Letter of Intent

Memorandum of Economic and Financial Policies and Technical Memorandum of understanding on the Program Supported under the Poverty Reduction and Growth Facility.

October 11, 2003

Mr. Horst Köhler
Managing Director
International Monetary Fund
Washington, D.C. 20431
U.S.A.

Dear Mr. Köhler:

Pakistan's government is committed to implementing the economic strategy set out in the Interim Poverty Reduction Strategy Paper (I-PRSP), supported by the Poverty Reduction and Growth Facility (PRGF) arrangement. This strategy is being developed into a longer-term set of policies aimed to allow higher sustainable growth and job creation, while reducing poverty, which will be articulated in the full Poverty Reduction Strategy Paper (PRSP) that will be finalized in about a month.

The Pakistani authorities held discussions with Fund staff in August–September 2003 for the sixth and seventh reviews under the PRGF Arrangement. Based on these discussions, the attached Memorandum of Economic and Financial Policies (MEFP) reviews economic developments and policy implementation through June 2003 and beyond under the arrangement, updates the macroeconomic framework, and discusses the financial policies and structural reform program for FY 2003/04. 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, and May 29, 2003.

All quantitative performance criteria for end-March and end-June 2003 were met. Moreover, all structural performance criteria were met, except on (a) submitting to parliament a fiscal responsibility law that reduces consolidated government debt (federal and provincial) to below 60 percent of GDP in 10 years; (b) eliminating the exemption from income tax withholding on National Saving Scheme (NSS) instruments; and (c) not introducing new tax exemptions. We have now submitted to parliament the fiscal responsibility law and agreed with Fund staff on an action plan for aligning yields on NSS instruments to market rates. Eliminating the previously prevailing culture of frequently issuing tax specific statutory regulatory orders is a key part of our strategy. In the last three budgets, 107 exemptions under the income and sales taxes were withdrawn. With the 2003/04 budget, a few minor amendments were made related to broad-based policies rather than individuals or special interests to ensure uniformity of treatment and remove discrimination, having virtually no revenue impact. We are committed to enhancing transparency and improving the structure of the budget, including by further reducing tax exemptions in the 2004/05 budget. On this basis, and in view of the policies set out in the attached memorandum, including the strengthening of measures to be undertaken in the areas of financial sector, tax reform and administration, and the power sector, the government requests waivers for the nonobservance of the structural performance criteria listed above and the completion of the sixth and seventh reviews.

For the remainder of the program period, we are requesting that reviews take place on a semiannual basis with the eighth review scheduled for March 20, 2004 and the ninth review for September 20, 2004. We are also requesting a rephasing of the remainder of the disbursements, with remaining installments being disbursed in equal amounts.

The government of Pakistan will provide the Fund with such information as the Fund may request in connection with Pakistan's progress in implementing the economic and financial policies, and achieving the objectives of the program. The government believes that the policies set out in the attached MEFP are adequate to achieve the objectives of the program, but it will take any further measures that may become appropriate for this purpose. The government of Pakistan will consult with the Fund on the adoption of these measures, and in advance of revisions to the policies contained in the MEFP, in accordance with the Fund's policies on such consultation.

Sincerely yours,

/s/
Shaukat Aziz
Minister of Finance and Economic Affairs

/s/
Ishrat Husain
Governor
State Bank of Pakistan

Attachments:
Memorandum of Economic and Financial Policies
Amendments to the Technical Memorandum of Understanding

PAKISTAN

Memorandum of Economic and Financial Policies for January–June 2003 and Program for FY 2003/04

I. Introduction

1. **Pakistan has made strong economic progress over the past few years, despite a weak international economic environment and regional security issues.** Reflecting the reduction of fiscal imbalances, complemented by structural reforms, inflation has been brought under control and the foreign reserve position has improved greatly. External and fiscal vulnerabilities have been reduced, the financial system has been strengthened, and the economy has become more resilient to shocks. Finally, and most importantly, economic growth has begun to recover.

2. **The government remains strongly committed to its reform agenda.** We have successfully made the transition to implementing our policies in a democratic, but inevitably more complicated, environment. Given our achievements in stabilizing the economy, we are now increasingly focusing on policies to improve living standards and reduce poverty on a sustainable basis. Key pillars of our approach are the acceleration of economic growth while maintaining macroeconomic stability, increased investment in human capital, targeted interventions to reduce poverty, expanding the social safety net, and improving governance.

3. **Our overall strategy is elaborated in the Poverty Reduction Strategy Paper (PRSP) that will be finalized in about a month.** The process of consultation is now complete. It was spread over two and a half years and involved a dialogue with communities, civil society, and business-type organizations, each at the federal, provincial (including the preparation of four provincial PRSPs), and district levels. A draft PRSP summary was submitted to Parliament along with the 2003/04 (July–June) budget. The summary was also discussed with development partners during the Pakistan Development Forum in mid-May 2003 and many of their comments have been incorporated in the PRSP. We aim to include the results of the pilot Core Welfare Indicators Questionnaire (CWIQ) survey that is being carried out in October 2003 in the full PRSP. While retaining the broad I-PRSP framework, the full PRSP will articulate a more comprehensive strategy covering rural development, gender issues, employment, and the environment.

II. Recent Developments

4. **Macroeconomic targets for 2002/03 have been exceeded and all quantitative performance criteria for end-March and end-June have been met (Table 1(a)).** Growth in 2002/03 was higher than targeted (5.1 percent compared with 4.5 percent), reflecting better-than-expected outcomes in most sectors. Of particular importance was the rebound in agricultural output, following three years of drought, which will enhance the incomes of the

poorest segments of the population. Also on the positive side, the private investment ratio rose modestly in 2002/03, but further increases in both public and private investment are needed to ensure sustainable growth over the medium term. Inflation slowed further to 1.8 percent year-on-year in August.

5. **The external position continues to strengthen.** Exports and imports grew in FY 2002/03 by 19 and 21 percent in U.S. dollar terms, respectively. This, coupled with very strong private transfers, resulted in a large current account surplus (4.4 percent of GDP, excluding grants). Despite a reduction in State Bank of Pakistan (SBP) purchases of foreign exchange in the interbank market in the last quarter of the fiscal year, gross official reserves reached $9.5 billion at end 2002/03.

6. **The 2002/03 overall fiscal deficit (excluding grants) was somewhat lower than the program target.** Central Board of Revenue (CBR) collection was slightly higher than envisaged under the program and federal nontax revenues exceeded the target because of an arrears-equity swap related to Water and Power Development Authority (WAPDA). Expenditures were higher than programmed, reflecting in part some overshooting in the running of the civil government and in pensions. According to preliminary (unreconciled) data, social sector spending ("I-PRSP expenditure") increased by 18 percent over 2001/02, and was very close to the indicative target.[1] Reflecting favorable interest rates on National Saving Scheme (NSS) instruments, domestic nonbank financing exceeded the target by a wide range. Consequently, the government was able to retire substantially more bank debt than programmed, despite a shortfall in external financing related to lower-than-expected program financing.

7. **Broad and reserve money growth accelerated to 19 percent and 16 percent, respectively, year-on-year at end-June.** Broad money growth was driven entirely by the continuing rise in net foreign assets (NFA) of the banking system. Net claims on government fell by over 4 percent during the fiscal year but this was fully offset by the sharp growth of private sector credit in the second half of the fiscal year. The yield on six-month treasury bills fell to 1.2 percent in early July, reflecting a sharp rise in bank excess reserves in the last quarter of 2002/03. However, short-term rates have risen modestly in recent weeks.

8. **The financial performance of the large public enterprises[2] in the second half of 2002/03 was broadly in line with the targets formulated under their respective Financial Improvement Plans (FIP).** WAPDA's performance was enhanced because of a return to more normal hydrological conditions after three years of drought, which permitted greater use

[1] The eighth progress report on implementation of poverty reduction strategy was published in September 2003 (see www.finance.gov.pk/poverty/home.htm)

[2] WAPDA, Karachi Electricity Supply Corporation (KESC), Pakistan International Airlines (PIA), Pakistan Railways (PR), and Pakistan Steel Mills (PSM).

of lower cost hydro power and enabled WAPDA to reduce supplier arrears substantially. In the case of KESC, collection performance improved considerably. However, technical and distribution losses were higher than targeted in both enterprises.

9. **Notwithstanding a few delays and setbacks, substantial progress continues to be made in implementing fiscal reforms.** The fiscal responsibility law was submitted to Parliament on October 11. Twenty **tax exemptions** were removed in the 2003/04 budget. However, the elimination of all exemptions from withholding tax on interest incomes was not implemented (it was maintained for NSS instruments valued at under PRs 150,000), because of the reluctance of Parliament to support this measure. Eliminating the previously prevailing culture of frequently issuing tax specific statutory regulatory orders is a key part of our strategy. In the last three budgets, 107 exemptions under the income and sales taxes were withdrawn. With the 2003/04 budget, a few minor amendments, having virtually no revenue impact, were made related to broad-based policies rather than individuals or special interests to ensure uniformity of treatment and remove discrimination. The structural benchmark on amending **tax regulations** to enable sales tax auditors to assess nonfilers tax liabilities on the basis of indirect methods of determination was observed. A steering committee was set up to coordinate the needed steps for introduction of universal self-assessment. The SBP issued a circular requiring the reporting by financial institutions of all interest incomes exceeding PRs 10,000, in line with technical assistance recommendations. The publication of the FY 2003/04 federal and North West Frontier Province (NWFP) budgets were prepared according to the New Accounting Model (NAM), but were not published because of technical problems.

10. **Some progress has also been made in reforming the energy and financial sectors.** In the **energy sector**, we have applied consistently the fortnightly automatic adjustment of petroleum product prices. The tariff increases determined by the National Electric Power Regulatory Authority (NEPRA) for WAPDA and KESC were notified by the government with delay and in the case of KESC only partly. In line with the WAPDA revised FIP, all WAPDA's successor entities filed petitions by end-June 2003 for their tariff determination with NEPRA. In the **financial sector**, a formulaic link to create greater transparency between the rates of return on General Provident Fund (GPF) and Pakistani Investment Bonds (PIB) yields by June 30 was observed. Key NSS rates were lowered by about 1.5 percent on July 1 to reflect falling PIB yields, though for two instruments the agreed formula was not strictly followed, thus increasing the spread between the rates on NSS instruments and PIB yields. The status of performance criteria and structural benchmarks established under the fifth review are outlined in Table 2(a).

III. Economic and Financial Policies for FY 2003/04

A. Macroeconomic Framework

11. **The macroeconomic framework for 2003/04 remains broadly unchanged from the June 2003 MEFP.** Our key objectives are to accelerate economic growth and increase social and development spending, while consolidating the progress made in macroeconomic stabilization and reducing debt vulnerability. With agricultural output expected to rise by 4.3 percent, growth could reach 5.3 percent. Inflation is targeted not to exceed 4 percent in 2003/04.

12. **The current account surplus (excluding grants) is expected to narrow, but nevertheless to remain at 0.6 percent of GDP.** We expect strong performance in exports to continue. Remittances and short-term private capital inflows are likely to decelerate, as the portfolio shift underlying the exceptionally high net inflows during the previous year may be gradually winding down.

13. **Monetary policy will remain geared toward maintaining low inflation.** The risks for an upsurge in inflation are limited because of weak import prices (except petroleum products), the strong Pakistani rupee, and the positive outlook for agricultural output. Nevertheless, the recent buildup of bank liquidity and the acceleration of private sector credit are of concern and underscore the need to carefully monitor inflation developments. The SBP will, if its stock of treasury bills is further depleted, introduce a new instrument (SBP certificates) and will use it to mop-up excess liquidity, with a view to moderating the growth of the monetary aggregates. Short-term real interest rates have begun to rise and can be expected to return to positive levels in the near future. The bilateral Pakistani rupee/ U.S. dollar exchange rate has remained broadly unchanged while there was very limited SBP intervention in the foreign exchange market.

14. **The 2003/04 federal budget, approved by Parliament on June 16, 2003, is consistent with the program targets.** The budget envisages a consolidated government overall deficit (excluding grants) of PRs 179 billion. CBR revenue collection is projected at PRs 510 billion, and bank financing would be limited to PRs 20 billion (excluding the costs of restructuring two public banks). In the process of finalizing the budget, we have made two substantial and several minor changes relative to the projections underlying the program. First, to address concerns of eroding real wages and pensions of civil servants, we raised base civil service wages and government pensions by 15 percent, increasing the allocations for running of the civil government and for pensions by PRs 7.6 billion and PRs 2 billion, respectively. This was fully offset by an upward revision of nontax revenue by PRs 6.6 billion (largely on account of Pakistan Telecommunications Company Limited (PTCL) and Oil and Gas Development Corporation (OGDC) dividend payments as well as a small profit transfer from the SBP), a reduction in the subsidy for wheat export by PRs 2 billion, and shifting an equity injection for the Government Holding Private Limited (GHPL) of PRs 1 billion into 2002/03. Second, without affecting the overall deficit, we also introduced an arrears for equity swap for

WAPDA of PRs 13 billion. Also, the budgetary support to WAPDA and KESC, as projected in their respective FIPs, is fully provided for by the budget. Finally, the budget envisages an increase in I-PRSP spending to 4.2 percent of GDP.

15. **There are two significant risks to the fiscal objectives for FY 2003/04.** First, until a comprehensive restructuring of the energy sector is completed, there is risk that the utilities' deficits could be higher than expected. For example, line losses could be larger than envisaged, or it may be difficult to increase bill collection in the federally administered tribal areas (FATA), forecast at PRs 2 billion in 2003/04. However, the more normal hydrological conditions now prevailing could be a mitigating factor. Second, the allocations for wages and pensions are tight, despite the upward adjustment mentioned above, in light of the increases in salary and pension rates. In case of unforeseen adverse developments in these or other areas, we would seek to safeguard achieving the program targets by cutting nonpriority expenditures on running of the civil government while protecting social- and poverty-related expenditures.

16. **In summary, we are confident that our macroeconomic policy targets for 2003/04 are attainable, especially in light of the improved domestic and external political environments and the strengthening of the global economy.** Among the various external risks to the macroeconomic outlook, the economy has already absorbed the impact of continued high oil prices after the Iraq conflict. If a reversal of private capital inflows were to occur (because of regional security factors, for example), it would be met by allowing a market-based exchange rate flexibility and monetary tightening, with reserves used only sparingly to maintain orderly market conditions.

B. Structural Policies

17. In 2003/04 we will continue to deepen our structural reforms with the objective of: (a) improving governance and creating a more favorable environment for private sector activity; (b) mobilizing additional revenues in order to further raise social and development spending; and (c) enhancing the transparency of public sector operations. Structural benchmarks and performance criteria for October 2003–June 2004 are outlined in Table 2(b).

Tax policy and tax administration

18. **We have already made considerable progress in implementing our reform agenda in the tax policy and administration area and will continue to work to strengthen human resource management, automation, and training.** A key objective will be to increase the number of income taxpayers (by 500,000 in three years time), including through the use of background information such as utility bills and registers of car and cell phone owners. We intend to broaden the coverage of the General Sales Tax (GST) and will prepare an action plan which will be submitted to the cabinet in February identifying specific steps needed for this. Any revenue gains would be used to strengthen social sector service delivery. In addition, we will propose to Parliament to remove income and sales tax

exemptions and adopt other tax base broadening measures yielding PRs 5 billion in estimated revenues in the 2004/05 budget. Regarding revenue administration, we will set up a pilot customs house in Karachi by June 30, 2004 that will involve entry processing on a 24-hour basis, electronic filing of declarations by importers on a self-assessment basis, parameter- and risk-based audits. Based on our positive experience with the large taxpayers unit (LTU) in Karachi and the medium taxpayers unit (MTU) in Lahore, we will open a second LTU in Lahore by August 31, 2004, and two additional MTUs by June 30, 2004. In late August 2003, we opened a model sales tax office in Karachi that experiments with functional specialization in the sales tax area and covers smaller sales taxpayers not administered by the LTU. Administrative reform is expected to be supported by a World Bank loan.

19. **The strategy we have elaborated to contain the 'Benami' practice (whereby assets are held in the name of a person who is not the true beneficiary) is being implemented with a view to enhancing compliance with taxes and supporting Customer Due Diligence for banks.** A task force has completed a first round of consultations with stakeholders and provincial governments. It will submit to the cabinet by end-October 2003 the result of these consultations and lay out the legislative steps at the federal and provincial levels that would be required to limit the enforceability of Benami transactions and holdings.

I-PRSP issues, public expenditure management, and fiscal transparency

20. **We plan to increase social and poverty-related expenditures to 4.2 percent of GDP in 2003/04.** In October 2003, we started a pilot of the CWIQ survey in collaboration with the World Bank; the full CWIQ survey will serve as input for the 2004/05 budget discussions. We hope that our efforts in raising spending and making it more effective by monitoring outcome indicators on a regular basis will lead to noticeable improvements in Pakistan's poverty situation. We intend to broaden the definition of social- and poverty-related expenditures to include law and order, justice, and rural electrification. In many studies, inter alia the recent participatory poverty assessment, these policy areas have appeared as important factors determining, in particular, the rural poverty situation.

21. **We are in the process of taking several steps to further strengthen our anti-corruption strategy.** In the fall of 2003, we are launching an awareness campaign which would explain what corruption is and how it affects people. The campaign would also inform about the rights and obligations of civil servants as well as citizens. Given the importance of the justice system in our fight against corruption, the National Accountability Bureau (NAB) will cooperate more closely with the access to justice program. Relatedly, we will strengthen control systems in government departments which will make existing rules and regulations more effective. Looking ahead, greater reliance on automation, civil service reform and training of legislators and civil servants will form integral parts of our strategy. An interministerial task force on reducing regulations and simplifying bureaucratic processes has been set up to reduce opportunities for corruption.

22. **We have made substantial progress in expenditure management and fiscal transparency in 2002/03.** Release of funds occurred on a more timely basis so that expenditures were better distributed over the full year. Even though the overall deficit target was ambitious, we were in a position to let ministries pursue their budget without curtailing them as a result of financing constraints. Consequently, we were able to largely execute our spending plans on social- and poverty-related expenditures as well as the Public Sector Development Program (PSDP). Reconciliation of fiscal data has improved. For the federal government provisional outcome data, revenues are reconciled to 100 percent and expenditures to 98 percent with a view to achieving 100 percent once the accounts are finalized. As a result, the statistical discrepancy between reported revenues and expenditures and the financing data has narrowed significantly. With support from DFID, we have started to develop a medium-term budget framework. As a first step, we are preparing three-year forward projections in the health and population welfare sectors based on a detailed costing exercise. We will use these forward projections as input for the 2004/05 budget. In addition, we intend to introduce general rules and regulations for procurement applicable to the whole public sector. Specific rules for individual public sector organizations would be introduced in the next fiscal year. The 2003/04 federal budget and NWFP budget were prepared on the existing accounting model and a new Government Finance Statistics (GFS) compatible new accounting model (NAM). Reporting of 2003/04 fiscal data for the federal government and NWFP is done in parallel in the old accounting system and the NAM. With the 2004/05 budget, we will introduce the NAM in the remaining provinces on a pilot basis.

Public enterprises and privatization

23. **We expect the privatization process to regain momentum in the coming months, as investors' concerns over regional security and the global economy subside.** Over the past six months, we have completed the privatization of the State Enterprises Mutual Fund and divested shares (including in Pakistan Oilfields Limited and in Attock Refinery Limited) for a total value of about PRs 6.5 billion (0.2 percent of GDP). Potential investors in Habib Bank Limited have been prequalified and have started due diligence. Bidding will take place in December. We expect to complete the divestment of the government's remaining shares in Allied Bank Limited and the privatization of Pakistan State Oil by end-2003, and the sale of up to 26 percent of shares of PTCL during the first quarter of 2004. In view of recent inquiries by several potential investors, we have sought once more expressions of interest for KESC. In general, we are optimistic that KESC can meet its financial targets for 2003/04 under the revised FIP. Our optimism is based on the recent improvement in bill collection and the expected reduction in technical and distribution losses following the completion of some key investments.

24. **Although WAPDA met its revised financial targets for the second half of 2002/03, its medium-term prospects (and those of its successor companies) remain difficult.** Nevertheless, with the more normal hydrological conditions now prevailing, we are confident that WAPDA will be able to achieve its financial targets in 2003/04, despite continued high technical and distribution losses. The revised plans specify and quantify

efforts to improve bill collection, including by initiating the metering of users in FATA (starting with commercial, industrial, and public consumers). A medium-term financial recovery plan quantifying the outlook for WAPDA will be prepared in the coming months, with the assistance of the World Bank. This plan will further develop measures to contain costs, increase efficiency, and spell out tariff policies. The plan will also identify sources of subsidy to the energy sector and develop a strategy for their rationalization over the medium term. We fully recognize the need for strong reform of WAPDA to improve operational efficiency and reduce large line losses. Such measures, coupled with the reduction over time in the upfront payments under the contracts with the independent power producers (IPPs) and lower costs resulting from the increasing output at Ghazi Barotha hydropower station, will improve WAPDA's financial position over the medium term.

25. **Progress continues to be made towards the unbundling of WAPDA.** The staff of WAPDA has been allocated to the successor entities. However, the legal transfer of assets and liabilities has been delayed to end-2003 essentially because it has taken additional time to obtain the consent of official lenders to transfer the debt to unbundled entities. We expect the new tariffs of WAPDA's successor companies to be determined by January 2004. The government fully accepts the principle of differentiated electricity tariffs by region.

26. **We will adjust energy prices regularly to reflect international market developments.** In the case of petroleum prices, fortnightly adjustments in line with import cost will continue, while maintaining stable average tax rates. For gas prices, we will apply the framework agreed with the World Bank, notably through the phased rationalization of Pakistan Petroleum Limited (PPL) wellhead prices, semiannual reviews of wellhead and consumer prices, and will endeavor to eliminate cross subsidies to the domestic sector (except lifeline consumers) by end-2005. For electricity, KESC and WAPDA (and its successor companies) we will adjust tariffs as provided under the NEPRA Act, with the government notifying adjustments as determined by NEPRA within 30 days; this adjustment will take effect on the day of notification. However, downward adjustments will not be notified until and unless final data are available showing that WAPDA's and KESC's respective cumulative accrual deficits during the preceding quarter have been at or below the levels targeted in Table 1(b).

27. **By end-October, we will finalize the action plan developed with World Bank assistance aimed at establishing a transparent regulatory framework for the setting of electricity tariffs.** We consider that the NEPRA Act constitutes an adequate base for such a framework, and that there is no need to amend it. The action plan will rather focus on improving the timely implementation and the transparency of the current framework. The action plan will also review the issue of budgetary subsidization of the power sector, especially in the context of the unbundling of WAPDA.

Financial sector reforms

28. **We will pursue the implementation of our financial sector reform strategy, and would welcome a contribution from the much-delayed Financial Sector Assessment Program (FSAP) mission that is now scheduled for February 2004.** In addition to efforts to privatize some of the remaining publicly owned commercial banks, as outlined above, we will take further steps to strengthen the legislative framework. A draft anti-money laundering law reflecting best practices and Financial Action Task Force on Money Laundering (FATF) recommendations will be submitted to Parliament by January 1, 2004. Moreover, a draft corporate bankruptcy law will be submitted to Parliament by June 30, 2004.

29. **A key element of our reform strategy is to strengthen the domestic capital market so that it will be capable of generating resources to support private sector investment and to reduce interest costs to the budget.** As part of this strategy, the NSS will need to become a modern savings institution, probably in the form of a mutual fund. In the context of an Asian Development Bank-supported (AsDB) reform of the nonbank financial sector, we have hired consultants to help with (a) the computerization (pilot project to be completed by end-March 2005 and complete automation by December 2005); and (b) reorganization of the administration of the NSS to be completed by October 2004. To address social concerns, we have opened special windows for retirees and widows. To limit the access to NSS instruments, we have taken steps to limit the involvement of commercial banks in the marketing of these instruments which have resulted in a sharp drop in the issuing of NSS instruments in the first two months of 2003/04. Our ultimate goal is to align NSS rates with market rates on comparable government instruments. As intermediate steps, we will strictly apply the existing formula agreed to on adjusting NSS rates to reflect PIB yields in January 2004 and agree with Fund staff in March 2004 on a new formula that will align NSS rates to government bonds of the same maturity. Financial penalties for early retirement of NSS instruments will be reviewed by March 31, 2004, with a view to discouraging early encashment.

IV. PUBLIC DEBT STRATEGY

30. **Our debt management strategy calls for the reduction of public debt to below 60 percent of GDP over the next 10 years, as stated in the draft fiscal responsibility law.** We have already made progress in reducing the debt burden, reflecting fiscal consolidation and the support of the international community. As part of the strategy, we intend to prepay some expensive debts totaling $1 billion in the current fiscal year.

31. **We recognize that over the medium term, Pakistan will need to diversify its sources of financing development and expand its international investor base by accessing global capital markets.** Indeed, we intend to return to the international capital markets in 2003/04 with a bond issue. Our objective is to establish an effective international pricing benchmark to diversify our sources of funding and to ensure that Pakistani debt is present in key markets following the repayment of the existing Eurobonds. Our return to

capital markets will create a mechanism to sell the government's securities in financial and capital markets. In negotiating the size and terms of the new issue, we will make every effort to minimize interest costs and extend its maturity structure.

V. Other Issues

Program financing

32. **The program is fully financed for 2003/04.** We will ensure that conditions attached to expected loan disbursements of the World Bank and AsDB are met. All (but one) bilateral agreements with the Paris Club creditors have been signed, with the remaining one expected to be concluded as soon as possible. Discussions are being held with creditors on debt swaps for social expenditure and outright debt cancellation. We will keep Fund staff informed about the discussions with creditors and ensure that implementation of any swaps will be consistent with the financial program.

Data issues

33. **The remaining steps to participate in the General Data Dissemination System (GDDS) are being finalized, with statistical metadata to be posted on the Fund's data dissemination board by December 2003.** The outstanding issues are preparing the metadata on the depository corporations survey and finalizing the metadata focusing on socio-economic components, which has benefited from World Bank technical assistance. To further improve data dissemination and move closer to subscribing to the Special Data Dissemination Standard (SDDS), we plan to meet by end-2003 the requirements of quarterly national accounts and of a regular survey on wage earnings. By end-2003, we intend to finalize work on establishing the Pakistan Bureau of Statistics (PBS) consolidating various existing agencies. PBS will be granted greater autonomy to enhance the quality of our statistics.

Program monitoring

34. **Given the improved external and fiscal prospects, we are requesting moving to six-monthly reviews for the remainder of the PRGF arrangement.** We propose the ninth disbursement (subject to the eighth review which will focus on the 2004/05 budget) in an amount of SDR 172.28 million for March 20, 2004 based on end-December 2003 data, and the tenth disbursement in an amount of SDR 172.28 for September 20, 2004 based on end-June 2004 data (ninth review). The proposed additional structural performance criteria/benchmarks for September 2003–June 2004 and the proposed end-December 2003 and end-June 2004 quantitative performance criteria and the indicative targets for end-March 2004 are listed in Tables 2(b) and 1(b), respectively.

Table 1(a). Pakistan: Quantitative Targets, December 2002–June 2003 1/

(Cumulative flows from July 1, 2002, unless otherwise specified)

	Act. End-Dec. 2002	Prog. End-Mar. 2003	Adj. Prog. End-Mar. 2003	Act. End Mar. 2003	Prog. End-Jun. 2003	Adj. Prog. End-Jun. 2003	Act. End-Jun. 2003
Net foreign assets of the SBP (floor in millions of U.S. dollars)*	3,629.0	809.0	409.0	5,197.0	4,327.0	4,240.5	5,868.0
			(In billions of Pakistani rupees)				
Net domestic assets of the SBP*	-152.8	-13.2	10.8	-237.2	-181.2	-176.0	-258.3
Overall budget balance (floor)*	-62.3	-142.3	-150.3	-99.1	-178.4	-186.4	-179.9
Net government bank borrowing*	-34.0	-38.6	-6.6	-52.5	-29.2	-16.0	-55.6
CBR revenue (floor)*	203.1	309.0	...	310.3	458.9	...	461.6
Net banking sector claims on public sector enterprises*	-7.0	16.3	...	-6.4	20.0	...	-10.3
Social- and poverty-related spending ("I-PRSP budgetary expenditure")	66.5	114.3	...	102.1	161.0	...	158.0
WAPDA accrual balance	...	...	...	...	-20.7	...	-20.0
KESC accrual balance	...	...	...	...	-14.1	...	-13.3
			(In millions of U.S. dollars)				
Outstanding stock of short-term external debt owed or guaranteed by the government and the SBP*	418.5	500.0	...	377.1	500.0	...	286.6
Contracting or guaranteeing of noncessional medium-term and long-term debt by the government* 2/	88.8	600.0	...	578.8	650.0	...	578.8
Accumulation of external payments arrears (continuous performance criterion during the program period)*	0.0	0.0	...	0.0	0.0	...	0.0
SBP's forex reserves held with foreign branches of domestic banks (outstanding stock)	56.3	100.0	...	45.8	100.0	...	65.6
Of which: other than current account*	0.0	0.0	...	0.0	0.0	...	0.0
Stock of outstanding foreign currency swap and forward sales between SBP and residents*	45.0	400.0	...	242.0	400.0	...	140.0
Memorandum items:							
Net external program financing 3/	367.2	689.1	...	-732.6	365.5	...	-691.4
Of which: privatization proceeds	186.0	150.0	...	186.0	284.0	...	186.0
External cash budget and capital grants 3/	117.5	193.0	...	1,208.9	238.5	...	1,208.9
Daily cash reserve requirements ratio (in percentage points)	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
Outstanding KESC borrowing 4/	4.0	...	...	9.0	0.0	...	0.0

Source: Pakistani authorities.

1/ The relevant variables are defined in the Technical Memorandum of Understanding (TMU) dated June 2002 (and as amended during the third, fourth, and fifth reviews) and are subject to adjustors specified in the TMU. For variables marked "*" the end-September 2002, end-December 2002, end-March 2003, and end-June 2003 program flows represent ceilings (or floors, if indicated) that constitute performance criteria. All other targets are indicative.

2/ Excluding PRGF loans.

3/ The difference between the program projections and the outcomes reflects essentially $1.0 billion in debt cancellation, which was reported as a capital grant in "External cast budget and capital grants," and, negatively, as debt amortization in "Net external program financing."

4/ Bonds issued and loans contracted by KESC in the course of 2002/03.

Table 1(b). Pakistan: Quantitative Targets, September 2003–June 2004 1/

(Cumulative flows from July 1, 2003, unless otherwise specified)

	Outstanding Stock End-Jun. 2003	Prog. End-Sep. 2003	Prog. End-Dec. 2003	Prog. End-Mar. 2004	Prog. End-Jun. 2004
Net foreign assets of the SBP (floor in millions of U.S. dollars)*	8,189.0	495.0	833.0	996.0	1,489.0
		(In billions of Pakistani rupees)			
Net domestic assets of the SBP*	187.2	-12.6	13.4	-1.3	-10.5
Overall budget balance (floor)*	...	-77.0	-126.3	-163.7	-179.2
Net government bank borrowing*	458.6	43.5	53.1	40.9	20.2
CBR revenue (floor)*	...	92.2	218.1	347.5	510.0
Net banking sector claims on public sector enterprises*	71.8	1.0	2.7	4.3	6.0
Social- and poverty-related spending ("I-PRSP budgetary expenditure")	...	40.7	81.4	131.4	185.1
WAPDA accrual balance	...	5.3	-3.9	-19.6	-19.2
KESC accrual balance	...	-4.4	-8.2	-12.4	-15.3
		(In millions of U.S. dollars)			
Outstanding stock of short-term external debt owed or guaranteed by the government and the SBP*	...	500.0	500.0	500.0	500.0
Contracting or guaranteeing of noncessional medium-term and long-term debt by the government* 2/	...	600.0	600.0	750.0	750.0
Accumulation of external payments arrears (continuous performance criterion during the program period)*	...	0.0	0.0	0.0	0.0
SBP's forex reserves held with foreign branches of domestic banks (outstanding stock)	...	70.0	70.0	70.0	70.0
Of which: other than current account*	0.0	0.0	0.0	0.0	0.0
Stock of outstanding foreign currency swap and forward sales between SBP and residents*	...	400.0	400.0	400.0	400.0
Memorandum items:					
Net external program financing	...	105.9	59.3	-239.1	132.7
Of which: privatization proceeds	...	25.0	50.0	75.0	100.0
External cash budget grants	...	22.5	55.6	148.3	148.3
Daily cash reserve requirements ratio (in percentage points)	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

Source: Pakistani authorities.

1/ The relevant variables are defined in the Technical Memorandum of Understanding (TMU) dated May 29, 2003 and are subject to adjustors specified in the TMU. For variables marked "*" end-December 2003 and end-June 2004 program flows represent ceilings (or floors, if indicated) that constitute performance criteria. All other targets are indicative.

2/ Excluding PRGF loans.

Table 2(a). Pakistan: Structural Performance Criteria and Benchmarks Under the PRGF Arrangement as Set Under the Fifth Review 1/

Measures	Timing	Status as of August 31, 2003	Related to
I. Structural Performance Criteria			
Publish quarterly progress reports on implementation of financial improvement plan of WAPDA/successors.	May 31, 2003 for the quarter January–March 2003 and August 31, 2003 for the quarter April–June 2003.	Observed so far. Fourth report on WAPDA (and other major public enterprises) published on the Ministry of Finance website in August 2003.	
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. A few minor changes were introduced with the 2003/04 budget to ensure uniform tax treatment and removing discriminatory treatment, having virtually no revenue impact.	
Submit to parliament a fiscal responsibility law, including (a) fiscal rules aimed at reducing consolidated government debt (federal and provincial) to below 60 percent of GDP within 10 years from the date of promulgation; and (b) the transparency and reporting requirements proposed in the draft published in July 2002.	June 1, 2003	Not observed on time. However, the law was submitted to Parliament on October 11, 2003.	7th disbursement
Eliminate all exemptions from withholding tax on interest income, including for NSS instruments.	June 30, 2003	Partially observed. All exemptions from withholding tax on income were eliminated except for NSS instruments under PRs 150,000.	8th disbursement
Establish formulaic link between rates of return on General Provident Fund and PIB yields.	June 30, 2003	Observed	8th disbursement
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 from June 30, 2003	Observed	
Elimination, with the approval of parliament, of at least 20 income tax exemptions.	July 1, 2003	Observed	8th disbursement

Table 2(a). Pakistan: Structural Performance Criteria and Benchmarks Under the PRGF Arrangement as Set Under the Fifth Review 1/ (concluded)

Measures	Timing	Status as of August 31, 2003	Related to
Promulgation of federal budget for FY 2003/04 consistent with a consolidated overall budget deficit (excluding grants) not exceeding PRs 179.2 billion.	July 1, 2003	Observed	8th disbursement
II. Structural Benchmarks			
Quarterly published progress reports on implementation of Poverty Reduction Strategy, including "I-PRSP expenditure," as well as on progress in (a) establishing institutional framework for I-PRSP monitoring; (b) preparation of full PRSP; and (c) developing baseline data and monitoring framework for intermediate indicators.	To start end-December 2001 for 2001/02 Q1 data, and continued on the basis of the same quarterly schedule throughout FY 2001/02 and FY 2002/03.	Observed so far. Eighth report published in September 2003.	
Effectiveness of amendments to the tax regulations to enable sales tax auditors to assess for nonfilers tax liabilities on the basis of indirect methods of determination, such as reconstructed income statements and presumptive criteria, and to authorize the CBR to make and order for assessment of tax, penalty, and additional tax on the basis of these criteria.	July 1, 2003	Observed.	
Issuance of CBR circular to require reporting by financial institutions of all interest income to the tax authority, effective from July 1, 2003.	July 1, 2003	Partially observed. The circular required reporting of interest income exceeding PRs 10,000.	
Publication for the federal government and NWFP of the 2003/04 budget according to the old accounting model and the new accounting model (NAM).	July 1, 2003	Partially observed. The documents were prepared and printed but, due to technical problems, it was not possible to publish the budgets based on NAM.	
Decision by Cabinet on future of the National Anti-Corruption Strategy (see MEFP, para. 5).	August 1, 2003	Partially observed. The previous Cabinet approved the strategy in November 2002.	
Submission to cabinet by the "Benami" taskforce of a report setting out the results of consultation with stakeholders and provincial governments and proposing specific legislation to limit enforceability of "Benami" transactions and holdings.	October 31, 2003		

1/ Conditionality as of the Executive Board's conclusion of the fifth review under the PRGF arrangement (IMF Country Report No. 03/180).

Table 2(b). Pakistan: Structural Performance Criteria and Benchmarks Under the PRGF Arrangement as Proposed for the Sixth and Seventh Reviews

Measures	Timing	Related to
I. Structural Performance Criteria		
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	
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	
Publish quarterly progress reports on implementation of financial improvement plan of WAPDA/successors.	November 30, 2003 for the quarter July–September 2003, February 29, 2004 for the quarter October–December 2003, May 31, 2004 for the quarter January–March 2004, and August 31, 2004 for the quarter April–June 2004.	
Preparation of an action plan to establish by end-2003 a transparent regulatory framework for the setting of electricity tariffs, that in particular (a) clarifies the respective roles of the government, NEPRA, and the power companies (including the new distribution companies) in the setting of tariffs; and (b) limits departures in actual tariff adjustments by distributors from NEPRA's determination based on the current procedures to well-specified cases of exceptional temporary spikes in oil prices.	October 31, 2003	9th disbursement
Privatize Habib Bank Limited through effective transfer of majority ownership to private investors.	December 31, 2003	9th disbursement
Adjust NSS rates to reflect PIB yields according to formula set in the amendment to the Technical Memorandum of Understanding (TMU).	January 1, 2004	9th disbursement
Government to notify electricity tariff adjustments determined by NEPRA within 30 days of their determination (effective on day of notification).	Continuous from January 1, 2004	
Propose to Parliament removing income and sales tax exemptions and adopt other tax-base broadening measures yielding a total of PRs 5 billion in estimated revenues in the context of the 2004/05 budget.	June 30, 2004	10th disbursement
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	10th disbursement

Table 2(b). Pakistan: Structural Performance Criteria and Benchmarks Under the PRGF Arrangement as Proposed for the Sixth and Seventh Reviews (concluded)

Measures	Timing	Related to
II. Structural Benchmarks		
Establish a new formula in consultation with Fund staff that will align NSS rates to government bonds of the same maturity.	March 31, 2004	
Set up two additional Medium Taxpayers Units.	June 30, 2004	
Open second Large Taxpayers Unit in Lahore.	August 31, 2004	
Submit to Cabinet an action plan on extending the coverage of the GST to additional services.	February 29, 2004	

Amendments to the Technical Memorandum of Understanding (TMU)

The TMU dated May 29, 2003 will remain valid for the remainder of FY 2003/04, with the revised baseline assumptions for net external program financing and external grants as indicated in Tables 1(a) and 1(b), and the following amendments to apply from October 1, 2003.

1. The second sentence in paragraph 11 of the TMU will be amended as follows: "Excluded from this performance criterion are (a) foreign currency deposit liabilities of the SBP; (b) the outstanding stock of debt of Foreign Exchange Bearer Certificates (FEBCs), Deposit Bearer Certificates (DBCs), and Foreign Currency Bearer Certificates (FCBCs); and (c) debt contracted from the Asian Development Bank."

2. A new paragraph will be added after paragraph 14 of the TMU, as follows: "For purposes of the performance criterion on applying existing formula on adjusting NSS rates to reflect PIB yields, the existing formula is defined as follows:

$$1.028*0.918\ YPIB - 0.5 \leq NRNSS \leq 1.028*0.918\ YPIB + 0.5$$

Where:

- YPIB is the average yield, in percent, over the last six months on Pakistan Investment Bonds for three-, five-, and ten-year bonds.
- NRNSS is the net compound rate, in percent, on three-, five-, and ten-year NSS instruments, which is the gross compound rate on three-, five-, and ten-year NSS instruments, as announced by the authorities, net of withholding tax and zakat."