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**Pakistan: 2004 Article IV Consultation, Ninth Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility, and Request for Waiver of Performance Criteria—Staff Report; Staff Statement; Public Information Notice and Press Release on the Executive Board Discussion; and Statement by the Executive Director for Pakistan**

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of a combined discussion of the 2004 Article IV consultation with Pakistan, ninth review under the three-year arrangement under the Poverty Reduction and Growth Facility, and request for waiver of performance criteria, the following documents have been released and are included in this package:

- the staff report for the 2004 Article IV consultation, ninth review under the three-year arrangement under the Poverty Reduction and Growth Facility, and request for waiver of performance criteria, prepared by a staff team of the IMF, following discussions that ended on September 7, 2004, with the officials of Pakistan on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on November 16, 2004. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- a staff statement of November 30, 2004 updating information on recent economic developments.
- a Public Information Notice (PIN) and a Press Release summarizing the views of the Executive Board as expressed during its December 1, 2004 discussion of the staff report that concluded the Article IV consultation and completed the request and review.
- a statement by the Executive Director for Pakistan on December 1, 2004.

The documents listed below have been or will be separately released.

Letter of Intent sent to the IMF by the authorities of Pakistan\*  
Memorandum of Economic and Financial Policies by the authorities of Pakistan\*  
Report on the Observance of Standards and Codes—Fiscal Transparency Module—Update  
Selected Issues Paper and Statistical Appendix  
\*May also be included in Staff Report

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PAKISTAN

**Staff Report for the 2004 Article IV Consultation,  
Ninth Review Under the Three-Year Arrangement Under the Poverty Reduction and  
Growth Facility, and Request for Waiver of Performance Criteria**

Prepared by the Middle East and Central Asia and  
Policy Development and Review Departments

(In consultation with other departments)

Approved by Saleh M. Nsouli and Michael T. Hadjimichael

November 16, 2004

- Discussions for the 2004 Article IV consultation and the ninth review under the Poverty Reduction and Growth Facility (PRGF) arrangement were held in Islamabad during August 30–September 7, 2004. The staff team consisted of Messrs. Zavadjil (head), van Rooden, Schimmelpfennig (all MCD), Baig (FAD), Finger (PDR), and Singh (ICM). Messrs. Khan (MCD) and Mirakhor (Executive Director) joined the mission during August 30–31. The mission was assisted by Mr. Lorie (Senior Resident Representative).
- The mission met with Prime Minister Aziz, State Bank of Pakistan (SBP) Governor Husain, Finance Advisor Shah, Finance Secretary Ahsan, and other government officials. The mission also met with representatives of commercial banks, private and public enterprises, labor unions, and nongovernment organizations.
- Pakistan's request for a three-year arrangement under the PRGF, with access of 100 percent of quota (SDR 1.03 billion), was approved by the Executive Board on December 6, 2001 (IMF Country Report No. 01/222). So far, Pakistan has drawn SDR 861 million under the current arrangement. As of September 30, 2004, total Fund credit and loans outstanding to Pakistan amounted to SDR 1.3 billion (126 percent of quota).
- The last Article IV consultation was discussed by the Executive Board on November 1, 2002 (IMF Country Report No. 02/246). At that time, Executive Directors noted the progress made in achieving macroeconomic stability, but urged the authorities to further improve public debt dynamics, address Pakistan's social gap, and deepen structural reforms. Pakistan's Poverty Reduction Strategy Paper (PRSP) was discussed by the Executive Board on March 8, 2004 (IMF Country Report No. 04/24 and 04/70). Directors noted that it represented an adequate framework for Pakistan's efforts toward sustainable growth and poverty reduction and provided a sound basis for Fund concessional assistance. The Executive Board completed the eighth program review on June 23, 2004 (IMF Country Report No. 04/211), when Directors commended the authorities for the country's impressive recovery from macroeconomic crisis, despite sometimes difficult domestic and external circumstances. They stressed that the country still faced major challenges to ensure that growth was maintained and translated into sustained poverty reduction.
- Pakistan has accepted the obligations of Article VIII. It maintains a restriction subject to Fund approval in the form of a 50 percent limit on advance payments for some imports.
- The principal authors of this report are Milan Zavadjil, Ron van Rooden, and Axel Schimmelpfennig, with contributions from Taimur Baig, Harald Finger, and Abhisek Banerjee.

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## List of Acronyms

ABL	Allied Bank Limited
AML/CFT	Anti-Money Laundering/Combating Terrorist Financing
AsDB	Asian Development Bank
CBR	Central Board of Revenue
CWIQ	Core Welfare Indicators Questionnaire
DFID	U.K. Department for International Development
FBS	Federal Bureau of Statistics
FDI	Foreign direct investment
FIBR	Floating interbank market exchange rate
FRL	Fiscal Responsibility Law
FRP	Financial Recover Plan
FSSA	Financial System Stability Assessment
GDDS	General Data Dissemination System
GFS	Government Finance Statistics
GRA	General Resources Account
GSP	Generalized System of Preferences
HBL	Habib Bank Limited
IDBP	Industrial Development Bank of Pakistan
KESC	Karachi Electric Supply Corporation
LTU	Large taxpayer unit
MEFP	Memorandum of Economic and Financial Policies
MTU	Medium taxpayer unit
NAM	New Accounting Model
NEPRA	National Electric Power Regulatory Agency
NFC	National Finance Commission
NSS	National Saving Schemes
NWFP	North West Frontier Province
PCs	Performance criteria
PIA	Pakistan International Airlines
PIB	Pakistan Investment Bonds
PIFRA	Project for Improvement of Fiscal Reporting and Auditing
PIHS	Pakistan Integrated Household Survey
PPM	Post-Program Monitoring
PRGF	Poverty Reduction and Growth Facility
PRSP	Poverty Reduction Strategy Paper
SBP	State Bank of Pakistan
SDDS	Special Data Dissemination Standard
TB	Treasury bill
WAPDA	Water and Power Development Authority

## Executive Summary

**Pakistan has successfully recovered from the 1998/99 crisis.** Growth has rebounded to 6½ percent. Fiscal adjustment, supported by official inflows and debt relief, has led to a substantial improvement in public and external debt indicators. Reflecting strong export growth and remittances, the balance of payments has turned around and international reserves now cover six months of imports. Still, poverty and unemployment remain high.

**Implementation of the PRGF program remains broadly on track.** All quantitative performance criteria (PCs) and indicative targets for end-June 2004 were met. Structural reforms continue to be advancing, although four structural PCs were breached. A temporary intensification of an existing and the imposition of a new exchange restriction, however, were quickly reversed, and new tax exemptions have been offset by other tax measures, while a missed PC in the energy sector has since been implemented.

**The discussions focused on the key policy challenges of sustaining strong economic growth and reducing poverty.** To help lift a significant share of the population out of poverty, the authorities are aiming to increase the pace of economic growth to 8 percent annually over the medium term. This is ambitious and will require a substantial increase in private and public investment. Improvements in the investment climate through structural reforms, including in the energy sector, are necessary to raise domestic investment and attract more foreign investment. Accelerating growth will also require the continuation of sound macroeconomic policies.

**The government's medium-term fiscal strategy aims to balance the need for higher levels of social and investment spending with reducing the debt burden.** The 2004/05 budget is consistent with this strategy and aims to limit the overall fiscal deficit (excluding grants) to 3.2 percent of GDP, helping to reduce the public debt ratio to 63 percent of GDP. Creating room for a further increase in health and education spending, as well as infrastructure investments, will depend on raising tax revenues and further reducing transfers to state-owned enterprises.

**Inflation picked up in 2003/04 and the SBP has stepped up its efforts to tighten monetary policy.** While inflation appears to have leveled off recently, the SBP should tighten monetary policy further to avoid that inflationary expectations become engrained. A tighter monetary stance would also alleviate pressures on the exchange rate and reduce the need for exchange market intervention.

**Pakistan will not seek a successor arrangement once the current PRGF arrangement expires in December 2004.** The authorities remain committed, however, to maintaining a close dialogue with Fund staff. The staff's position is that Post-Program Monitoring (PPM) is not warranted for Pakistan, even under the proposed framework for extending PPM to PRGF resources. The outstanding combined PRGF/GRA resources at end-2004 will be only 117 percent of quota, given the authorities' commitment not to draw the final PRGF tranche, while Pakistan's external position has strengthened considerably.



## I. INTRODUCTION

1. **In the attached letter dated November 12, 2004 and the accompanying Memorandum of Economic and Financial Policies (MEFP), the government of Pakistan requests completion of the ninth and final review under the PRGF arrangement.** The authorities also request waivers for the nonobservance of four structural PCs. While the tenth disbursement is conditional upon completion of this review, the authorities state in the attached letter that they will not draw the final tranche.

2. **The political and security situations remain complex.** A new government was announced in August 2004. Prime Minister Aziz retained the finance portfolio, which bodes well for the continuation of reforms. Pakistan's National Assembly has approved a bill to allow President Musharraf to continue as both president and army chief, much to the ire of the opposition. Operations against militants in the border areas are ongoing and have prompted retaliation from affected groups, including an attempt on the prime minister. The dialogue with India is progressing, though differences over Kashmir remain.

## II. BACKGROUND

3. **As part of the Article IV consultations, the staff took a fresh look at developments and reforms since the 1998/99 crisis, and particularly performance under the 2000 Stand-By Arrangement and the subsequent PRGF arrangement.** By 1998/99, Pakistan had virtually run out of foreign exchange reserves and public debt obligations were not being met. Economic growth had slowed to an average of below 3 percent in 1996/97–1998/99. The Stand-By Arrangement focused therefore on restoring macroeconomic stability. The subsequent PRGF arrangement centered on further strengthening macroeconomic stability, raising growth, and reducing poverty.<sup>1</sup> The PRGF arrangement included wide-ranging structural reforms, focusing on revenue administration, expenditure management, and the energy and financial sectors. Unlike under previous programs, quantitative targets were mostly met or exceeded, and structural reforms measures were largely followed through, though in some cases with delays.

4. **The fiscal and monetary policy mix yielded quick macroeconomic stabilization** (Table 1, see also Box 1). Significant fiscal consolidation was achieved largely by savings on the interest bill and increases in nontax revenues. The resulting fiscal space was used to reduce government debt while raising social- and poverty-related spending. Monetary policy was tightened immediately after the crisis, and inflation was brought down successfully. Large remittances strengthened the Pakistani rupee and helped to achieve an unprecedented accumulation of foreign exchange reserves. This allowed the SBP to reduce interest rates,

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<sup>1</sup> This strategy is further elaborated in Pakistan's Poverty Reduction Strategy Paper (IMF Country Report No. 04/24).

### Box 1. Pakistan's Macroeconomic Improvement—Windfall or Homemade?

**Of great interest in both Pakistan and abroad has been the question of whether the stronger macroeconomic situation stems primarily from an improved external setting in the aftermath of the September 11, 2001 events, or because of domestic adjustment.** Many, sometimes

complex, external factors have affected Pakistan's economy. On the positive side, Pakistan has benefited from higher external grants and remittances, and increases in textile and clothing quota allowances. On the negative side, Pakistan has suffered from high petroleum prices, a prolonged drought (2000–02) and the perception of a worsened security situation. These factors are not easily quantified, but a decomposition of the fiscal and external accounts can shed some light on the contribution of external versus domestic factors.

Pakistan: External Performance, 1993/94–2003/04 (in millions of U.S. dollars)		
	Average 1993/94– 2000/01	Average 2001/02– 2003/04
SBP reserves accumulation (+) increase	200	2,943
Balance of trade on goods and nonfactor services	-3,272	1,181
<i>Of which:</i> defense receipts	0	676
Other private flows 1/	2,908	3,670
Other official flows 2/	563	455
Official gross inflows	4,077	4,622
Official gross outflows (-)	3,679	3,997
Other net flows	165	-171

1/ Private net income, transfers and capital flows; and commercial bank reserve accumulation.  
2/ Official income, transfers and capital flows; exceptional financing; and privatization receipts.

On the external side, domestic adjustment seems to have been the key to the macroeconomic improvement, although external factors played some role. The main element underscoring the increase in reserve accumulation was an improvement in the trade and nonfactor service accounts (see table). This was helped by higher defense receipts (\$676 million) and increased access to foreign markets, but also by strong performance of Pakistan's export-oriented industries. Higher defense receipts reflected payments to cover costs in the war against terror. Moreover, strong reserve accumulation was helped by higher remittances. The latter may partly reflect the tighter scrutiny of financial holdings of Pakistanis living in some industrialized countries, providing an extra incentive to transfer funds to Pakistan. However, it also reflects efforts to bring informal remittances into the official net, and enhanced confidence in the Pakistani rupee and in Pakistan's financial system. By contrast, official flows have not contributed to Pakistan's reserve build-up, as higher gross inflows merely helped to meet the increase in Pakistan's external obligations. On the fiscal side, the improvement in the overall balance (including grants) was helped by significantly higher grants, but were facilitated also by improvements in nontax revenue (including defense receipts), along with substantial savings on domestic interest expenditure (see table). Lower domestic borrowing costs reflected improved macroeconomic policies and financial reforms.

Pakistan: Fiscal Performance, 1993/94–2003/04 (in percent of GDP)		
	Average 1993/94– 2000/01	Average 2001/02– 2003/04
Tax revenue	11.2	11.2
Nontax revenue	2.5	3.4
Defense-related receipts	0.0	0.8
Grants	0.3	1.6
Expenditure	19.2	18.7
Current expenditure	16.1	15.5
<i>Of which</i>		
Interest payments	5.5	4.5
Domestic	4.4	3.5
Foreign	1.1	1.1
Defense	4.0	3.4
Development expenditure and net lending	3.1	3.2
Budget balance (including grants)	-5.3	-2.3





































































































































































































