

November 12, 2004

Mr. Rodrigo de Rato  
Managing Director  
International Monetary Fund  
Washington, D.C. 20431  
U.S.A.

Dear Mr. de Rato:

While Pakistan exits from its Poverty Reduction and Growth Facility (PRGF) arrangement, the government remains committed to the economic strategy outlined in the Poverty Reduction Strategy Paper (PRSP), which aims to create an enabling environment for sustained high growth, job creation, and poverty reduction.

We held discussions with Fund staff in August/September 2004 for the ninth review under the PRGF arrangement. The attached Memorandum of Economic and Financial Policies (MEFP) reviews economic developments and policy implementation through August 2004, and discusses our policies for 2004/05 and beyond. It supplements the MEFP dated November 22, 2001, as well as the supplementary MEFPs dated March 12, 2002, June 18, 2002, October 16, 2002, February 8, 2003, May 29, 2003, October 11, 2003, and June 7, 2004.

All quantitative performance criteria for end-June 2004 were met. Moreover, most structural performance criteria were met, except for: (i) the introduction or extension of tax exemptions; (ii) the announcement of a tariff and subsidy policy for regional electricity tariff setting; (iii) the publication of financial recovery plans for the successor companies of the Water and Power Development Authority (WAPDA); and (iv) the performance criterion on not imposing or intensifying restrictions on payments and transfers for current international transactions. The tax exemptions are intended to strengthen our business climate, and the minor negative revenue impact has been more than offset by revenue raising measures taken in the budget. The tariff and subsidy policy was announced in early November. However, the financial recovery plans are further delayed because the regulator has yet to determine tariffs consistent with the cost recovery principle. We temporarily intensified an existing, and imposed one new restriction on advance payments of certain imports, but upon learning that this constituted a breach of a performance criterion, we have taken remedial measures to reinstate the status quo ante.

In light of our improved external situation, which is much better than projected, and despite the temporary pressures in the foreign exchange market, we have decided not to draw the tenth and final tranche under the PRGF so that these resources would become available for other countries in need of concessional support from the Fund.

On this basis, and in view of the policies set out in the attached MEFP, the government requests waivers for the nonobservance of the structural performance criteria listed above, and the completion of the ninth review.

We look forward to our continued cooperation with the Fund, in the context of its normal consultation with member countries on their economic developments and policies. In this regard, the government will, of course, continue to provide the Fund with such information as the Fund may request in connection with Pakistan's progress in implementing its economic and financial policies.

Sincerely yours,

/s/

Salman Shah

Advisor to the Prime Minister on Finance

/s/

Ishrat Husain

Governor  
State Bank of Pakistan

Attachment:

Memorandum of Economic and Financial Policies

## PAKISTAN

### Memorandum of Economic and Financial Policies

#### I. INTRODUCTION

1. Pakistan's three-year arrangement under the IMF's Poverty Reduction and Growth Facility (PRGF) will come to an end in December 2004. With this, we will also bring to a close a long period of financial support from the IMF. Instead, in the period ahead, Pakistan will primarily rely on domestic and international markets to meet its financing needs, complemented by continued support from official creditors including the World Bank and the Asian Development Bank. Indeed, we have already made a successful re-entry in the international capital markets earlier this year.

2. **The end of IMF-supported programs, however, will not result in a shift in our economic policies.** On the contrary, the prudent fiscal and monetary policies, combined with broad-based structural reforms, implemented in the past few years have served Pakistan well. The country has made an impressive recovery from macroeconomic crisis to stability and a resumption of economic growth. Fiscal and external vulnerabilities have been reduced, through a reduction in fiscal imbalances and supported by debt relief and other assistance provided by the international community.

3. **The task ahead is to maintain stability and further accelerate economic growth.** Strong growth will remain crucial for creating new employment opportunities and reducing poverty. Thus, we will need to continue on the path set out in our Poverty Reduction Strategy Paper (PRSP) "Accelerating Economic Growth and Reducing Poverty." We will continue to implement sound financial policies and will further advance our reform agenda to create a vibrant market-based economy. In addition, our policies will also continue to aim to reduce poverty through greater social inclusion, including through human development and devolution of political and economic power.

4. This Memorandum of Economic and Financial Policies reviews macroeconomic performance and the implementation of structural measures in 2003/04 and sets out our economic policies for the remainder of 2004/05. It provides an update on our policy objectives and prospects for the current fiscal year, as well as on the actions we have already taken or will take to help achieve these objectives.

#### II. RECENT DEVELOPMENTS

5. **The economy continues to gather steam.** Real GDP growth accelerated to 6.4 percent in 2003/04, exceeding our target of 5.3 percent by a wide margin, and up from 5.1 percent in the preceding year. Growth has been strong across most sectors, but has been most pronounced in the large-scale manufacturing sector. Moreover, growth is broadening from predominantly export-led to being domestic demand-driven as well. Exports and

imports grew by 13.8 percent and 20.1 percent, respectively, in U.S. dollar terms. In U.S. dollar terms, per capita GDP has increased from \$500 in 2001/02 to \$638 in 2003/04.

6. **Inflation has picked up, however.** Annual average inflation in 2003/04 was 4.6 percent, marginally exceeding our 4.1 percent target. The pickup in inflation is more visible in the twelve-month rate of inflation, which has increased from 1.9 percent in June 2003 to 9.0 percent in September 2004. To some extent, this increase in inflation reflects special factors, notably the sharp increase in wheat prices during 2003/04 that resulted from an unanticipated shortage in the supply of wheat, as well as an increase in the support price of wheat. Similarly, the rise in international oil prices contributed to inflation, although the full effect of this has not been passed on to consumer prices. Strong demand and a rapid expansion of credit also contributed to inflation. Notably, house rents, which have a relatively large share in the consumer price index, have increased significantly.

7. **The 2003/04 overall budget deficit remained well within its limits.** The consolidated government deficit (excluding grants) is estimated at PRs 129 billion (2.4 percent of GDP), considerably less than the budget target of PRs 179 billion (3.3 percent of GDP). As a result, the ratio of public debt to GDP fell to under 70 percent, down from its peak of 89 percent in 2000/01. Revenue collection by the Central Board of Revenue (CBR) exceeded the target by a solid margin, reaching PRs 519 billion or 9.5 percent of GDP. Revenue performance benefited from the higher-than-expected rate of economic growth, but also reflected the impact of our ongoing efforts to strengthen revenue administration. Social- and poverty-related expenditures, as well as development expenditures exceeded budget projections, which is a welcome break with past trends of underutilizing resources and attests to improved implementation capacity.

8. **The State Bank of Pakistan (SBP) has started to tighten monetary policy, slowly but steadily, in response to rising inflation and continued strong money growth.** Short-term interest rates (six-month treasury bills) have been increased by 2.07 percentage points since the start of 2004 to 3.73 percent in November. Broad money grew by 19.6 percent in 2003/04, while reserve money grew by 15.4 percent. Credit to the private sector continued to grow rapidly, at almost 30 percent, reflecting the buoyant economy, low interest rates, and ample liquidity in banks.

9. **All quantitative performance criteria under the PRGF arrangement set for end-June 2004 were met (Table 1a).** Similarly, all but two of the indicative targets for end-March and end-June were also met. Exceptions were the end-March target for social- and poverty-related spending—which was missed by a small margin—and the end-March ceiling on the contracting or guaranteeing of nonconsessional medium- and long-term debt. The latter ceiling was breached due to a government guarantee on a larger-than-anticipated loan contracted by Pakistan International Airlines (PIA). Given PIA's improved performance, the IMF's Executive Board augmented the end-June ceiling during the completion of the eighth review under our PRGF arrangement to accommodate this guarantee. The shortfall in social- and poverty-related spending was more than made up by end-June.

10. **Further progress was made in implementing structural reform measures, although some slippages and delays occurred (Table 2).** In the area of tax policy, the 2004/05 budget removed income and sales tax exemptions and incorporated other base-broadening measures that together will yield a total of PRs 5 billion. However, some new exemptions were introduced with the 2004/05 budget, including exemptions for: (i) income tax on vocational and technical institutions; (ii) import duties on all agricultural machinery; (iii) import duties on raw materials for pesticides; and (iv) import duties on commercial aircraft and engines. In addition, the exemption for capital gains tax was extended. These exemptions aim to remove anomalies and discriminatory practices in the tax system, as well as promote investment. The revenue impact of these measures is estimated to be small: less than 0.1 percent of GDP and, in any event, revenues in 2004/05 are projected to be substantially higher than projected earlier under the program.

11. **Revenue administration** was strengthened further as: (i) a pilot customs office has been opened in the port of Karachi that will allow much faster processing and clearance; (ii) two additional medium-taxpayers units (MTU), organized along functional lines, have been opened; and (iii) a new large-taxpayers unit (LTU) has become operational in Lahore.

12. In the **energy sector**, the Water and Power Development Authority (WAPDA) and the Karachi Electric Supply Company (KESC) met their financial targets for 2003/04. WAPDA benefited from a greater availability of hydro energy, while both WAPDA and KESC realized higher production and sales volumes. The Ministry of Water and Power issued the broad principles for the determination of regional electricity tariffs in June 2004. These principles clarified the respective roles of the government, National Electric Power Regulatory Authority (NEPRA), and the power companies in the setting of tariffs. Following this, NEPRA completed the process of determining the structural tariffs for the individual distribution companies succeeding WAPDA. Subsequently, eight distribution companies filed review motions with NEPRA because the tariff determinations were below cost recovery. NEPRA's revised determination issued in late October also fell short of the cost recovery principle. The determination would have implied much higher-than-budgeted government subsidies to the utilities and would have put our fiscal targets at risk. Therefore, the government rejected the revised determination and has asked NEPRA to review its decision again. The government's electricity subsidy policy was announced in November and aims to ensure that distribution companies achieve cost recovery while protecting consumers from very high tariffs that are not viable on social and economic grounds. The policy also sets a timetable for phasing out electricity subsidies by 2010.

13. With the structural tariffs under review, the Financial Recovery Plans (FRPs) for the distribution companies could not be finalized by end-July as planned. Instead, the companies presented financial scenarios based both on the initially determined tariffs, as well as on the tariffs aimed for in their review motions. We are confident that this will prove to have been a useful exercise that aided the distribution companies in the review process and will allow them to quickly finalize their FRPs once NEPRA had determined new tariffs.

14. In the area of **financial sector** reform, following the sale of Habib Bank Limited (HBL) earlier this year, in August, Allied Bank Limited (ABL) was transferred into private ownership through the sale of additional shares. With this, our agenda for the restructuring and privatization of the banking sector has been almost completed, leaving only the Industrial Development Bank of Pakistan (IDBP) to be divested. National Savings Schemes (NSS) rates were adjusted on July 1, 2004, based on the new formula, to better align them with yields on Pakistan Investment Bonds (PIBs). To help combat money laundering, we have issued several regulations that require inter alia reporting of suspicious transactions and set out minimum record keeping standards to ensure compliance with Financial Task Force recommendations. Discussions among all stakeholders continue on the drafting of the *Benami* law and we expect to submit a first draft to the Cabinet in 2005.

### **III. ECONOMIC AND FINANCIAL POLICIES FOR THE REMAINDER OF 2004/05**

#### **A. Macroeconomic Framework**

15. **Economic growth in 2004/05 is forecast to reach about 6.5 percent**, building on the current momentum and provided that weather conditions remain favorable. Over the medium term, we are aiming to further accelerate the pace of economic growth and reach 8 percent annually. This will require the steadfast implementation of sound financial policies and structural reforms to promote investment, as discussed in our PRSP. Moreover, to achieve such a high rate of economic growth, it will be crucial to substantially increase productivity in the agricultural sector, which accounts for almost one quarter of Pakistan's output. Thus, in our policies we are placing particular emphasis on this sector, with improving the availability of water as one of our key objectives. Furthermore, to achieve and sustain such high economic growth, we will require strong physical infrastructure, for which we are allocating a large sum in the federal budget.

16. **Given recent trends in inflation, annual average inflation in 2004/05 is expected to exceed the 5 percent target.** By further tightening monetary policy, together with measures to regularize conditions in the wheat market, we aim to reduce the twelve-month rate of inflation to 4–5 percent by June 2005, but due to the carry over of price increases in 2003/04, this implies an annual average rate of inflation for 2004/05 of about 7 percent.

#### **B. Fiscal Policy**

17. **The budget for 2004/05 adopted in June balances the need for increased social and development spending and a further reduction of the debt burden.** The 2004/05 budget limits the consolidated government overall deficit (excluding grants) to PRs 199 billion (equivalent to 3.2 percent of GDP). Social- and poverty-related expenditures are budgeted to reach PRs 278 billion (4.5 percent of GDP, compared to 3.8 percent of GDP in the previous year), while the Public Sector Development Program was raised to PRs 188 billion (3.0 percent of GDP).

18. **A few measures were taken in the context of the budget that will need to be accommodated within the overall envelope.** This includes an increase in government wages and pensions by 15 percent—estimated to cost PRs 16 billion—and the further reduction in petroleum development levies to insulate domestic petroleum prices from the recent increase in international oil prices. Assuming that international oil prices will gradually decline in line with the IMF's World Economic Outlook projections, this measure is estimated to result in a revenue loss of some PRs 30 billion. Offsetting these measures will be a higher-than-budgeted collection of revenues by the CBR (PRs 10 billion), due to a higher base in 2003/04 and a slightly higher nominal income growth this year; lower-than-budgeted subsidies (PRs 6 billion); and higher-than-budgeted nontax revenues (PRs 30 billion). The latter stems from higher-than-anticipated dividends from public enterprises and other receipts. Once the current spike in oil prices has passed, we will return petroleum development levies to the levels prevailing at the beginning of 2004 and will resume the fortnightly adjustment of domestic petroleum prices in line with import costs.

19. **The 2004/05 budget and current nominal growth projections imply a further reduction in the public debt-to-GDP ratio to about 64 percent.** This is in line with the path set out in the PRSP and the draft Fiscal Responsibility Law (FRL). The draft FRL has already been approved by the Standing Committee on Finance of the National Assembly and we expect parliamentary approval later this year.

### C. Monetary and Exchange Rate Policy

20. **Monetary policy will be tightened further to help contain inflationary pressures.** As noted above, our goal is to reduce twelve-month inflation to about 5 percent by the end of 2004/05. An increased supply of wheat will help contain further increases in food prices, but considerable uncertainty remains about the development of oil prices. Moreover, interest rates in international markets have begun to edge upwards and they are expected to continue to rise in the months ahead. Thus, to avoid undue pressure on the exchange rate of the Pakistani rupee, interest rates in Pakistan will have to rise as well. But in determining the appropriate pace of raising interest rates, the SBP will maintain a balance between stemming inflationary pressures, preventing an undue weakening of the exchange rate, and continuing to support economic growth.

21. **Taking into account the lags with which monetary policy affects inflation, the SBP has already acted to raise interest rates since August 2003.** The SBP has raised interest rates more significantly since mid-2004, reducing the gap between twelve-month inflation and short-term interest rates (six-month treasury bills) from almost 7 percent in July to 6 percent in September. Short-term interest rates have been increased by 1.4 percentage points so far since mid-2004, compared to 0.4 percent in the first half of 2004. Monetary expansion is targeted to be in line with nominal income growth. Interest rates can be expected to increase further in the remainder of 2004/05 and the SBP stands ready to tighten further should inflationary pressures not abate. Meanwhile, SBP operations in the foreign exchange market will be limited to smooth short-term fluctuations, and the SBP will make every

attempt to maintain external competitiveness. While the SPB remains committed to a liberal foreign exchange regime, on November 1, 2004, we introduced some new measures in respect of advance payments for imports. These measures were primarily intended to remove certain anomalies and to forestall misuse of some of the facilities by certain market participants. However, upon realizing that parts of our new measures could constitute an intensification of and a new restriction, and thus a breach of a performance criterion, we immediately amended the respective new measures on November 10, 2004, thus reinstating the status quo ante for genuine importers.

22. All (but one) bilateral agreements with the Paris Club creditors have been signed, with the remaining one (with the Russian Federation) expected to be concluded soon. We are seeking comparable treatment from non-Paris Club bilateral creditors and all but three agreements have been signed. Discussions are underway to finalize the remaining agreements with the United Arab Emirates, Libya, and China.

#### **D. Structural Policies**

23. **We will continue to build on our efforts to expand the tax base and strengthen revenue administration.** Further steps to broaden the tax base will focus on: (i) expanding the general sales tax to cover more services; (ii) reducing exemptions; (iii) improving compliance of existing taxpayers; and (iv) bringing more taxpayers under the tax net. Revenue administration is being enhanced through the CBR reform project, supported by the World Bank. By setting up LTUs and MTUs, and moving toward a functional organization that relies on self-assessment and risk-based auditing, revenue collection will become more efficient and more taxpayer-friendly. With these measures we aim to gradually increase the share of revenues collected by the CBR by 0.2–0.3 percentage point of GDP annually.

24. **Similarly, we will continue to move ahead with our agenda to improve expenditure management.** We are working to improve our fiscal reporting system through the Project for Improvement of Fiscal Reporting and Accounting, with the help of the World Bank. A new chart of accounts under the New Accounting Model (NAM) has been introduced with the 2004/05 budget for the federal government. The provincial governments are gradually moving toward producing their budgets under the NAM. Work is underway to introduce a medium-term budget framework in two pilot ministries—the Ministry of Health and the Ministry of Population—with the assistance of the U.K.’s Department for International Development.

25. **Two major surveys are underway to assess progress made in improving social indicators.** A Core Welfare Indicators Questionnaire (CWIQ) started in August 2004, and a full Pakistan Integrated Household Survey (PIHS) was launched in the same month. The results of the CWIQ are expected to be available in time to serve as input for the 2005/06 budget discussions, but those of the PIHS—which covers a full year—will only become available in late 2005. The results of these surveys will help us to increase the effectiveness

of social- and poverty-related spending. For the next PRSP progress report we will develop a prioritized action plan for implementing our PRSP agenda.

26. **We will continue with the reform and divestiture of public enterprises, notably in the power sector.** With the unbundling of WAPDA and the establishment of a regional tariff and subsidy policy, crucial steps have been taken on the road to improve efficiency in the power sector. We will finalize the financial recovery plans for the distribution companies as soon as NEPRA has determined tariffs that are consistent with the cost recovery principle. We will also continue to work with the World Bank on a medium-term adjustment program for the sector that aims to eliminate the sector's drain on the budget. Our goal is to increasingly transfer the sector into private ownership. In this regard, in 2004/05 we will offer for sale KESC, the Faisalabad Electric Supply Corporation, the Jamshoro generation company, as well as shares in the Kot Addu Power Company. Outside the power sector, privatization plans for the near future include the sale of majority stakes in Pakistan State Oil and National Refinery Limited.



Table 1b. Pakistan: Quantitative Targets, September 2004–June 2005 1/

(Cumulative flows from July 1, 2004, unless otherwise specified)

	2004		2005		End-Jun. Rev. Proj.				
	End-June Stock PreI. Est.	End-Sept. Proj.	End-Dec. Proj.	End-Mar. Proj.					
		Rev. Proj.	Rev. Proj.	Rev. Proj.					
Net foreign assets of the SBP (floor in millions of U.S. dollars)	8,750.1	208.8	-430.0	-194.5	-385.0	7.5	276.8	-52.5	357.8
Net domestic assets of the SBP	314.5	-8.9	61.3	39.3	132.3	61.3	104.3	75.4	53.3
Overall budget balance (floor)	...	-78.5	-89.4	-115.9	-121.1	-160.1	-179.7	-199.2	-199.2
Net government bank borrowing	...	15.0	10.0	30.0	20.0	70.0	40.0	90.0	60.0
CBR revenue (floor)	...	110.0	112.7	255.0	261.2	400.0	409.8	576.0	590.0
Net banking sector claims on public sector enterprises	38.3	1.0	5.0	2.0	10.0	3.0	15.0	4.0	18.0
Social- and poverty-related spending ("I-PRSP budgetary expenditure") 2/	...	59.8	59.8	119.2	119.2	159.2	159.2	278.0	278.0
<i>Memorandum items:</i>									
Net external program financing	...	247.7	-342.9	-823.6	-192.4	-809.9	104.5	-926.2	21.2
Of which: privatization proceeds	...	0.0	0.0	0.0	0.0	99.0	96.0	99.0	96.0
External cash budget grants	...	0.0	0.0	315.0	314.0	315.0	328.0	330.0	343.0
External capital grants	...	0.0	495.0	0.0	495.0	0.0	495.0	0.0	495.0
External privatization budget receipts	...	...	...	...	...	...	...	15.0	15.0
Daily cash reserve requirements ratio (in percentage points)	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0
Special cash reserve requirements ratio on foreign currency deposits (in percentage points)	15.0	15.0	15.0	15.0	15.0	15.0	15.0	15.0	15.0

Source: Pakistani authorities.

1/ The relevant variables are defined in the Technical Memorandum of Understanding (TMU) dated May 29, 2003 and are subject to adjustments specified in the TMU. All program flows are indicative ceilings or floors as indicated.

2/ Expanded definition as described in the December 2003 PRSP.

Table 2. Pakistan: Structural Performance Criteria and Benchmarks  
Under the PRGF Arrangement for the Ninth Review

Measures	Timing	Status as of July 31, 2004
<b>I. Structural Performance Criteria</b>		
No new exemptions (as per status of March 1, 2003) or special privileges regarding income tax, custom duties, or GST to be granted, no new regulatory import duties to be imposed (except for anti-dumping measures), and all time bound exemptions and regulatory import duties to lapse without extension, except for existing contracts and exemptions based on international commitment.	Continuous	Not observed; 5 new exemptions were introduced with the 2004/05 budget.
KESC or WAPDA downward electricity tariff adjustments determined by NEPRA not to be implemented unless cumulative quarterly deficit targets of KESC, respectively WAPDA, for the preceding quarter were observed.	Continuous	Observed.
Publish quarterly progress reports on implementation of financial improvement plan of WAPDA/successors.	May 31, 2004 for the quarter January–March 2004, and August 31, 2004 for the quarter April–June 2004.	Observed.
Government to notify electricity tariff adjustments determined by NEPRA within 30 days of their determination (effective on day of notification).	Continuous	Observed for KESC; nonapplicable for WAPDA, as WAPDA's successor companies filed review petitions following the initial determination of new individual tariffs in June/July. Revised tariffs were appealed by the government.
Propose to Parliament removing income and sales tax exemptions and adopt other tax-based broadening measures yielding a total of PRs 5 billion in estimated revenues in the context of the 2004/05 budget	June 30, 2004	Observed.
Set up a pilot customs house in Karachi that will involve entry processing on a 24-hour basis, electronic filing of declarations by importers on a self-assessment basis, and parameter and risk-based audits.	June 30, 2004	Observed.
Promulgation of a federal budget for FY 2004/05 consistent with a consolidated overall budget deficit (excluding grants) not exceeding PRs 199.2 billion.	June 30, 2004	Observed: budget was passed by parliament on June 24, 2004.
Adjust NSS rates to reflect PIB yields according to formula set in the amendment of the Technical Memorandum of Understanding (TMU).	July 1, 2004	Observed.

Table 2. Pakistan: Structural Performance Criteria and Benchmarks  
Under the PRGF Arrangement for the Ninth Review (concluded)

Measures	Timing	Status as of July 31, 2004
Announce tariff and subsidy policy for regional electricity tariff setting, as further specified in paragraph 12 of the MEFP.	July 31, 2004	Delayed; implemented on November 5, 2004.
Publish Financial Recovery Plans for WAPDA and its successor entities, prepared in consultation with the World Bank, including financial targets for the power utilities, as specified in paragraph 13 of the MEFP.	July 31, 2004	Delayed.
<b>II. Structural Benchmarks</b>		
Set up two additional medium-taxpayers units.	June 30, 2004	Observed.
Open second large-taxpayers unit in Lahore	August 31, 2004	Observed.