat faster than the growth in nominal GDP. In the context of an improved environment for monetary policy, the SBP will intensify its reliance on open market operations to control the expansion of domestic liquidity. As regards rates of return, the efficiency gains associated with the restructuring and privatization of financial institutions are likely to be reflected in a narrowing of the spread between deposit and lending rates. This, together with a declining borrowing requirement of the government, would contribute to a simultaneous moderation of real lending rates and enhancement of real deposit rates over the program period.

10. The above described fiscal and monetary policies, and the structural and sectoral policies discussed below, should substantially strengthen Pakistan's external position. These policies will be supported by an exchange rate policy directed at achieving competitiveness for Pakistan's tradeable goods sector. Annual export growth is projected to average 9 percent in

U.S. dollar terms during the program period, driven by an expected recovery of traditional exports such as raw cotton, cotton yarn, and textile products and a rapid expansion of nontraditional exports. By contrast, import growth will be contained in the first year of the program, in spite of the reduction in effective protection in the economy, as buoyant imports by the private sector will be offset by a strong adjustment in imports by the public sector. Following this correction, imports are projected to grow broadly in line with real GDP growth. As a result, the current account deficit (before official transfers) is projected to decline to 4.2 percent of GDP by 1999/2000.

IV. MACROECONOMIC PROGRAM FOR 1997/98

11. Consistent with the understandings under the SMP, and in line with the above macroeconomic strategy, the program for 1997/98 will seek to raise the growth rate of real GDP to 5.5 percent; reduce year-on-year inflation to 10.5 percent; and maintain gross official reserves (before disbursements and purchases from the Fund) at their end-June 1997 level of US$1.2 billion. To achieve these objectives, the budget deficit will be contained to PRs 148 billion (5.0 percent of GDP), the composition of net domestic asset expansion will be redressed in favor of the private sector, and the competitiveness of the tradeable goods sector rate will be strengthened. These policies are expected to bring down the external current account deficit to a manageable level of 5.1 percent of GDP.

12. The targeted reduction in the consolidated federal/provincial budget deficit to 5.0 percent of GDP represents an improvement of 1.1 GDP percentage points in relation to the 1996/97 outcome.[1] This is significant given the revenue losses of about 1 percent of GDP associated with the recently implemented reduction in import tariffs and rates of income and general sales taxes. Specifically, tax revenue is expected to decline by 0.2 percent of GDP (to 12.7 percent), but this will be more than offset by increased nontax revenue (0.5 percent of GDP) and a reduction in total expenditure (by 0.7 percent of GDP). The loss in customs duties would reflect a lower effective rate of import duty (at 17 percent, against 20 percent in 1996/97). Nontax revenue will benefit from higher profit transfers from the central bank. On the expenditure side, the 1997/98 budget provides for containment of virtually all noninterest current expenditure of the federal government (excluding mandatory grants to the provinces) at the nominal level of 1996/97. If further fiscal restraint is needed during the course of the fiscal year, in particular if CBR revenue falls short of any quarterly indicative target, the government will stand ready to implement, in consultation with the Fund staff, additional revenue–increasing and/or expenditure–cutting measures that will secure observance of the fiscal deficit targets while fully protecting the tariff reform program and the Core Development and the Social Action Programs.

---

[1]The targeted adjustment in the primary deficit amounts to 1.6 percent of GDP (or 1.3 percent excluding the projected decline in capital outlays).

13. The extent of the overall public sector adjustment in 1997/98 will be consistent with the targeted reduction in the external current account deficit by 1.3 percent of GDP. To this end, the reduction in the budget deficit to 5.0 percent of GDP will be reinforced by an improvement in the operations of the seven major public enterprises which dominate production and distribution of the public utilities,[2] amounting to 0.3 percent of GDP. Under existing tariff structures and levels of internal efficiency, and with an unchanged ratio of capital expenditure to GDP, the overall deficit of these seven key public enterprises would have widened to 2.6 percent of GDP in 1997/98 (from an estimated 2.1 percent in 1996/97). A set of measures amounting to 0.8 percent of GDP are being implemented, which would reduce the overall deficit of these enterprises to 1.8 percent of GDP. These measures include: (i) capital expenditure cuts (PRs 8.7 billion); (ii) the increase in WAPDA's electricity tariffs implemented in late 1996/97, resulting in an average tariff 6.6 percent higher in 1997/98 than in 1996/97 (yield: PRs 4.6 billion);[3] (iii) increase in the bulk rate of electricity tariff to the Federally Administered Tribal Areas (FATA) and to Azad-Jammu Kashmir (AJK), and metering of tubewells (with a combined yield of PRs 4 billion); (iv) a cut in generation and transmission losses in WAPDA and KESC (total yield: of PRs 4.2 billion); (v) increase in PTCL's installation fee, from PRs 2,500 to PRs 4,150, and in line rents, from PRs 50 per month to PRs 125 per month (yield: PRs 1 billion); and (v) increase in security deposits by customers for KESC (yield: PRs 1 billion).

14. The monetary program envisages an increase in domestic liquidity amounting to 15.7 percent of the initial domestic liquidity (compared with a nominal GDP growth of 17.1 percent)—a prudent limit in view of the trend towards higher velocity observed over the last three years, which may not be reversed in the short term. Bank borrowing for budgetary support would be reduced to PRs 58 billion (2.0 percent of GDP), of which no more than PRs 30 billion would come directly from the central bank. As a result of this much lower pressure from the budget, the SBP would keep net domestic credit expansion at no more than PRs 150 billion, reflecting a containment in credit expansion to the non-government sector at 14.0 percent. Consistent with its increasing reliance on open market operations, the SBP has recently lowered the Statutory Liquidity Ratio from 25 percent to 20 percent for the commercial banks, and from 19 percent to 14 percent for the nonbank financial institutions. The authorities will stand ready to further tighten monetary policy if developments under the program, in particular the evolution of the inflation rate and of the external reserve position, indicate such a need.

---

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

[3]The authorities are reviewing various other options which would substantially improve the financial position of WAPDA in 1997/98.

15. The stronger fiscal and monetary policy stance, together with a strengthened competitiveness of the tradeable goods sector, would bring the external current account back to a manageable level in 1997/98 (projected at 5.1 percent). Exports are projected to increase by more than 8 percent in volume terms on account of, inter alia, the expected recovery in raw cotton production and the impact of the ongoing structural reforms. By contrast, the total volume of imports would remain roughly constant, as buoyant imports by the private sector would be offset by a strong adjustment in the volume of public sector imports. The current account deficit will be covered mainly by multilateral and bilateral financing in support of the structural reforms, as well as substantial amounts of medium- and long-term capital inflows. Short-term external financing will contribute at positive but modest levels, reflecting a reflow of nonresidents' foreign currency deposits.

V. Structural and Social Policies

16. As described in the PFP, economic growth in Pakistan has been hindered by structural impediments to investment, savings, and productivity gains. Against this background, and reflecting a consensus on the need for far-reaching systemic changes, the government intends to follow a comprehensive structural reform agenda, including: (i) reform of the tax system and tax administration, involving a further shift away from import duties and meaningful inclusion of agricultural income in the tax net; (ii) rationalization of government expenditure; (iii) public enterprise reform; (iv) financial sector reform, culminating in the privatization of the public sector banks within an effective regulatory framework anchored around an enhanced autonomy of the SBP; (v) development of an interbank foreign exchange market and liberalization of the exchange system, with a strategic plan and process to exit from the scheme of exchange rate guarantees for foreign currency deposits; and (vi) expanded and more rapid privatization encompassing large utilities and other public sector corporations in the context of an appropriate regulatory framework. Concurrently with the structural policies of most immediate macroeconomic impact, the government intends to implement policies directed at developing Pakistan's human capital, raising productivity in key sectors, and protecting the environment.

A. Fiscal Reforms

17. The tax reform component of the program is consistent with the government's overall emphasis on the revival of growth and exports, and documentation of the economy. It seeks to promote a more equitable distribution of the tax burden through reductions in tax rates and a broadening of the tax base to include hitherto untaxed income and undertaxed sectors, supported by improvements in tax administration.

18. Significant progress has been made over the last two years towards converting the **General Sales Tax (GST)** into a modern, broadly-based value-added-tax. The base was expanded in 1996 to cover most commodities at the manufacturing and import stages while removing excise-type features and establishing a turnover threshold for registration. This was

followed by major improvements in the 1997/98 budget, including unification of the GST rates into a single standard rate of 12.5 percent; compulsory registration of importers, wholesalers, and distributors, and abolition of replacement invoices; effective extension of the GST to two major sectors of the economy, namely textiles and steel; improved refund procedures; and strengthening of the legal provisions to deal with delinquent tax payers, curb tax fraud, and minimize evasion. Building on these achievements, the next steps in GST reform will involve: (i) removing the exemptions for sugar and edible oils by end-June 1998; (ii) as a transitional step for the extension of the GST to the retail stage, introducing a 3 percent turnover tax on traders in January 1998, with an option to pay the standard GST; (iii) phasing out the turnover tax and extending the standard GST to the retail stage by June 1999 for outlets beyond a minimum turnover threshold; and (iv) considering reducing the coverage of remaining exempted goods with the 1998/99 and 1999/2000 budgets. In this regard, the exemption for fertilizers will be reviewed in the broader context of the government's policy for the agricultural sector; and that for electricity will be reviewed in the context of a rationalization of the tax incidence on this key commodity and associated legal implications. Moreover, the recent changes in refund policy and the related exemption for capital goods will be assessed following an initial implementation stage.

19. Steps aimed at expanding the base of the **income tax** have already been taken with effect from July 1, 1997. The concept of taxable income has been redefined to include perquisites in kind, and certain deductions have been reduced. Concurrently, personal and corporate income tax rates have been reduced with the assessments beginning from July 1, 1998. The government will undertake a comprehensive review of the income tax system with a view to specifying steps aimed at imparting simplification and neutrality. The recommendations emanating from this review, which the government expects to complete by March 1998, and for which it intends to request technical assistance from the Fiscal Affairs Department of the Fund, would be implemented with the 1998/99–1999/2000 budgets.

20. The government is fully committed to initiating implementation of a meaningful **agricultural income taxation**. The recent enactment of land-based taxes by all four provinces represents a breakthrough in the tax policy area. Initially, the provincial governments have opted for a presumptive land-based tax, with exemption limits based on farm size, and variation in rates by irrigation status and coverage of types of farm land across the four provinces; the land revenue will continue to be collected along with this new tax. As the first step, the provinces will strengthen the collection mechanisms and ensure achievement of the 1997/98 budgeted revenue target of PRs 2.1 billion. As a second step, provinces will harmonize the tax rates and coverage to those prevailing in the province of Punjab by end-June 1998. As a third step, tax rates and exemptions will be adjusted by end-June 1999 to achieve a major improvement in revenues in 1999/2000. The federal and provincial governments, with technical assistance from World Bank, will initiate in 1997/98 a study on various options for moving from the land-based tax toward an agricultural income tax over the medium-term. The study will be completed by June 1998. Based on the recommendations of the study, provinces will decide on an appropriate form of agricultural income taxation by

December 1999 and will develop in 1999/2000 an action plan for phased implementation of the new system.

21. Major efforts are being initiated and will be intensified over the next three years to strengthen **tax administration** in support of the above policies regarding the GST and the income tax. With regard to the GST, a registration enforcement program is being implemented which aims to reduce the number of non-filers, from 30 percent currently to 15 percent by July 1998, and to 10 percent by July 1999. Moreover, 10–15 percent of the GST payers will be audited during 1997/98 and 20–25 percent will be audited during 1998/99 and subsequent fiscal years. Collection of a minimum amount of PRs 4.5 billion during 1997/98 under this audit program would constitute one of the structural benchmarks of the proposed program. With regard to income tax, a Tax Audit and Investigation Unit will be established by December 1997. To promote integration of the tax system, an information exchange system encompassing the income tax, GST, and customs administrations is being prepared.

22. The **tariff reform** component of the program constitutes one of the cornerstones of the structural reform agenda. Following the bold steps taken in March 1997 (lowering of the maximum tariff to 45 percent, reducing the number of slabs from 14 to 6, and eliminating the 10 percent regulatory duty for most imports), the rate structure will be further lowered and rationalized and the remaining concessional rates will be further merged with the statutory regime. Specifically, the maximum tariff rate will be lowered to 30–35 percent, and the number of slabs will be reduced to four or five, by June 1999. The possibility of implementing an intermediate tariff reform step in June 1998 will be discussed in the context of the first review under the ESAF and EFF arrangements. Also in the context of the first review, a timetable will be specified for phasing out, during the course of the program, the remaining quantitative import restrictions which cannot be justified on health, safety, social, national security, religious, or environmental grounds.

23. As part of the structural component of the stand-by arrangement approved in December 1995, a **petroleum pricing mechanism** was adopted according to which the domestic retail prices of petroleum products were reviewed monthly, and adjusted whenever the cumulative change in their landed cost exceeded 3 percent. Following an interruption dictated by revenue considerations, the government will reinstate the automatic mechanism, under a revised formula, by December 1997.[4] Pending the return to an automatic mechanism, the government will take steps as necessary to ensure the achievement of the budgeted amount of petroleum surcharge in 1997/98.

24. The composition of **government expenditure** will be improved by reallocating budgetary resources toward high-priority uses, such as essential operations and maintenance and high-return development projects, and providing adequate budgetary allocations for basic

---

[4]In revising the formula, the government will consider adopting a system of quarterly reviews instead of monthly reviews.

social services. Satisfactory implementation of the Social Action Program will constitute a structural benchmark. These objectives will be pursued by restructuring the government, improving the planning and monitoring of budgetary expenditures, and initiating a reform of *the civil service. Operational plans for restructuring government ministries/divisions, attached* departments, and autonomous bodies will be prepared by June 1998 and phased in during 1998/99-1999/2000. A medium–term expenditure framework will be developed by March 1998 for use in preparing future budgets, starting with the 1998/99 budget; and an action plan will be developed by June 1998, and implemented during 1998/99–1999/2000, to improve the quality and timeliness of information flows relating to public expenditures at both federal and provincial levels. An action plan for reforming the civil service will be prepared by June 1999, on the basis of which initial steps will be taken in 1999/2000 to enhance the skills base and rationalize management, terms and conditions of service, and the pension system.

25. As regards the **Public Sector Development Program** (PSDP), a Core Development Program (CDP) of high-riority projects is being developed for the current fiscal year—an exercise which will be repeated in each year—in consultation with the World Bank and other donor agencies. The funding allocations for these projects/programs will be determined in consultation with the World Bank, and the CDP will be protected from fiscal cutbacks that may become necessary during the course of each year. A multi-year development plan will be finalized by June 1998, and updated in each year thereafter, to ensure that the consequences of projects for PSDP expenditures in subsequent years, as well as recurrent cost implications, are fully taken into account.

26. The government has constituted committees that have reviewed the performance of *the seven major* **public enterprises** *and formulated remedial measures for improving their* financial situation and preparing them for privatization. The measures recommended include appointment of top managements and a restructuring aimed at an overall improvement in the operations of these enterprises—involving generation of internal efficiencies (including reduction in line losses for utilities), expenditure containment, rationalization of tariff structures, and stepped–up efforts to collect overdue receivables and to settle the arrears among the enterprises and the government. Performance improvement arrangements will be introduced by December 1997 between the government and WAPDA. These policies, combined with the development and implementation of a strategy to rationalize employment, are expected to set the stage for privatization of several of the key public enterprises.

B. Monetary and Financial Sector Reforms

27. The **monetary reform** agenda will target further financial liberalization and greater reliance on market-based instruments of monetary control. Consistent with this approach, the following actions will be taken to enhance the enabling institutional environment for market-based monetary control: (i) with immediate effect, the government will begin to reform the primary dealer system for government securities; (ii) treasury bills covering a range of maturities (three months, six months, and one year) will be introduced in steps during

1997/98; and (iii) the existing six-month federal bonds will be eliminated as they are not well suited for trading in the secondary market. Within this improved environment, the operational procedures for open market operations will be refined with a view to, inter alia, reducing short-term interest rate volatility in the interbank market. Also, public debt management will be improved with a view to channeling an increasing share of financial savings into marketable debt instruments in order to broaden the market for government securities and to ensure comparable and market-related terms on the various debt instruments.

28. Further **reform of the financial sector** will be based on a three-pronged approach to restoring good governance and imposing financial discipline: (i) privatization of banks and development finance institutions; (ii) enhancement of the ability of the SBP to supervise banks and effectively enforce regulations; and (iii) improvement of the legal environment for loan recovery and enforcement of financial contracts. The **privatization plan** calls for: (i) divestiture of the government's remaining ownership interests in the Muslim Commercial Bank, Allied Bank Limited, Pakistan Industrial Credit and Investment Corporation, and Bankers' Equity Limited; (ii) privatization of Habib Bank Limited (HBL), United Bank Limited (UBL), National Bank of Pakistan (NBP), National Development Finance Corporation (NDFC), Industrial Development Bank of Pakistan (IDBP);[5] and (iii) replacement of the bad assets (net of provisions) of these institutions by government securities at the time of their privatization. In order to enhance the **regulatory and supervisory system**, and to improve the legal environment and strengthen judicial institutions for **loan recovery**, the following steps will be taken: (i) the prudential regulations on capital adequacy, loan classification and provisioning, loan concentration and exposure limits, and accounting and auditing standards will be made consistent with international norms starting by December 1997 (compliance by all banks and nonbank financial institutions with the new capital adequacy standards will be phased in starting by December 1997 and ending by June 2000); (ii) an early warning system and on-site and off-site supervision mechanisms, which have already been initiated, will be fully operational by January 1998; (iii) a deposit insurance scheme will be in place by January 1999; (iv) the number of banking courts will be increased and their operations will be fully funded by December 1997 to enforce the recently enacted recovery law; and (v) a centralized system of registering bank securities will be operational by January 1999.

29. The government has developed a program, with the assistance of the Asian Development Bank, to accelerate the development of **capital markets** in Pakistan. The key objectives of the program are to augment mobilization of long-term financial resources and improve the efficiency of their allocation. To achieve these objectives, reforms will be implemented, as detailed in the PFP, with a view to eliminating market distortions, strengthening market regulation and supervision, modernizing and upgrading the securities market infrastructure, and improving investment alternatives and efficiency of market participants.

---

[5] A timetable for these actions is specified in the PFP.

C. Exchange Market and Exchange System Reforms

30. The program envisages a gradual withdrawal of the SBP from its current central role in the foreign exchange market and the development of an **interbank foreign exchange** market. This will allow the SBP's gradual exit from provision of **forward cover** to foreign currency deposits. The strategy for promoting the development of the interbank foreign exchange market and exiting from the forward cover scheme involves the following elements: (i) authorizing banks to provide forward cover for non-trade transactions (by end-September 1997); and to increase the term of forward cover for trade transactions to one year (by end-December 1997); (ii) increasing banks' nostro account limits by at least 15 percent by March 1998; (iii) issuing, by March 1998, a two year marketable foreign currency bond, with a fixed coupon, to be available to both resident and nonresidents, while allowing banks to cover a portion of their foreign currency deposit liabilities by investing in the new foreign currency bond; (iv) widening the buy/sell margin for SBP operations; (v) phasing out the surrender requirement for export earnings during the program period (while maintaining the repatriation requirement); (vi) ending the practice of fixing daily buy/sell spot market prices at which banks are required to transact with customers; and (vii) permitting an opening, according to a phased schedule, for the uncovered foreign exchange position of banks. In the context of the first review, agreement will be reached on the steps to widen the buy/sell margin of the SBP; to phase out the surrender requirement for export earnings; to end the practice of fixing the buy/sell spot market prices of banks; and to increase banks' uncovered position limits for foreign exchange. During the program period, the SBP will progressively raise the forward cover fee to encourage the development of private forward cover and reduce its own role in this activity.

D. Other Structural and Social Policies

31. The government has established ambitious **privatization** targets for the next three years. By June 1998, the Sui Northern Gas Pipelines Ltd. and Sui Southern Gas Company will be brought to the point of sale. In the industrial sector, 18 industrial additional units will have been sold, including fertilizer and vegetable oil facilities and a heavy electrical complex. Within the same time period, an effective regulatory regime will be put in place for the utility sector. By June 1999, the government will have divested a total of 46 mainly industrial units; and the Karachi Electricity Supply Corporation and the Faisalabad Area Electricity Board will have been brought to the point of sale. In addition, the government will either put in place private management or pursue privatization of five other area electricity boards. The government is reviewing the timing of the privatization of other public sector power generating plants in light of sectoral developments, including the Jamshoro Electric Power Plant; the Guddu, Muzaffargarh, Multan, and Faisalabad thermal plants. The Pakistan National Shipping Corporation and the National Tanker Company will be brought to the point of sale by June 1999. Finally, by June 2000, Pakistan Railways, Oil and Gas Development Corporation, and PTC will be brought to the point of sale. Privatization proceeds will continue to be deposited

in special extrabudgetary government accounts with the SBP, from which they will be withdrawn to retire public debt or, on an exceptional basis in consultation with the Fund staff, to cover costs associated with the restructuring of the government and public enterprises.

32. Public expenditures on social sectors under the second phase of SAP are projected to rise from an annual average of 2 percent of GDP over the last three years to at least 2.4 percent of GDP a year during the program period (with federal and provincial governments' contribution at least in the range of 1.8 percent to 1.9 percent of GDP per year and donors' contribution in the range of 0.5 to 0.6 percent of GDP per year). The SAP program and its related sub-programs—which will be protected from budgetary cutbacks—will be agreed upon on an annual basis by the government, the World Bank, and other participating donors. To monitor effectiveness, the government will conduct an annual Integrated Household Survey (PIHS) as a basis for the evaluation of sectoral outcomes, and it will also conduct an annual assessment of the impact and effectiveness of the SAP reform agenda with the support of commissioned studies.

VI. External Financing and Program Monitoring

33. The authorities believe that the policies described in this Memorandum will contribute importantly to lifting domestic savings and promoting higher rates of investment, growth, and exports, in the context of a declining rate of inflation and a strengthening balance of payments. However, the achievement of higher and sustainable growth will also depend on the relaxation of protectionist measures in Pakistan's major export markets and the timely availability of external financing on appropriate terms.

34. In support of its medium-term economic and financial program, the government of Pakistan is requesting multi-year financial assistance from the Fund under the Enhanced Structural Adjustment Facility (in an amount of SDR 682.38 million, equivalent to 90 percent of quota) and under the Extended Fund Facility (in an amount of SDR 454.92 million, equivalent to 60 percent of quota).[6] As detailed in the PFP, it is expected that Pakistan will receive substantial amounts of external assistance from other official sources over the medium term on relatively concessional terms. As part of the medium-term financing program, the government will seek to improve the maturity structure of Pakistan's external liabilities (thereby reducing the economy's vulnerability to disruptive capital outflows) and to attract increasing nondebt creating inflows, with particular emphasis on containing the growth and lengthening the maturity of foreign currency deposits.

35. The government is aware that disbursements under the ESAF and purchases under the extended arrangement are subject to observance of prior actions and performance criteria, completion of program reviews, and the standard clauses regarding the exchange and trade

---

[6] The program period covered by the arrangements would be specified from July 1, 1997 to June 30, 2000.

system. The following quarterly performance criteria are proposed to monitor progress under the program: (i) ceilings on the net domestic assets of the SBP, with sub-ceilings on lending for budgetary support; (ii) ceilings on the overall budget deficit with sub-ceilings on bank borrowing for budgetary support; (iii) ceilings banking system credit to the seven public enterprises specified in paragraph 13; (iv) ceilings on the outstanding stock of short-term external debt; (v) ceilings on contraction of new non-concessional medium- and long-term public and publicly-guaranteed external debt with sub-ceilings on debt with an initial maturity of over one year and up to and including five years; and (vi) floors on the net foreign assets of the SBP. The data presented in Table 1 for end-September 1997 constitute revised targets under the Staff-Monitored Program and indicative targets under both the ESAF and extended arrangements, with the exception of the ceiling on SBP budgetary support and the floor on net foreign assets of the SBP, observance of which constitutes a prior action as defined in footnote 1 of the table. Those for end-December 1997 and end-June 1998 (except for specified indicative targets) constitute performance criteria under both the ESAF and extended arrangements. Those for end-March 1998 constitute performance criteria under the extended arrangement and indicative targets for the ESAF arrangement. Structural performance criteria and benchmarks are presented in Table 2. Disbursements under the ESAF arrangement will be subject to the completion of mid-year program reviews; the program review under the first annual ESAF arrangement is to be completed by end-March 1998. Purchases under the extended arrangement will be subject to program reviews to be completed by end-March 1998; end-September 1998; end-March 1999; end-September 1999; and end-March 2000.

Attachments

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

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

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

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

	End-Sep. 1/ 1997	End-Dec. 1997	End-Mar. 2/ 1997	End-Jun. 1998
Performance Criteria				
	(In billions of Pakistan rupees)			
Net domestic assets of the SBP 3/ 4/ 5/	24.8	31.2	43.1	49.6
Of which: Budgetary support 3/ 6/ 7/	19.1	24.7	29.7	30.0
Overall budget deficit	43.1	83.3	123.3	148.0
Of which: Bank budgetary support 3/ 6/ 7/	37.0	47.8	57.4	58.0
Credit to the seven major public enterprises	0.6	1.3	1.9	2.5
Net foreign assets of the SBP 3/ 4/ 5/ 8/	-12.0	-8.1	-3.3	-10.6
	(In millions of U.S. dollars)			
Stock of public and publicly guaranteed short-term external debt	1,000	1,000	1,000	1,000
Contraction of non-concessional medium- and long-term public and publicly guaranteed external debt	1,500	2,800	4,000	5,000
Of which: External debt with an initial maturity of over one year and up to five years	600	1,100	1,500	1,800
Indicative Targets				
	(In billions of Pakistan rupees)			
NDA of the banking system 3/ 4/ 5/	37.1	81.5	121.0	150.0
Federal tax revenue 9/	68.2	160.1	244.7	354.8
Memorandum items:				
Net external financing of the budget	-4.1	10.1	21.3	29.5
Net inflows of non-residents foreign currency deposits (in millions of U.S. dollars)	110	135	150	150
Inflows of program financing (in millions of U.S. do	0	650	650	900

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

1/ These targets replace those for end-September 1997 under the SMP and constitute indicative targets under the ESAF/EFF arrangements, with the exception of the ceiling on SBP budgetary support and the floor on the net foreign assets of the SBP, observance of which constitutes a prior action. In the event that end-September data relating to any of the adjusters described in footnotes 3 and 5 is not available prior to the Executive Board meeting, end-August or more recent available data will be taken into account in assessing observance of this prior action if comparison of such partial data with the corresponding programmed figures for end-September indicate the need for adjustment.

2/ The performance criteria are only applicable under the extended arrangement.

3/ These ceilings (floors) will be adjusted downward (upward) by the entent to which net external financing of the budget exceeds the programed levels.

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

5/ 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.

6/ 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.

7/ 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 31.

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

9/ Refers to the taxes collected by the Central Board of Revenue, 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
I. Structural Performance Criteria	
Adopting appropriate procedures for the introduction of a 3 percent turnover tax on traders, taking effect from January 1998, with an option to pay the standard GST	By end-December 1997
Reinstating the automatic petroleum pricing mechanism	By end-December 1997
Making all prudential regulations on capital adequacy, loan classification and provisioning, loan concentration and exposure limits, and accounting and auditing standards consistent with international norms	By end-December 1997
Measures relating to development of the interbank foreign exchange market and exit from the forward cover scheme:	By end-March 1998 1/
• Issuing new foreign currency bonds	
• Increasing bank's nostro account limits by at least 15 percent	
Removing the GST exemptions for sugar and edible oils	By end-June 1998
Harmonizing provincial taxation of agricultural income with that prevailing in the province of Punjab	By end-June 1998
Establishing the Gas Regulatority Authority, making the Pakistan Telecommunications Authority fully operational, and strengthening the National Electric Power Regulatory Authority	By end-June 1998
Introducing three-month, six-month, and one-year treasury bills	By end-June 1998
Implementing the automatic petroleum pricing mechanism	Program period 2/

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

Measures	Timing
II. Structural Benchmarks	
Achieving the revenue targets for 1997/98 under the audit program for the GST:	
Collecting a minimum of PRs 1.5 billion	By end-December 1997
Collecting a minimum of PRs 3.0 billion	By end-March 1998
Collecting a minimum of PRs 4.5 billion	By end-June 1998
Establishing a Tax Auditing and Investigation Unit	By end-December 1997
Introducing performance improvement arrangement between the government and WAPDA	By end-December 1997
Divesting the government's remaining ownership interest in four commercial banks, as described in paragraph 28	By end-March 1998
Establishing an information exchange program encompassing the income tax, GST, and customs administration	By end-June 1998
Selling at least 18 industrial units	By end-June 1998
Bringing Sui Northern Gas Pipelines Ltd. and Sui Southern Gas Company to point of sale	By end-June 1998
Preparing operational plans for restructuring government ministries and divisions, attached departments, and autonomous bodies	By end-June 1998
Developing action plans for restructuring the seven major public enterprises	By end-June 1998
Satisfactory implementation of the Social Action Program	Program period

1/ Structural performance criteria applicable only under the extended arrangement.
2/ Following reinstatement of the mechanism by December 1997.