

**ADB**

**PAKISTAN  
ECONOMIC UPDATE  
(JULY—NOVEMBER 2002)**



**ASIAN DEVELOPMENT BANK**

**DECEMBER 2002**

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Pakistan Resident Mission  
Asian Development Bank

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The views expressed in the Economic Update are those of the authors and do not necessarily reflect the views of the ADB or its member governments.

## FOREWARD

The Asian Development Bank is a long-standing development partner of Pakistan, having provided a total of US\$12.4 billion to the country in development assistance from December 1968 to December 2002. Of this amount, US\$1.1 billion were provided in 2002. The projected assistance for the period 2003-2005 amounts to US\$2.4 billion. Historically, the major development sectors in which ADB has invested have included agriculture and rural development, energy, social sectors, finance and trade, and transport and communications. Under its Country Strategy and Program for Pakistan for 2002-2006, reduction of poverty is the central objective, which is operationalized through promoting sustainable pro-poor growth, inclusive social development, and good governance, with governance being the key area of focus.

Together with this extensive lending portfolio, the Pakistan Resident Mission (PRM) is actively engaged in Economic and Sector Work to develop an understanding of important economic policy and sector concerns, particularly with regard to poverty and governance issues. To bring this work to a wider audience, PRM published, in July 2002, a country poverty assessment titled “Poverty in Pakistan: Issues, Causes, and Institutional Responses”, after extensive consultations and dialogue with the key development partners. PRM has also started a working paper series on topical issues, and the first one titled “Escaping the Debt Trap: an Assessment of Pakistan’s External Debt Sustainability” was published in December 2002.

Earlier this year, PRM initiated a quarterly series to provide a regular update on the state of the national economy. The first Pakistan Economic Update was published in April 2002. The present report, which is the third in this series, provides an analysis of economic trends in Pakistan for the first five months of fiscal year (FY) 2003. The report also discusses economic and governance reform measures undertaken in FY 2003, and reviews the progress in the area of poverty reduction, particularly with regard to public expenditure. The report also presents outlook of the economy for FY2003 based on current trends. We hope that the contents of this report will be of use to all stakeholders including the Government, civil society, donors, academia, media, and others. We look forward to receiving comments on the report, and also suggestions for improvement of future reports in this series.

M. Ali Shah  
Country Director, Pakistan



# PAKISTAN ECONOMIC UPDATE: JULY-NOVEMBER 2002

*With the economic upturn gaining further momentum in the first five months of FY2003, the target of 4.5 percent growth in GDP for the year is likely to be attained, and possibly even surpassed. The economic and governance reforms program also seems to be on track so far, and continuity of economic policies is likely to result in most internal and external economic targets being met if not exceeded.*

The Government has implemented a comprehensive agenda of macroeconomic stabilization, and economic and governance reforms in the last three years, the positive effects of which are now beginning to become apparent in terms of improvement in key macroeconomic indicators, including the fiscal deficit, the external account, and the external debt sustainability. The Government has also undertaken a number of poverty alleviation initiatives as a part of its poverty reduction strategy. The first five months of FY2003 witnessed positive trends in most sectors,

with significant growth in the commodity producing sectors, improvement in the fiscal position, and increases in both exports and imports. Developments thus far indicate that the target of 4.5 percent growth in GDP in FY2003 is likely to be attained, and possibly even surpassed. The first section of this report analyses developments in key sectors over the last five months, the second section highlights some of the measures undertaken for the implementation of economic and governance reforms in the current fiscal year, and the third section reviews the progress in the area of

poverty reduction, particularly with regard to public expenditure. The fourth section provides our current assessment of the outlook for FY2003.

## I. MACROECONOMIC DEVELOPMENTS

### Domestic Sector

**Growth:** Preliminary data for three major crops, namely sugarcane, rice, and cotton, show that both sugarcane and rice crops are estimated to be 9 percent higher than last year, while the cotton crop may be slightly smaller than last year.<sup>1</sup> Greater availability of water and early rains for the winter crops has improved the outlook for the wheat crop.<sup>2</sup> However, while there is some improvement in the water situation, the drought is not yet over. According to official estimates, industrial production increased by 5.2 percent in the first quarter of FY2003, compared with the corresponding period of last year.

<sup>1</sup> Arrivals at ginneries up to 31 December 2002 were 15.5 percent higher than in the corresponding period of last year due to farmers growing varieties, which mature relatively early.

<sup>2</sup> According to the Indus River System Authority, Mangla Dam, one of the two main water reservoirs, this year was filled to its capacity after three years. Although still 35 percent short of the normal water availability, there is a significant improvement over last year, when the water shortfall was of the order of 50 percent.

*The performance of the agriculture sector is expected to improve in FY2003.*

Individual items, which recorded significant increases were: cement (9.7 percent); cars (25.4 percent); motorcycles (28.8 percent); bicycles (27.3 percent); refrigerators (16.3 percent); and air conditioners (8.5 percent). Increase in the production of consumer durables reflects commercial banks aggressive drive to expand consumer credit because of excess liquidity in the banking system.

With summer crops output higher than last year and better outlook for the winter crops, the performance of the agriculture sector is expected to improve in FY2003. The large increase in volume of textile exports in the first five months of FY2003 (see below) augurs well for the performance of the textile industry, which is the single largest industry in Pakistan's manufacturing sector. In addition, several factors are likely to boost demand for manufacturing and other sectors. The recent judgment of the Supreme Court striking down the law, which banned serving of meals at weddings, is expected to give boost to production of meat, particularly poultry, and raise demand for catering services. Higher price of cotton this year is expected to raise farmers' incomes and generate additional demand in the economy. Similarly, continued increase in remittances is likely to support growth of residential construction and of industries providing inputs for this activity. Thus overall growth is likely to improve further in FY2003.

**Inflation:** The upturn in inflation observed toward the end of FY2002 continued in the first five months of FY2003. The annual rate of inflation based on comparison of 12-month

moving average of the Consumer Price Index (CPI) in November 2002 increased marginally to 3.6 percent from 3.5 percent in June. The upturn in inflation is mainly on account of increases in prices of petroleum products. The point-to-point comparison of sub-indices for fuel and lighting and transport and communication, the two groups most affected by increase in petroleum prices, showed increases of 9.9 percent and 5.3 percent, respectively, in November. The annual rate of inflation based on the Wholesale Price Index (WPI) increased from 2.1 percent in June to 2.3 percent in November.

**Monetary Developments:** The State Bank of Pakistan (SBP) continued to maintain an easy monetary stance in the first five months of FY2003. The SBP lowered its discount rate by 150 basis points to 7.5 percent, effective from 19 November 2002. Subsequently, the rate of interest on 6-month treasury bills, which serves as a benchmark for all other interest rates, declined to 4.3 percent on 11 December 2002 compared with 6.3 percent as of end-June 2002. However, SBP did follow a policy of "sterilization" of the liquidity generated by its purchases of foreign exchange in the inter-bank market. Money supply increased by Rs 129.8 billion, or 7.4 percent in this period, compared with an increase of 5.2 percent in the corresponding period of FY2002. Increase in money supply was triggered exclusively by a large expansion of Rs 177.5 billion in net foreign assets of the banking system, which was partly offset by a net decline of Rs 47.7 billion in domestic credit. Private sector credit, however, seems to have picked up and net borrowing by the private sector,

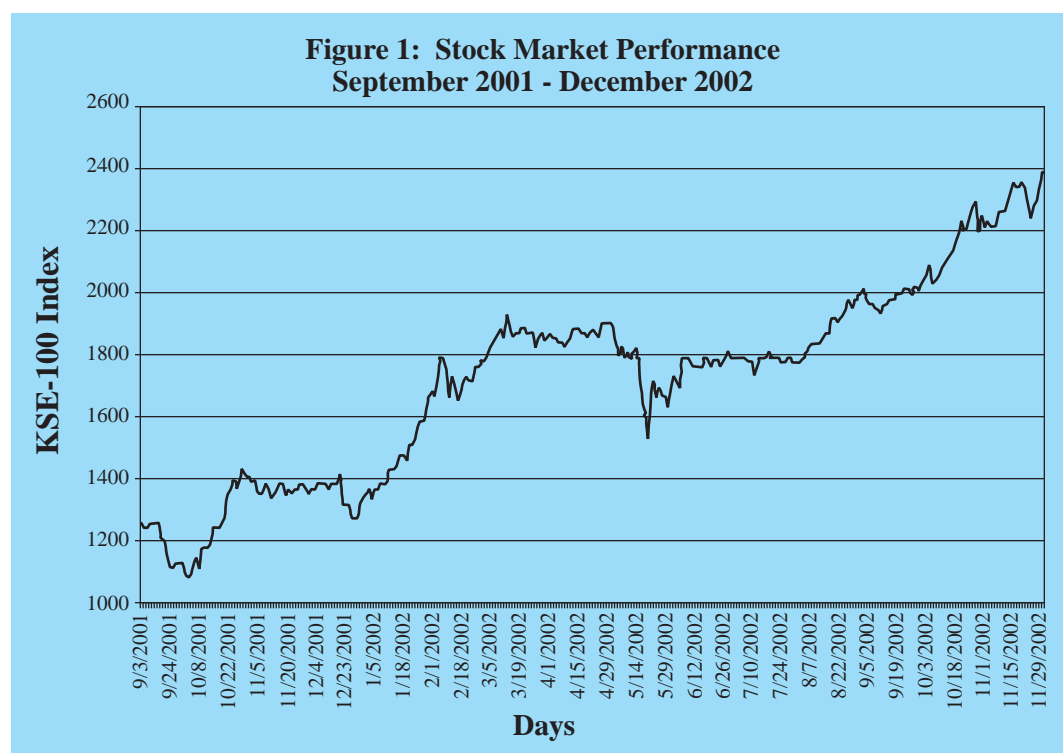
*The rate of interest on 6-month treasury bills, which serves as a benchmark for all other interest rates, declined to 4.3 percent on 11 December 2002 compared with 6.3 percent as of end June 2002.*

including export finance, increased by Rs 30.5 billion compared with no net borrowing in the corresponding period of last year. Excluding export finance, net borrowing by the private sector increased by Rs 40.2 billion.

**Stock Market:** Share prices maintained a rising trend through most of the period, with the KSE-100 index increasing by 33 percent from 1,770 on 28 June 2002 to 2,452 on 13 December

(see figure 1). Market capitalization increased by 34.3 percent to Rs 548 billion over the same period. Continued increase in remittances, appreciation of the Rupee, low interest rates, and absence of investment opportunities in real sectors raised the demand for equities. Peaceful conduct of general election and the Indian Government's decision to withdraw troops from the border with Pakistan in October also gave boost to the market sentiment.

*Private sector credit picked up and net borrowing by the private sector, including export finance, increased by Rs 30.5 billion compared with no net borrowing in the same period of last year.*



The corporate debt market remained active in the first quarter of FY2003, and eight term finance certificates (TFCs) were floated for a total amount of Rs 4,585 million, compared with five issues for Rs 2,460 million offered in the corresponding quarter of FY2002. Coupon rates of these TFCs were fixed with reference to either rate of return on Pakistan Investment Bonds or SBP's

discount rate, generally with floor and ceiling of 11 percent and 15 percent, respectively.

**Fiscal Situation:** Pakistan's fiscal position improved significantly in the first quarter of FY2003, according to data on consolidated fiscal operations of federal and provincial governments released by the Finance Division (see

*The overall fiscal deficit decreased to 1.0 percent of GDP in the first quarter of FY2003 compared with 1.7 percent in the corresponding quarter of FY2002.*

table 1). The overall fiscal deficit decreased to 1.0 percent of GDP compared with 1.7 percent in the corresponding quarter of FY2002, mainly due to a sharp increase of 32.7 percent in revenues. However, the increase in total revenues for the first quarter of FY2003 is overstated because of the payments by the USA for logistic support for war against terrorism in Afghanistan for the past six months. Within total revenues, tax receipts increased by 17.2

percent to Rs 97.6 billion. Expenditure increased by 9.3 percent to Rs 194.5 billion. While increase in tax revenues is on track, increase in expenditure is on the high side because of the base effect, as explained below. The underlying trend in expenditure will become clear in the second half of the year. However, if the current trend in expenditure continues, it will be difficult to achieve the fiscal deficit target of 4.0 percent for FY2003.

	FY2001 (Revised Actuals)	FY2002 (Revised Estimates)	% Change	July-September		% Change
				FY2002 (Revised Estimates)	FY2003 (Prel. Estimates)	
Total Revenue and Grants	593.4	700.1	18.0	123.6	167.3	35.4
Total Revenue	552.8	616.9	11.6	115.3	153.0	32.7
Tax Revenue	411.1	423.7	3.1	83.3	97.6	17.2
Of which:						
Federal Taxes	392.1	403.9	3.0	78.3	91.6	17.0
Provincial Taxes	19.0	19.8	4.2	5.0	6.0	20.0
Surcharges	30.3	47.3	56.1	11.1	17.4	56.8
Non-tax Revenue	111.3	145.9	31.1	20.9	38.0	81.8
Federal	91.5	124.6	36.2	17.9	34.1	90.5
Provincial	19.8	21.3	7.6	3.0	3.9	30.0
Grants	40.5	83.1	105.2	8.3	14.3	72.3
Total Expenditure	732.5	858.2	17.2	178.0	194.5	9.3
Current Expenditure	645.7	713.3	10.5	138.8	161.2	16.1
Federal	479.0	537.7	12.3	109.5	116.4	6.3
Of which:						
Interest	234.5	245.3	4.6	65.0	49.1	-24.5
Of which:						
Domestic	183.5	184.6	0.6	50.6	41.0	-19.0
Foreign	51.0	60.6	18.8	14.3	8.1	-43.4
Defense	130.8	149.0	13.9	25.2	32.6	29.4
Running of Civil Administration	75.4	83.5	10.7	13.4	17.3	29.1
Subsidies	19.9	16.7	-16.1	1.5	13.7	813.3
Provincial	166.7	175.6	5.3	29.3	44.8	52.9
Development Expenditure	89.8	126.3	40.6	13.5	21.7	60.7
Federal	66.9	98.4	47.1	10.7	14.6	36.4
Provincial	22.9	27.9	21.8	2.8	7.1	153.6
Net Lending by Federal Government	-17.6	31.8		9.6	-0.6	
Statistical Discrepancy/ Unidentified Expenditure	14.7	-13.2		16.1	12.3	-23.6
KESC Capitalization and CBR Bonds Issued to Banks	0	52.0		0	0	
Budget Deficit (Excl. grants)	-179.7	-241.0		-62.7	-41.5	
Budget Deficit (Excl. One-time expenditure)	-179.7	-189.0		-62.7	-41.5	
As % of GDP						
Budget Deficit	-5.2	-6.5		-1.7	-1.0	
Budget Deficit (Excl. One-time expenditure)	-5.2	-5.1		-1.7	-1.0	

Sources: (1) IMF: Review of the Economy, October 21, 2002. (2) Ministry of Finance Website

The increase in consolidated expenditure of federal and provincial governments was mainly due to higher expenditure on development, defense, and federal subsidies, partly offset by a sharp decline in interest payments. Defense expenditure increased by 29.4 percent to Rs 32.6 billion compared with the first quarter of FY2002, mainly because of the base effect. Compared with average of quarterly defense expenditure in the second half of 2002, when tension with India was at its peak, defense expenditure in the first quarter of FY2003 was 33.2 percent lower. The withdrawal of troops from the border with India is expected to have a downward impact on defense expenditure in the remaining three quarters of the year. Development expenditure increased by 60.7 percent to Rs 21.7 billion. With 15.2 percent of the budgeted development expenditure incurred in the first quarter of FY2003 (compared with 10.8 percent last year), the prospects of meeting the target for the whole year seem reasonably good. Expenditure on federal subsidies, at Rs 13.7 billion, in the first quarter of FY2003 has already absorbed 66.2 percent of the amount budgeted for the whole year. The large overrun in subsidies was mainly because of higher than expected losses of Karachi Electric Supply Company (KESCO) and Water and Power Development Authority (WAPDA). At this trend, expenditure on subsidies will exceed the allocation made in the budget by a wide margin. Interest payments on the other hand declined by 24.5 percent to Rs 49.1 billion, because of substitution of high-cost short-term foreign loans with low-cost long-term

loans and lower interest rate in the domestic market.

Break-down of expenditure by federal and provincial level shows that while expenditure by the Federal Government increased by only 9.0 percent to Rs 131.0 billion, expenditure by the four provincial governments put together increased by 61.7 percent to Rs 51.9 billion. Provincial expenditures in the first quarter of last year were below normal because of disruption resulting from the ongoing devolution of fiscal responsibilities to lower tiers of government.

Increase in revenues in the first quarter of FY2003 was broad-based, with tax revenues increasing by 17.2 percent to Rs 97.6 billion, surcharges by 56.8 percent to Rs 17.4 billion, and non-tax revenues by 81.8 percent to Rs 38.0 billion, compared with the first quarter of FY2002. Within tax revenues, the Central Board of Revenue (CBR) collections increased by 17.0 percent to Rs 91.6 billion, while provincial taxes increased by 20.0 percent to Rs 6.0 billion. The sharp increase in non-tax revenues was mainly due to payments from the United States for the use of civil aviation facilities for war in Afghanistan. Total receipts from civil administration, the bulk of which consists of payments for the use of civil aviation facilities, increased to Rs 19.6 billion compared with only Rs 0.8 billion in the first quarter of FY2002. Receipts under this head in the third and fourth quarters of FY2002, when payments for the use of civil aviation facilities first started flowing in,

*Interest payments declined by 24.5 percent, because of substitution of high-cost short-term foreign loans with low-cost long-term loans and lower interest rates in the domestic market.*

*Increase in revenues in the first quarter of FY2003 was broad-based, with tax revenues increasing by 17.2 percent, surcharges by 56.8 percent, and non-tax revenues by 81.3 percent.*

were Rs 18.8 billion and Rs 0.2 billion, respectively.<sup>3</sup>

The latest data shows that net tax collection by CBR increased by 15.6 percent to Rs 157 billion in the first five months of FY2003 in contrast with a decline of 4.7 percent in the corresponding period of FY2002.<sup>4</sup> Both larger increase in gross tax receipts and slower growth in tax refunds contributed to improvement in net tax receipts. The largest increase was recorded in customs (34.6 percent), followed by General Sales Tax (25.0 percent) and direct taxes (2.1 percent). Receipts from excise duty declined by 2.8 percent. Sharp increase in GST is explained by increase in imports, upturn in domestic economic activity, and extension of GST to vegetable ghee and cooking oil, as well as increase in the GST rate on a number of imports, including edible oil, talc, and solvent oil from 15 percent to 20 percent. Substantial increase in imports (13.7 percent), particularly those imports which are subject to highest tariff rates, like motor vehicles (33.4 percent), and levy of 6-10 percent import duty on POL products effective from 1 July 2002, account for the bulk of the increase in collection from customs. The smaller increase in direct taxes was due to the base effect, as their receipts showed a large increase last year.

CBR tax collection, which constitutes 60 percent of total revenues

of the Government, has been on target in the first six months of FY2003. With increased domestic economic activity and higher imports, the Government should be able to meet its revenue target of Rs 460 billion for the whole year.

### External Sector

The sharp improvement in balance of payments observed in the last three quarters of FY2002 continued into the first quarter of FY2003, with the current account remaining in surplus in contrast with a deficit recorded in the corresponding quarter of FY2002 (see table 2). Continued increase in workers' remittances, additional receipts for the use of civil aviation facilities by the coalition forces against terrorism, and receipt of official grants were the main factors contributing to improvement in balance of payments. The deficit on the balance of trade also decreased. As a result of a sizeable surplus in the current account in the quarter, foreign exchange reserves held by SBP increased from \$4,333 million as of end-June 2002 to \$5,934 million by end-September.<sup>5</sup>

**Balance of Trade:** The recovery in exports and imports observed in the last quarter of FY2002 gained further momentum in the first five months of FY2003 (see figure 2). Exports increased by 15.9 percent to \$4.3 billion and imports by 13.7 percent to \$4.7 billion, compared with the same period of FY2002.

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*The recovery in exports and imports observed in the last quarter of FY2002 gained further momentum in the first five months of FY2003.*

<sup>3</sup> It seems these payments are received on a six-monthly basis, and the amount received in the third quarter of FY2002 was for the second and the third quarters. Similarly, receipts appearing in the first quarter of FY2003 are actually for use of facilities in the fourth quarter of FY2002 and first quarter of FY2003.

<sup>4</sup> Preliminary data available for the first six months of FY2003 indicates that CBR revenues, at Rs 200.5 billion, are 20 percent higher than the corresponding period last year and also compare favorably with the target of Rs 199.5 billion.

<sup>5</sup> Foreign exchange reserves with the SBP increased further to \$6,930 million by 14 December 2002. Total foreign exchange reserves, including those held by commercial banks, now stand at \$9,069 million.

**Table 2: Balance of Payments (\$ Million)**

	FY2001	FY2002	% Change	July-September		% Change
				FY2002	FY2003	
Trade Balance	-1,269.0	-294.0	-76.8	-209.0	-174.0	-16.7
Services (net)	-3,211.0	-2,617.0	-18.5	-829.0	-150.0	-81.9
Current Transfers	4,737.0	5,744.0	21.3	970.0	1,551.0	59.9
Of which:						
Workers' Remittances	1,087.0	2,390.0	119.9	340.0	1,053.0	209.7
Official Transfers	839.0	1,495.0	78.2	198.0	287.0	44.9
Purchases from Kerb Market	2,157.0	1,376.0	-36.2	398.0	0.0	
Current Account Balance	257.0	2,833.0	1,002.3	-68.0	1,227.0	
Current Account Balance (excl. official transfers)	-582.0	1,338.0		-266.0	940.0	
Capital Account (net)	-644.0	-1,107.0	71.9	-587.0	-67.0	-88.6
Change in Reserves (-Inc/+Dec)	-1,000.0	-2,792.0	179.2	80.0	-1,687.0	
Errors and Omissions	626.0	928.0	48.2	360.0	274.0	-23.9
Exceptional Financing	692.0	138.0	-80.1	215.0	253.0	17.7
Official Reserves (End-period)	1,677.0	4,333.0	158.3	1,720.0	5,934.0	245.0
(In weeks of imports of goods and non-factor services)	7.5	17.5	133.3	7.7	24.0	212.2

Sources: (1) IMF: Review of the Economy. October 21, 2002. (2) State Bank of Pakistan Website.

**Figure 2: Quarterly Trends in Exports & Imports During FY2001-2003**  
(% change over corresponding quarters of the previous year)



Growth in exports in the first five months of FY2003 was led by textile manufactures, which, at \$2,762 million, showed an increase of 16.6 percent compared with the corresponding period of FY2002. Export of primary commodities increased by 14.0 percent to

\$386 million, and there was a large increase of 60.1 percent to \$404 million in export of other unclassified items. Export of non-textile manufactures, mainly comprising leather and leather manufactures, sports goods, and carpets, remained more or less unchanged at \$778 million.

*So far, growth of exports and imports has been above the target, with imports growing much faster than the target.*

Increase in export of textile manufactures during the first five months of FY2003 reflects greater access to the European Union markets since January 2002, as well as improved competitiveness of the domestic textile industry. Three major items (cotton cloth, knitwear, and bedwear), which together contribute more than half of export receipts from textile manufactures, registered large increases in both volume and value of their exports. While increases in volume ranged from 18.0 percent (bedwear) to 28.9 percent (knitwear), increases in value ranged from 19.9 percent (knitwear) to 28.7 percent (cotton cloth). Export of readymade garments, in terms of value, increased by 26.5 percent, exclusively because of increase in their unit value. The volume declined by 9.2 percent.

Increases in imports during the first five months of FY2003 were fairly broad-based, and were shared by food products (36.4 percent), raw materials for textiles (20.2 percent), knocked down kits for car assembly (33.4 percent), and machinery (26.9 percent). However, imports of petroleum and petroleum products and metals registered declines of 1.7 percent and 10.5 percent, respectively.

Increases in imports of machinery in the first five months of FY2003 were mostly in imports by the public sector, like power generating equipment for the Ghazi Barotha hydel electricity generation project and aircrafts for upgrading the fleet of the Pakistan International Airlines. Import of other machinery, at \$368

million, also was 69.5 percent higher compared with the first five months of FY2002. On the other hand, import of textile machinery declined by 11.3 percent, although at \$178 million it still remains the single largest item of imports in the machinery group. Import of construction and mining machinery also declined.

So far, growth of exports and imports has been above the target, with imports growing much faster than the target. With greater access to the European Union markets and increased production by the textile industry, export target of 13.4 percent set in the Export Policy looks achievable. However, with the economy pick up continuing as expected, imports are likely to exceed the growth target of 7.4 percent.

**Current Account:** The current account of the balance of payments recorded a large surplus of \$1,227 million in the first quarter of FY2003 in contrast with a deficit of \$68 million in the same quarter of last year. All three components of the current account showed significant improvements, which are discussed below.

- The trade deficit decreased by 16.7 percent to \$174 million compared with \$209 million in the corresponding quarter of FY2002.<sup>6</sup>
- There was a substantial reduction of \$679 million in deficit in the services account, mainly because of large receipts from the USA for logistic

*The current account of the balance of payments recorded a large surplus of \$1,227 million in the first quarter of FY2003 in contrast with a deficit of \$68 million in the same quarter of last year.*

<sup>6</sup> The trade balance numbers quoted here are derived from export receipts and import payments based on foreign exchange transactions and, because of leads and lags, differ from trade numbers based on the physical movement of goods across borders discussed earlier. The trade balance based on physical movement of goods declined by 14.8 percent to \$201 million in the first quarter of FY2003 compared with \$236 million in the same period last year.

support provided for war in Afghanistan. Lower interest payments resulting from reduction in the stock of high cost FE45 foreign currency deposits and foreign private debt, and net receipts for transportation and travel also contributed to improvement in the services account.

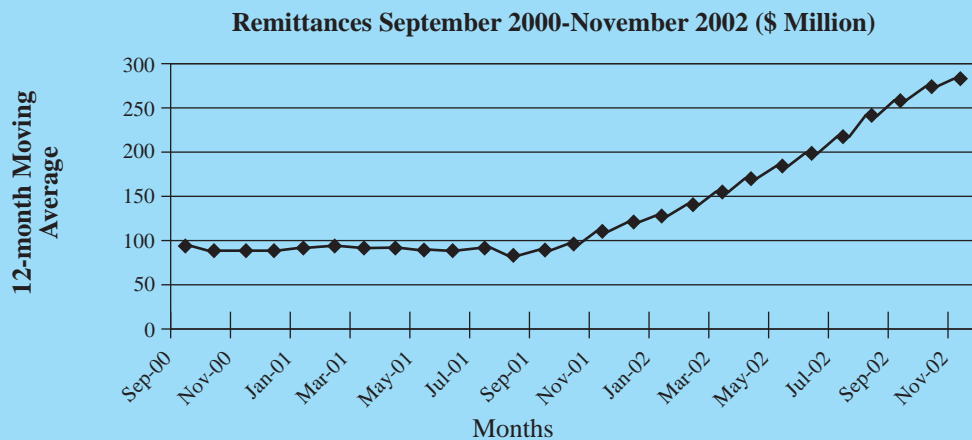
- Net current transfers to Pakistan increased by 60.0 percent to \$1,551 million compared with \$970 million in the corresponding quarter of

FY2002, mainly due to a three-fold increase in remittances to \$1,053 million (see box 1).<sup>7</sup> Increase in residents' foreign currency deposits and larger inflow of official grants also helped. There were no outright purchases of foreign exchange in the kerb market, as SBP discontinued the practice with effect from 1 July 2002. In the corresponding quarter of last year, SBP purchased \$398 million.

*The SBP discontinued purchases of foreign exchange from the kerb market with effect from 1 July 2002.*

### Box 1: Remittances

Increase in remittances, which started after clampdown on international money transfers through informal channels and greater scrutiny of bank accounts held abroad by Pakistani nationals following the 11 September events, has continued in the first five months of FY2003 (see figure below). Other than the switchover from informal to formal channels for transfer of money, continued large inflow of remittances is the result of reverse capital flight, possibly because: (1) overseas Pakistani workers and resident Pakistanis holding bank accounts and other financial assets abroad, have started liquidating their financial assets due to increasing feeling of insecurity; and (2) those keeping their regular savings abroad prior to 11 September events now find it more attractive to hold their savings in Pakistan because of appreciating Rupee and higher interest rates.



<sup>7</sup> Remittances increased by \$732.6 million in October and November, raising the cumulative figure for the first five months of FY2003 to \$1,784.5 million, compared with \$789.1 million in the corresponding period of FY2002.

*Foreign direct investment more than doubled, from \$69 million in the first quarter of FY2002 to \$170 million in the first quarter of FY2003.*

**Capital Account:** The deficit in the capital account declined sharply to \$67 million in the first quarter of FY2003 from \$587 million in the corresponding quarter of FY2002, primarily because of a large increase in disbursement of foreign long-term loans and credits. Foreign direct investment also more than doubled, from \$69 million last year to \$170 million,<sup>8</sup> reflecting enhanced investor confidence following the buildup of foreign exchange reserves.<sup>9</sup> The bulk of foreign investment has come in the form of privatization proceeds for the sale of UBL and oil fields and other investments in the oil and gas sector. The oil and gas sector has become quite attractive for investors after the reforms implemented during the last three years.

**External Debt:** Pakistan's total external liabilities, including private non-guaranteed debt and short-term foreign exchange liabilities, declined from \$37.9 billion as of end-June 2000 to \$37.1 billion by end-June 2001 and further to \$36.5 billion by end-June 2002. This has been achieved through a deliberate policy of paying off high-cost short-term foreign exchange liabilities in order to lower the country's external debt servicing liability. Short-term foreign exchange liabilities, mainly consisting of foreign currency accounts, Special US\$ Bonds, and other foreign currency bonds, were reduced from \$5.7 billion to \$3.1 billion over this period. The Government has continued to pursue this strategy in the first quarter of FY2003, when short-term foreign

exchange liabilities declined further by \$421 million to \$2.7 billion.

## Conclusion

The economic upturn, which started in the second half of FY2002, gained further momentum in the first half of FY2003, particularly in the external sector. Growth of both exports and imports accelerated and remittances from overseas workers continued to grow, resulting in a large surplus in the current account of the balance of payments. In the domestic sector also, with larger availability of water, the prospects of growth in the agricultural sector improved, and demand enhancing factors are providing a boost to other sectors of the economy. At the same time, the fiscal position improved with a substantial increase in revenues and inflation remained low.

## II. ECONOMIC POLICIES AND REFORMS

Over the last three years, the Government has been implementing a comprehensive program of macroeconomic stabilization and governance and economic reforms. As a part of this reform agenda, the Government has taken a number of initiatives in the first five months of FY2003, particularly in the area of tax administration, power generation policy, legal and judicial

*Pakistan's external liabilities have been reduced in last two years through a deliberate policy of paying off high-cost short-term foreign exchange liabilities.*

<sup>8</sup> Latest available data shows that foreign direct investment for the first five months (July-November) of FY2003 was \$474 million compared with \$98 million in the corresponding period of FY2002.

<sup>9</sup> The Standard and Poor's Rating Services have recently raised Pakistan's long-term foreign currency sovereign credit rating from B- to B and long-term local currency sovereign credit rating from BB- to B+.

system, and freedom of information, which are discussed in this section.

Reform of tax administration is crucial for fiscal stability in the medium term, and to ensure that the Government is able to adhere to its medium term budgetary targets, including restricting the size of the budget deficit. This is particularly important given that the Government has committed to increase pro-poor expenditures to 4 percent of GDP by 2004. Reform of the power sector also has important budgetary implications. In FY2002, the Government financed the Rs. 30 billion debt-equity swap for KESC to prepare it for privatization, and the power sector has the potential to generate further contingent liabilities for the Government in the future, unless structural reform measures are undertaken to improve efficiency in the sector. Similarly, governance reform is the cornerstone of the Government's reform agenda, and legal and judicial reform forms the basis of improved governance. ADB is assisting the Government in implementing the Access to Justice Program, which supports reform of the judiciary and the police service with a view to strengthening legal protection for all, and empowering the poor and other vulnerable groups.

**Tax Administration Reforms:** Implementation of tax administration reforms, which had been lagging behind, has picked up recently. The CBR has taken some important steps in the first five months of FY2003 to strengthen the tax administration. These include setting up of a Large Taxpayers Unit (LTU) in Karachi, a Model Income Tax Unit (MITU) in Lahore, Sales Tax Automated

Refund Repository (STARR), preparation of Customs Administration Reform Plan, and development of a new recruitment, training and promotion policy (see box 2). These measures aim at improving services for taxpayers through reorganization of the CBR on functional lines and automation of processing of tax returns and applications for tax refunds, as well as improving the skill mix of the CBR staff through merit-based recruitment and training. With these measures and other planned reforms, the CBR is in the process of developing an efficient and taxpayer friendly tax administration.

**Power Sector Reforms:** The Government approved the Power Generation Policy 2002 on 22 October 2002. The main objective of the policy is to encourage the private sector to invest in hydel and indigenous fuel-based electricity generation projects, which can come on line by FY2005 and after when the country's present generation capacity will fall short of its requirements. Under the new policy, the Government will: (1) solicit bids for hydel and indigenous fuel-based projects, for which feasibility studies are already available; and (2) initiate feasibility studies on raw sites for exploiting indigenous as well as renewable resources. The basis for selection of successful bidders will be the minimum levelized tariff, either through international competitive bidding (ICB) for projects for which feasibility studies exist, or through negotiations/ICB for proposals for raw sites.

Competitive tariffs will comprise an energy purchase price (EPP) and a capacity purchase price (CPP) with provisions for escalation. Because of

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*With recent measures and other planned reforms, the CBR is in the process of developing an efficient and taxpayer friendly tax administration.*

### Box 2: Tax Administration

**Large Taxpayers Unit (LTU):** LTU was set up in Karachi on 1 July 2002 to provide special treatment to about 300 large taxpayers, who contribute about 14 percent of the total tax revenue. LTU handles income tax, sales tax, and excise duty payable by these taxpayers. In the past, they had to deal with different departments for different taxes. LTU is organized by functions, such as registration, information processing, accounting, assessment, audit, and enforcement. It is proposed to subsequently organize whole of CBR along these lines. This will facilitate greater standardization of work processes across taxes. The operations of LTU for the first quarter have been evaluated and found highly satisfactory. For instance, collection of sales tax from designated large taxpayers increased by 55.3 percent (from Rs 5.2 billion to Rs 8.1 billion) compared with the national average increase of 20.5 percent. Response time to taxpayers' inquiries and grievances was greatly reduced.

**Model Income Tax Unit (MITU):** The CBR has set up MITU in Lahore to provide quality service to medium and small taxpayers who account for 99 percent of total number of taxpayers in the country. MITU will test run the organizational structure based on functional specialization. After reviewing the performance of LTU and MITU, the CBR plans to establish such units in other large cities.

**Sales Tax Automated Refund Repository (STARR):** The CBR has established STARR to expedite the process of verification of invoices submitted with sales tax refund claims and to reduce the chances of spurious refunds. Ultimately, a management information system for verification of invoices will be established. STARR will electronically store all invoices submitted with sales tax refund claims, which will automatically become available to concerned sales tax collectorates. Software is being developed to generate reports and alerts to detect undue refund payments through the use of nation-wide data. Future plans include linking the STARR database with databases available with the Income Tax and Customs Departments, National Database and Registration Authority (NADRA), WAPDA, Pakistan Telecommunication Company Limited (PTCL), etc.

**Customs Administration Reform Plan,** prepared by the CBR, envisages computerization of all customs refund applications. In a computerized environment, the refund application, along with documents submitted with it, will appear as a job in hand at the concerned Assistant Collector's terminal, the moment it is filed at the front office. The computerized process will automatically confirm the payment claimed in the refund application by making a reference to customs data on payments and detect any duplication of claim application if the same refund has been claimed/paid earlier. The system will also indicate any amount to be recovered from the claimant so that it could be adjusted against the claim.

**New Recruitment and Promotion Policy:** The new recruitment policy for the CBR envisages a rigorous 18-24 months' pre-induction training program for those selected for Grade 17 by the Federal Public Service Commission (FPSC) through a competitive examination. The training program will be conducted in association with recognized business/law school/university leading to a Master's degree in Tax Administration. Only those successfully qualifying for the Master's degree will finally be inducted into the CBR. Employees in grade 11-16 will also be recruited through FPSC and will have to successfully complete necessary training before being inducted in the CBR. The new promotion policy will take into consideration competencies, skills, performance, and leadership qualities, in addition to seniority. To encourage high level of commitment, dedication, and creativity, compensation package for the CBR employees will be such as to ensure "living wages". There will also be additional compensation to those employees who will play a substantial role in the achievement of CBR objectives.

low EPP, CPP will be approximately 60-66 percent of the levelized price in case of hydel projects. For hydel and thermal projects based on fuel other than oil, power companies will be allowed to import plant and equipment not manufactured locally at concessionary duty. For these projects there will also be complete exemption from income tax, including turnover tax and withholding tax on imports.

**Governance Reforms:** The Government has taken a number of very significant steps to implement **police, legal and judicial reforms**. These include: (1) the abolition of the office of District Commissioner and the executive magistracy; (2) separation of executive from the judiciary; (3) issuance of the Police Order in August 2002 by the President to reconstruct and regulate police and set up independent police complaint authority within Public Safety Commissions; (4) separation of prosecution service from police; (5) establishment of dedicated full time benches for commercial cases in Lahore and Karachi High Courts; (6) amendment of the Family Courts Act in October 2002 to reduce delays in resolution of family disputes; (7) enactment of the law to establish Small Causes Courts in June 2002 to provide citizens access to speedy and cheap justice in minor cases; (8) amendment of contempt of court laws to remove arbitrariness and give right of appeal to those convicted of contempt and thereby allow genuine review of judicial judgements; (9) changes in laws to empower session judges in each district to provide relief against unlawful

imprisonment;<sup>10</sup> and (10) designation of principal officers in all federal Government departments for dealing with public grievances. The Government has also made changes in the Constitution to allow the Supreme Judicial Council to proceed against higher judiciary suo moto, that is, without waiting for the President to make reference to them.

The Government promulgated the **Freedom of Information Ordinance (FIO) 2002** on 14 October 2002. Under this law, with a few exceptions, all records of the Federal Government departments and its organizations related to transactions involving acquisition and disposal of property, expenditure, grant of licenses, allotments, and contracts have been declared to be the public record and are to be provided to citizens at a reasonable cost, when requested. The law also requires the Government to publish all acts, rules and regulations, notifications, manuals, and orders having the force of law.

Government's records, excluded from the purview of the new law are: (1) noting of the files; (2) minutes of meetings; (3) any intermediary opinion or recommendation; (4) records of banks and other financial institutions relating to accounts of their customers; (5) records relating to defense forces and defense installations; (6) information related to the personal privacy of any individual; and (7) records declared as classified by the Federal Government. Disclosure of such information as may damage Pakistan's interest in international

*The Government has taken a number of very significant steps to implement police, legal and judicial reforms.*

*The Government has designated principal officers in all federal Government departments for dealing with public grievances.*

<sup>10</sup> Previously only High Courts located in provincial capitals and few other large cities could provide relief against unlawful imprisonment.

*The Freedom of Information Ordinance is expected to make the working of the Government more transparent and enhance the accountability of government functionaries.*

*The Government is committed to increase pro-poor budgetary expenditures annually by 0.2 percent of GDP to 4 percent of GDP in FY2004.*

relations, or undermine law enforcement, or cause harm to the economy, has also been exempted from public disclosure.

On receiving the application for information and prescribed fee, the designated officer is to provide the requested information within 21 days. In case the access to information is refused, the requester can complain to the head of the department and on failing to get information even after the complaint, he/she can file a complaint with the Federal Tax Ombudsman where the information is related to the Revenue Division and to the Ombudsman in all other cases. FIO is expected to make the working of Government more transparent and enhance the accountability of government functionaries.

### **III. RECENT POVERTY REDUCTION INITIATIVES**

The incidence of poverty increased from 26.6 percent in FY1993 to 32.2 percent in FY1999 and the number of poor increased by 12 million over this period. The Musharraf Government, which assumed power in October 1999, made poverty alleviation the key objective of its economic policies. The Government's poverty reduction strategy, articulated in the Interim Poverty Reduction Strategy Paper (I-PRSP), envisages a multi-pronged strategy of

reviving growth, improving governance, reorienting public expenditure toward poverty reducing programs, and revamping the safety net system. The Government is striving to revive broad-based and equitable economic growth through macroeconomic stabilization and structural reforms. It is implementing comprehensive governance reforms with particular emphasis on enhancing the effectiveness of basic social services through devolution plan and providing access to justice and reducing vulnerability of the poor through judicial and legal reforms.

The Government is committed to increase pro-poor budgetary expenditures annually by 0.2 percent of GDP to 4 percent of GDP in FY2004.<sup>11</sup> A new program to rehabilitate the poor by giving them one-time rehabilitation grants ranging from Rs 5,000 – 50,000 out of the Zakat Fund was initiated.<sup>12</sup> The Government increased funding for small public works program, namely the Khushal Pakistan Program (KPP),<sup>13</sup> which aims at providing gainful employment to the poor, besides creating essential infrastructure (farm-to-market roads, water supply schemes, repair of schools, etc.) in rural and low-income urban areas. The Government also set up the Khushali Bank (KB) with ADB's financial support in August 2000, as the first microfinance bank in the country.

<sup>11</sup> These are expenditures on: education, health, water supply and sanitation, population planning, land reclamation, rural development, irrigation, roads and bridges, social security and other welfare, relief in natural calamities and disasters, food subsidies, and food support program.

<sup>12</sup> Zakat Fund, an off-budget Islamic Welfare Fund financed through a 2.5 percent religious levy on fixed financial assets of Muslim citizens of the country, has been in operation as a major social safety net since 1980.

<sup>13</sup> KPP is not a new program. Similar programs have been implemented before under names like Taamir-e-Watan Program and Public Works Program.

The Government has put in place a mechanism for tracking anti-poverty expenditures identified in I-PRSP and posting them on the Finance Division's website on a quarterly basis. Most intermediate human development indicators are currently reported on annual basis.<sup>14</sup> The Government is working with the provincial education departments and National Education Management Information System (NEMIS) to build a reporting system that will report progress on intermediate indicators of education, including teacher absenteeism, on a six-monthly basis. Pro-poverty expenditures will also be linked with the achievement of relevant outcomes/targets to assess the effectiveness of these expenditures.

**Implementation of I-PRSP:** FY2002 was the first year of I-PRSP implementation. This was also the year when responsibilities for primary and secondary education, basic health units and tehsil and district hospitals, water supply and sanitation, and rural development, which constitute the bulk of pro-poor expenditure, were devolved to local governments. Modalities for fiscal devolution had not been fully completed in the first half of the year. The district governments finalized their budgets only in December 2001 and thereafter started incurring development expenditure. As a result of this transition, poverty reduction budgetary outlays in the first half of FY2002 were 15 percent lower than in the same period of FY2001.

Once the devolution of fiscal resources was completed and local government budgets were finalized, pro-poor expenditures started increasing at a rapid pace. These expenditures increased by 31.7 percent in the third quarter of FY2002 and by 22.9 percent in the fourth quarter, resulting in a cumulative increase of 9.1 percent for the year as a whole (see Table 3). However, at Rs 133.5 billion, pro-poor budgetary expenditure remained unchanged at 3.6 percent of GDP. Data on I-PRSP budgetary expenditures, now available for the first quarter of FY2003, shows a 30.3 percent increase over the corresponding quarter of FY2002. As local governments strengthen their implementation capacity, pro-poor expenditure is expected to increase further. Progress in implementation of I-PRSP in various sectors is discussed below.

Despite teething problems of the transfer of responsibilities for provision of social services from the provincial to local governments, expenditure on education and health increased by 17.3 percent and 9.7 percent, respectively, in FY2002 compared with FY2001. The entire increase took place in the second half of the year, with the first half experiencing a substantial decline. Expenditure on education increased by 51.1 percent in the second half of the year after declining by 13.0 percent in the first half. Similarly, health expenditure, which had declined by 11.7 percent in the first half of the year,

*The Government has put in place a mechanism for tracking pro-poor budgetary expenditures and posting them on the Finance Division's website on a quarterly basis.*

*Data on pro-poor budgetary expenditures, now available for the first quarter of FY2003, shows a 30.3 percent increase over the corresponding quarter of FY2002.*

<sup>14</sup> The Government has identified four intermediate human development indicators to capture the intermediate impact of the bulk of the Government's human development expenditures. These indicators are: (1) percentage of population registered with lady health workers; (2) utilization of curative health care facilities; (3) number of functional primary and middle schools; and (4) percentage of functional primary and middle schools with basic facilities including water, latrines, electricity, and boundary walls.

**Table 3: I - PRSP Budgetary Expenditure  
(Rs million)**

	FY2001	FY2002	%age Change	Q1-FY 2002	Q1-FY 2003	%age Change
Roads, Highways & Bridges	8,332	6,340	-23.9	976	647	-33.7
Water Supply & Sanitation	4,497	4,644	3.2	669	780	16.5
Education	56,536	66,290	17.2	12,352	15,541	25.8
Health	17,508	19,211	9.7	2,841	4,092	44.0
Population Planning	1,588	1,331	-16.1	356	797	123.8
Social Security & Social Welfare	1,576	3,664	1,32.4	165	152	-7.8
Natural Calamities & Other Disasters	912	189	-79.2	42	228	442.8
Irrigation	8,154	10,133	24.2	1,154	1,590	37.7
Land Reclamation	1,380	1,838	33.1	192	264	37.5
Rural Development	11,415	12,325	7.9	2,066	3,512	69.9
Food Subsidies	9,390	5,513	-41.2	0	700	-
Food Support Program	1,061	2,017	90.1	961	58	-93.9
<b>Grand Total</b>	<b>122,349</b>	<b>133,495</b>	<b>9.1</b>	<b>21,774</b>	<b>28,361</b>	<b>30.2</b>

Source: I - PRSP Fourth Quarter/ Full Year Progress Report, FY2002, and I - PRSP First Quarter Progress Report FY2003. Ministry of Finance Website.

*The number of lady health workers increased from 40,080 in March 2001 to 65,743 in September 2002.*

increased by 26.6 percent in the second half.

The trend of robust increases in expenditure on education and health in second half of FY2002 was sustained in the first quarter of FY2003, when expenditure on education was 25.8 percent higher than in the corresponding quarter of FY2002 and that on health was 44.0 percent higher. For both FY2002 and the first quarter of FY2003, within the education sector, there were much larger increases in expenditure on professional, general university, and college education compared with secondary and primary education.

In the health sector, expenditure on preventive health measures increased only nominally (1.2 percent) and expenditure on mother and child health showed no increase at all in FY2002. Expenditure on preventive health

measures picked up in the first quarter of FY2003 and showed a sharp increase of 121.6 percent over the corresponding quarter of FY2002. There was a substantial increase in other (unspecified) health expenditure in FY2002 as well as in the first quarter of FY2003, presumably on hiring of lady health workers (LHWs), whose number increased from 40,080 in March 2001 to 65,743 in September 2002. LHWs currently are providing primary health and family planning services in rural areas and in urban slum areas.

In terms of intermediate human development indicators, there was substantial progress in health indicators, while education indicators hardly showed any progress in FY2002. For instance, the percentage of population registered with LHWs increased from 29 percent in FY2001 to 43 percent in FY2002. Improvement in coverage of rural

population was even more impressive; it increased from 32 percent to 48 percent. The utilization of health facilities, defined as number of cases handled per day, per facility, also increased from 170 to 210. While the increase in utilization of first level health facilities was small (from 28 to 31) that of hospitals increased sharply from 142 to 179. In education, the number of functional primary and middle schools each increased by only 2.0 percent to 137,104 and 12,573, respectively.

Expenditure on water supply and sanitation recorded decreases in each of the first three quarters of FY2002, but picked up in the fourth quarter registering an increase of 16.2 percent. For the year as a whole there was a small increase of 3.3 percent. Increase in expenditure on water supply and sanitation recorded in the fourth quarter of FY2002 was sustained in the first quarter of FY2003.

There was a large increase of 24.3 percent in expenditure on irrigation in FY2002 and a further increase of 37.8 percent in the first quarter of FY2003, reflecting the high priority assigned by the Government to storage and conservation of water to tackle the drought situation prevailing in the last 3-4 years. Rural development expenditure, another area of high priority and executed under the KPP by local governments, almost doubled (registered an increase of 93.4 percent) in the fourth quarter, after declining in each of the first three quarters. It showed an increase of 8.0

percent for the year as a whole. In the first quarter of FY2003 also, there was a large increase of 70.0 percent in expenditure on rural development.

Among non-budgetary income transfer programs, disbursement of Zakat increased by 69.0 percent to Rs 3,089 million in the first three quarters of FY2002 compared with the corresponding period of the preceding year.<sup>15</sup> Total Zakat disbursement for full FY2002 amounted to Rs 5.2 billion, of which rehabilitation grants accounted for 31 percent. Because of the emphasis given to rehabilitating the poor on a permanent basis, one-time rehabilitation grants, at Rs 1,010 million, accounted for four-fifths of the increase in disbursements. With 52,556 households availing these grants, the average size of the grant was Rs 19,209. Educational stipends for the poor students, another way of rehabilitating the poor, more than doubled (Rs 307 million compared with Rs 143 million) in FY2002. The conventional use of the Zakat Fund by way of subsistence grants declined marginally by 1.4 percent from Rs 1,551 million to Rs 1,529 million.

Disbursement of micro credit through KB, Pakistan Poverty Alleviation Fund (PPAF), and Agricultural Development Bank of Pakistan (ADBP), taken together, increased by 110.6 percent to Rs 1,215 million in FY2002 compared with FY2001, and the total number of borrowers availing small loans increased by 208 percent to 148,728. Disburse-

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*Disbursement of micro credit increased by 110.6 percent in FY2002 compared with FY2001, and the total number of borrowers availing small loans increased by 208 percent.*

<sup>15</sup> While the data on disbursement of Zakat is available for full FY2002, this information for FY2001 is available only for the first three quarters. Hence for the purpose of comparison, only the data for the first three quarters has been used.

*PRPA, signed in September 2002 between ADB and the Government of Pakistan, sets out a shared vision for reducing poverty and key priorities for joint development cooperation to achieve this vision.*

ments by KB, which started its operations in August 2000, increased by five times to Rs 477 million during the year. PPAF also doubled its disbursement. The average size of loan by KB was Rs 10,335, while that by PPAF was Rs 6,615. The two institutions expanded their coverage from 5 and 32 districts, respectively, to 26 and 63 districts. Number of borrowers availing loans from PPAF increased by 213 percent to 99,011, while those borrowing from KB increased by 353 percent to 46,150. Disbursement of micro credit by KB in the first quarter of FY2003 stood at Rs 184 million compared with Rs 34 million in the same period of the last year. Disbursement by PPAF also increased by 67.5 percent to Rs 181 million.

**Poverty Reduction Partnership Agreement (PRPA)**, signed in September 2002 between ADB and the Government of Pakistan, sets out a shared vision for reducing poverty and key priorities for joint development cooperation to achieve this vision. To achieve reduction in poverty, the Government and ADB have agreed on the following priorities: (i) improving quality of governance, including devolution of power to local communities, restructuring of government, and reform of the civil service, judiciary and police; (ii) achieving broad-based growth through development of SMEs and a diversified agriculture sector; (iii) asset creation for the poor, especially women, through support of microfinance and rural development programs; (iv) human

development through education and health program, with gender equality; and (v) social safety nets with targeted programs for vulnerable groups.

**Pakistan Integrated Household Survey (PIHS)**, a national sample survey covering 16,182 households, has been carried out four times starting in FY1996 to monitor and assess the impact of Social Action Program. The data on social indicators based on results of the latest round of PIHS carried out in FY2002<sup>16</sup> shows a significant improvement in health indicators, but no improvement in most education indicators. Infant mortality declined from 89 per 1,000 live births as reported in the PIHS for FY1999 to 82 by FY2002; percentage of children of 12-23 months age, who have received full immunization, increased from 49 percent to 53 percent; and contraceptive prevalence among women of childbearing age went up from 17 percent to 19 percent. Percentage of households having flush toilet increased from 41 to 45 and those without any toilet dropped from 46 to 43. However, fertility rate (number of children born per woman aged 15-49 years) failed to decline and remained at 4.46.

Key education indicators, like primary school enrollment, school dropout rate, and literacy rate, did not show any improvement over the last three years, according to the latest PIHS results. Literacy rate for population 10 years and older and net primary school enrollment remained unchanged at 45 percent and

*Results of the latest round of PIHS carried out in FY2002 show a significant improvement in health indicators.*

<sup>16</sup> Results of PIHS related to household income and expenditure, which form the basis of estimation of poverty incidence, will be released later.

42 percent, respectively, while cumulative drop out rate up to the sixth class increased slightly from 27.2 percent to 27.9 percent. The share of public schools in total primary school enrolment also declined from 75 percent to 74 percent.

Lack of progress in education indicators during the last three years, as reported in PIHS, despite a major shift in Government's policy toward development of social sectors, prompted the Government to look more closely at the quality of PIHS data. These investigations reveal major problems in sampling methods, design of the survey questionnaire, enumeration, and weakness in supervision of conduct of PIHS. For instance, in Sindh where PIHS results show a substantial decline in literacy (from 51 percent to 45 percent), persons responding in affirmative to two of three questions asked about their ability to read, write, and solve a simple Mathematics sum, were treated as illiterate in many cases. At the national level, in case of primary school enrollment, boys/girls aged 6 years or above, who reported as enrolled in school, were recorded as not attending the school, if their class was not mentioned.

When some of the weaknesses were corrected, results show significant improvement in most education indicators. For instance, according to corrected results, there is a three-percentage point increase from 45 to 48 percent in literacy rate, and net enrolment in primary schools increased from 42 percent to 53 percent. Although net enrolment in middle schools (classes 6-8) showed no improvement even after

correction, its level in both years increased from 16 to 20 percent.

#### IV. OUTLOOK

Prospects of realizing and possibly surpassing the Government projected growth rate of 4.5 percent in FY2003 mentioned in our last Economic Update are quite bright. This optimism is based on improved outlook for agriculture, manufacturing, and services sectors. Both supply factors (better availability of water for agriculture and better placed textile industry after heavy investment in the past two years) and demand factors (larger remittances, lifting of ban on serving meals at weddings, and financial institutions aggressively marketing consumer credit) are expected to boost domestic economic activity.

As the domestic economy is expected to pick up and the upturn in imports is likely to be maintained in remaining part of the year, the prospect of achieving the CBR tax collection target of Rs 460 billion this year looks reasonably good. However, if the current trend of larger-than-budgeted increase in expenditure continues, the fiscal deficit target of 4.0 percent of GDP will be difficult to achieve. Of particular concern are continuing losses being incurred by KESC and WAPDA, which are likely to undermine efforts to keep expenditure under control.

Because of better access to the European Union markets and higher production in textile industry, the 13.4 percent growth target for exports in FY2003 seems quite achievable. As the economy picks up, demand for imports

*Both supply factors and demand factors are expected to boost domestic economic activity.*

*Of particular concern are continuing losses being incurred by KESC and WAPDA, which are likely to undermine efforts to keep expenditure under control.*

is likely to increase further. Hence increase in imports may overshoot the target growth of 7.4 percent, resulting in a somewhat larger trade deficit than the target of \$1 billion set in the beginning of the year. However, because of larger amount of remittances, Pakistan should still end the year with a comfortable surplus in the current account of the balance of payments.

The elected governments formed at the Center and the provinces on the basis of general elections held in October, augur well for the continuation of the economic policies and reforms implemented in the

last three years. The Pakistan Muslim League (Quaid Group), which in its election campaign vowed to continue policies of the Musharraf Government, has succeeded in forming the government at the Center and three out of four provinces. Mr. Zafrullah Khan Jamali, the newly elected Prime Minister of the country, has appointed Mr. Shaukat Aziz, the main architect of economic policies over the last three years, as his Advisor on Finance and Planning, and Mr Hafeez Shaikh, the successful reform-minded, former Finance Minister of Sindh, as his Advisor on Privatization.



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