04

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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 83/27

10:30 a.m., February 4, 1983

J. de Larosière, Chairman
W. B. Dale, Deputy Managing Director

Executive Directors	Alternate Executive Directors
A. Alfidja	W. B. Tshishimbi
J. Anson	C. Taylor
J. de Groote	H. G. Schneider
	A. Le Lorier
A. Donoso	
R. D. Erb	
M. Finaish	T. Alhaimus
	I. R. Panday, Temporary
T. Hirao	T. Yamashita
R. K. Joyce	
A. Kafka	
G. Laske	G. Grosche
G. Lovato	C. P. Caranicas
R. N. Malhotra	
Y. A. Nimatallah	
J. J. Polak	T. de Vries
A. R. G. Prowse	K. G. Morrell
G. Salehkhou	
F. Sangare	
M. A. Senior	
J. Tvedt	
Zhang Z.	

L. Van Houtven, Secretary
L. Collier, Assistant

Also Present

Asian Department: H. Neiss, Deputy Director; U. Baumgartner. Exchange and Trade Relations Department: S. Mookerjee, Deputy Director; D. J. Donovan, M. R. Kelly. External Relations Department: A. F. Mohammed, Director; H. P. Puentes. Fiscal Affairs Department: K. W. O'Connor. Legal Department: G. P. Nicoletopoulos, Director; G. F. Rea, Deputy General Counsel; J. K. Oh. Middle Eastern Department: M. Arif, R. K. Basanti, S. H. Hitti, Z. Iqbal, H. E. Jakubiak, B. A. Karamali, M. Shadman, G. Tomasson, E. M. Taha, M. Yaqub. Research Department: W. C. Hood, Economic Counsellor and Director; A. D. Crockett, Deputy Director. Secretary's Department: J. A. Kay. Treasurer's Department: W. O. Habermeier, Counsellor and Treasurer; D. Williams, Deputy Treasurer; D. S. Cutler, T. M. Tran. Finance and Development: S. Nawaz. Personal Assistant to the Managing Director: N. Carter. Advisors to Executive Directors: S. R. Abiad, J. R. N. Almeida, C. J. Batliwalla, J. Delgadillo, S. El-Khouri, M. A. Janjua, P. Kohnert, H.-S. Lee, P. D. Péroz. Assistants to Executive Directors: E. M. Ainley, H. Arias, L. Barbone, R. Bernardo, J. Bulloch, T. A. Connors, G. Ercel, I. Fridriksson, G. Gomel, A. Halevi, J. M. Jones, M. J. Kooymans, P. Leeahtam, W. Moerke, V. K. S. Nair, Y. Okubo, J. K. Orleans-Lindsay, J. G. Pedersen, G. W. K. Pickering, E. Portas, M. Z. M. Qureshi, J. Reddy, J. Schuijer, D. I. S. Shaw, H. Suzuki, J. C. Williams, A. Yasseri, Zhang Z.

1. <u>GENERAL ARRANGEMENTS TO BORROW - REVISION AND EXPANSION</u>

The Executive Directors continued from EBM/83/26 (2/3/83) their discussion of the revision and expansion of the decision on the General Arrangements to Borrow. They reviewed a note prepared by the staff summarizing the changes in the text of the revised GAB decision to reflect the discussion at EBM/83/26 (SM/82/239, Rev. 2, Sup. 1, 2/3/83) and heard comments by the staff on paragraph 22 of the proposed decision, dealing with participation by the Swiss National Bank (SM/82/239, Rev. 2, 1/31/83).

The Director of the Legal Department explained that, as a result of EBM/83/26, the staff had made a number of changes in SM/82/239, Revision 2 as set out in SM/82/239, Revision 2, Supplement 1. Apart from deleting paragraphs 1(xi) and 21(a) referring to parallel creditors, renumbering paragraphs 21(b) and 21(c), and deleting the first formulation in square brackets at the end of paragraph 3(b), the staff had added a sentence to paragraph 9(a). The purpose of that sentence was to require the agreement not only of the Fund but also of at least two thirds of the participants having three fifths of the total amount of the credit arrangements in order for a change in the method of calculating the combined market rate to become effective. The second half of the sentence provided that if a participant so requested at the time that the agreement was reached, the change should not apply to the Fund's indebtedness for that participant at the moment that the change became effective.

Similarly, the Director went on, a slight modification had been introduced into paragraph 10 to reflect the change of emphasis requested by Mr. Donoso and Mr. Malhotra. The staff had also added a new paragraph 23 dealing with associated borrowing arrangements. There would be two subparagraphs. The first, similar to the one discussed at EBM/83/26, made it possible in certain circumstances to treat an associate member as if it were a participant in respect of certain aspects of the decision of the General Arrangements to Borrow. If the language were accepted, it would be possible for the Fund to activate the GAB to make calls for the benefit of that member or to repay indebtedness by the Fund to that member under the associated agreement. The second subparagraph was intended to reflect Mr. Erb's preference for indicating that it would be possible for the Fund to enter into other types of association agreements with a member that would establish an association between the Fund, the member, and participants without involving any of the benefits referred to in paragraph 23(a).

Continuing, the Director remarked that he wished to support a change in the language of paragraph 23(a) as circulated that would make it clearer. He would like to insert a period after the word "both" at the beginning of the last line and to add the words "for the purposes of this decision, such calls or requests shall be treated..." so that there would be a new last sentence reading: "For the purpose of this decision, such calls or requests shall be treated as if they were calls or requests in respect of a participant."

Finally, the Director of the Legal Department explained, the words "or parallel creditors" in square brackets in paragraph 21(b) (SM/82/239, Rev. 2) would be deleted.

Paragraph 10

Mr. Donoso observed that under the language suggested for the second sentence in paragraph 10 access to the Fund's resources by members would not depend on whether the Fund could borrow under the decision. The doubts that he had expressed at EBM/83/26 therefore still remained. The last clause seemed to be a qualification on the freedom of access by members to the Fund's resources, so that members could rely only on the resources available to the Fund without borrowing under the decision. His preference would be to end the paragraph with the words "shall be determined by the Fund's policies and practices." The remaining clause seemed to him restrictive.

Mr. Kafka, however, stated that the final clause in paragraph 10 seemed to make it clear that the Fund's own practices and policies would prevail, and that there would be no limitation on the Fund's autonomy even if it borrowed under the decision.

Mr. Malhotra said that he agreed with Mr. Kafka that the final clause of paragraph 10 should be retained. As he understood it, Mr. Donoso's worry might perhaps be met if a reference could be made to the fact that the possibility of activating the General Arrangements to Borrow under the agreed criteria would be a relevant factor in considering the total availability of resources to the Fund.

The Chairman remarked that, as he understood it, the purpose of the last sentence in paragraph 10 was to state plainly that even if the Fund were unable to borrow from the participants in the General Arrangements to Borrow, members' access to Fund resources would not be impaired, and that the Fund could always seek to finance that access in other ways.

Continuing, the Chairman commented that it was surely clear that in devising its access policies the Fund would of course take into account the existence of the General Arrangements to Borrow, as indeed the existence of other borrowing arrangements and resources, but that it would not be limited in applying those practices and policies by the possibility that it would be unable to borrow from participants in the GAB.

It was agreed to leave paragraph 10 unaltered.

Paragraph 22 (SM/82/239, Rev. 2)

The Treasurer remarked that there was still one point on which complete certainty had not yet been reached, namely, that the Swiss National Bank would become a participant. That was a point that would have some effect on paragraph 22.

The Director of the Legal Department said that he had spoken the previous day with the Vice President of the Swiss National Bank, who had told him that the Swiss authorities had considered the matter and that they had had no difficulty of substance. There was however some doubt about the authority of the Swiss National Bank to agree to become a participant without an act of Parliament. That point was under consideration by the Swiss Federal Council. The Vice President of the Bank hoped for a positive decision of the Swiss Federal Council in two or three weeks.

Mr. Anson suggested that if there was still a procedural difficulty on the point at the time when the decision had to be taken to submit the document to the participants, a form of language should be adopted for paragraph 22 that would make it possible for either the Swiss Confederation or the Swiss National Bank to become a participant at a later date.

The Director of the Legal Department undertook to be in touch with the Vice President of the Swiss National Bank.

Paragraph 23(a)

Mr. Prowse suggested that the words "that is not a participant" in the second line of paragraph 23(a) should be moved to the first line to qualify the words "a member." The purpose was to make clear that the associated borrowing arrangements would be between the Fund and a member that was not a participant. More substantively, he wished to be sure that the authorization would be of a general nature, so that it would not be necessary to seek concurrence of the participant each time that the Fund wished to make a call in accordance with paragraphs 6 and 7 or to make requests under paragraph 11(e).

The Director of the Legal Department confirmed Mr. Prowse's understanding. The language seemed quite clear, since the text described the borrowing arrangements between the Fund and the member that was not a participant and the final sentence of paragraph 23(a) said: "For the purposes of this decision such calls or requests shall be treated as if they were calls or requests in respect of a participant." However, an explanatory sentence could be included in the commentary.

Paragraph 23(b)

Mr. Laske commented that he had understood from EBM/83/26 that the additional arrangements referred to in paragraph 23(b) would also require the concurrence of participants in the General Arrangements to Borrow. The language as now written did not contain that implication.

The Director of the Legal Department explained that the agreements referred to in paragraph 23(b) would not confer any right involving participants in the GAB. Consequently, the right of the Fund to enter into such agreements would not need to be subject to concurrence by the participants. Naturally, the participants could, if they wished, include the associated lenders in their consultations; such an arrangement could clearly be made only with the agreement of the participants.

The Chairman added that, as long as the agreements between the Fund and associated lenders did not entail financial and legislative consequences for the participants in the GAB, it was not for the Fund to stipulate the ways in which the participants would associate themselves with lenders involved in looser types of agreement.

Mr. Malhotra commented that he had understood that under the agreements mentioned in paragraph 23(b) any privileges that might have accrued to lenders would not be available to associated lenders. Consequently, if an arrangement contemplated in paragraph 23(b) between the Fund and an associated lender were to be made subject to concurrence by the participants, there would be a restriction of the Fund's normal authority to enter into such agreements.

Mr. Laske explained that he had read the penultimate line of paragraph 23(b)--"involving an association between the Fund, the lender and participants"--as implying the participants as a group. However, if the words "and participants" referred primarily to individual participants, he could understand that concurrence would be unnecessary.

The Director of the Legal Department confirmed that the words "and participants" in paragraph 23(b) referred to participants individually or in any other way that might be decided. He agreed with Mr. Malhotra that the arrangements referred to in paragraph 23(b) did not involve any benefits for the lenders associated with the Fund; consequently, concurrence by the participants would not be needed. The type of agreement referred to in paragraph 23(b) could involve an agreement between potential lenders and the Fund that would be perhaps a one-time arrangement to support a particular operation involving the General Arrangements to Borrow. It was possible that in connection with such an arrangement the participants of the GAB would wish to associate the potential lender with their discussions.

In that connection, the Director of the Legal Department recalled, the Baumgartner letter, although communicated to the Executive Board, which had as a result acquired certain expectations--meaning that the participants could not in good faith change the Baumgartner letter without notifying the Fund--had never been part of the General Arrangements to Borrow, nor even annexed to them. Nevertheless, it was certainly true that the Executive Board had known of its contents at the time that it had taken the decision on the General Arrangements to Borrow. It was for that reason that the staff hoped that whatever supplementary understandings were included under paragraph 23(b) would be communicated to the Executive Board.

Mr. Anson commented that Mr. Malhotra's point, with which he very much agreed, and which he himself had indeed raised at EBM/83/26, was fully covered by the first one-and-a-half lines of paragraph 23(b). The last two-and-a-half lines of the paragraph were simply illustrative. As to Mr. Laske's proposal for inserting the words "with the concurrence of the participants," the agreement referred to in paragraph 23(b) would be a borrowing agreement between the Fund and the lender. The suggestion that provided for concurrence by the participants had been made to cover the case in which provisions in that agreement between the Fund and the lender might in some way or another affect the participants. One way of dealing with the matter would be to rewrite the third line of paragraph 23(b) to read, "involving some agreed association between the Fund, the lender, and participants."

The Director of the Legal Department explained that Mr. Anson's language would still require agreement by the participants; it had been his understanding that the majority of Executive Directors did not wish to involve the participants so closely in the type of agreement being covered by paragraph 23(b).

Mr. Anson said that he had not intended to suggest that the agreement between the Fund and the lender should be concurred in by the participants, unless it affected the rights of the participants in the same way.

The Director of the Legal Department commented that the language of paragraph 23(b) had been formulated so as to permit an agreement between the Fund and the lender that would permit association with the GAB but without requiring agreement of the participants, because the participants would be free to associate the lender with their deliberations and consultations without reference to the Fund.

Mr. Anson stated that, in the light of the statement by the Director of the Legal Department, he would be satisfied with the proposed language.

Mr. Polak suggested that throughout paragraph 23 it would be better to use the term "borrowing arrangement" than "borrowing agreement," and that in paragraph 23(b) a solution might be reached by deleting the words "an association between" in the third line.

After further discussion it was agreed that paragraph 23(b) should read: "Nothing in this decision shall preclude the Fund from entering into any other types of borrowing arrangements, including an arrangement between the Fund and the lender, involving an association with participants that does not contain the authorizations referred to in paragraph 23(a)."

The Executive Directors completed their review of changes in the text proposed for a revision and expansion of the General Arrangements to Borrow and invited the staff to issue a revised text that would be brought to the attention of the Deputies of the Group of Ten when they met in Washington the following week.1/

1/ See SM/82/239, Revision 3 (2/4/83).

The Executive Board then took the following decision:

> The Executive Board approves the text prepared for a revision and expansion of the General Arrangements to Borrow, and invites the Secretary to transmit it to the participants for consideration by their Deputies at a forthcoming meeting.

Adopted February 4, 1983

2. PAKISTAN - 1982 ARTICLE IV CONSULTATION AND PROGRAM UNDER EXTENDED ARRANGEMENT

The Executive Directors considered the staff report for the 1982 Article IV consultation with Pakistan and the program under the extended arrangement (EBS/83/3, 1/6/83; and Sup. 1, 2/3/83), together with proposed decisions. They also had before them a report on recent economic developments in Pakistan (SM/83/14, 1/21/83).

Mr. Finaish made the following statement:

> For the past several years the Pakistan authorities have been pursuing a policy of economic reform aimed at a sustained improvement in domestic economic performance and achievement of a viable external financial position. Measures taken under this policy have been wide ranging, combining restrained demand management with important structural adjustments. Since 1980/81 this policy has been carried out within the framework of a three-year adjustment program, which is supported by an extended arrangement with the Fund. It is mainly as a result of this continuing process of economic reform that, despite a highly adverse international environment, the performance of the economy has improved considerably in recent years. Output growth in excess of an average rate of 6 per cent has now been maintained for five consecutive years. At the same time, both the domestic and external financial imbalances have been narrowed--the former appreciably--relative to the high levels reached in the latter half of the 1970s, and the rate of inflation has been reduced. The structural adjustment measures being taken augur well for this improvement in economic performance to be sustained in the coming years.
>
> As shown by the staff's review, developments in the domestic economy continued to be favorable during the fiscal year 1981/82, the second program year, following the economy's highly satisfactory performance in 1980/81. A real growth rate of 6.2 per cent was achieved. The growth of output was well spread, with manufacturing output increasing by about 12.5 per cent, the third consecutive year during which it has grown at a rate close to or over 10 per cent. While growth in the agricultural sector fell short of target, largely reflecting the adverse effect on

the wheat crop of untimely rains, the self-sufficiency in foodgrain production achieved in 1980/81 was maintained. Investment activity picked up substantially during the year, both in the public and private sectors, with fixed capital formation increasing by over 15 per cent in real terms and the ratio of aggregate investment to GNP rising to 16.2 per cent from 15.4 per cent in 1980/81.

These positive developments in the real sector were accompanied by fulfillment of the fiscal and monetary objectives of the program. Despite an appreciable shortfall in tax revenues--resulting mainly from slower than projected import growth--and external financing, government recourse to the banking system was kept within the program ceiling of 2 per cent of GDP, compared with the actual level of about 5 per cent in 1978/79. Total domestic credit expansion was also within its ceiling, with overall monetary growth amounting to only about 12 per cent against a rate of increase of close to 20 per cent during several successive years prior to the introduction of the program. These policies of financial restraint appear to have succeeded in appreciably reducing excess demand pressures; notwithstanding the substantial impact on domestic prices of exchange depreciation during the year, the rate of inflation--as measured by the increase in consumer prices--fell to 8.5 per cent from 15 per cent in the previous year.

Developments in the balance of payments during 1981/82, however, turned out to be quite adverse, causing a break in the improving trend witnessed over the previous two years, during which the current account deficit had been reduced from 5.1 per cent of GNP to 3.2 per cent. Largely as a result of depressed world demand and a further worsening of the terms of trade, export receipts recorded a sharp fall, compared with a high average rate of increase of 30 per cent during the preceding three years. Although imports increased by much less than had been projected, the drop in export receipts caused the current account deficit to widen beyond the target for the year. While, at 4.5 per cent of GNP, the deficit was still less than the original target under the extended arrangement, it did represent an appreciable deterioration relative to the outcome for 1980/81. In recognition of the weakening external position, and in response to the continuing appreciation of the U.S. dollar, to which the rupee had remained pegged, the authorities took an important step in early January 1982. The rupee's peg to the U.S. dollar was terminated, and a managed floating rate system was introduced. In making periodic adjustments to the exchange rate under the new system, the authorities have been guided by changes in relative competitiveness--arising from exchange rate movements among major currencies and inflation rate differentials--and the requirements of the balance of payments situation. By the end of fiscal year 1981/82 on June 30, 1982, the rupee had been allowed to depreciate by about 19 per cent vis-à-vis the U.S. dollar and by over 14 per cent in real trade-weighted terms.

Turning to the program for 1982/83, the third program year under the extended arrangement, a principal objective is to sustain the momentum of economic reform built up over the past two years. The new policies being introduced and the strengthening of policies already in place are expected to contribute to a further improvement in economic performance. Growth in real GDP is projected to reach 6.7 per cent, with the agricultural growth rate rising to about 6 per cent and manufacturing output increasing by close to 10 per cent for the fourth consecutive year. Real fixed investment is expected to go up by 11 per cent, raising the aggregate investment ratio to about 16.5 per cent. On the demand management side, measures taken to increase revenues and restrain expenditure growth under the 1982/83 budget are expected to keep the overall fiscal deficit relative to GDP down to the level of the previous year. Despite an anticipated large shortfall in foreign assistance, domestic bank financing of the deficit is to be reduced further to 1.8 per cent of GDP (in line with the original target under the extended arrangement). The ceiling on domestic credit expansion has been further lowered, and monetary growth is projected to be kept at about 13 per cent. These measures are expected to contribute to a further significant reduction in the rate of inflation; consumer prices at the end of the second quarter of 1982/83 were only about 4 per cent above their level a year earlier.

The balance of payments position is also expected to improve in 1982/83 and to be broadly in line with that foreseen at the outset of the program. Encouraged by the improved competitiveness resulting from the depreciation of the rupee, and assuming no further slowdown in the world economy, exports are expected to recover well and grow by 12.5 per cent. Growth of workers' remittances is also projected to recover to 15 per cent, compared with the relatively low rate of about 6 per cent in 1981/82. As a result, the current account deficit is expected to decline to about 4 per cent of GNP. With regard to the exchange rate, the flexible policy initiated in early 1982 is being continued. As of end-January 1983, the depreciation of the rupee since end-December 1981 amounted to 23.3 per cent in terms of the U.S. dollar (equivalent to an increase of over 30 per cent in the number of rupees per U.S. dollar) and about 17 per cent in real effective terms. Assuming a modest recovery in world demand, tentative forecasts for 1983/84 show a further significant improvement in the balance of payments. Despite the setback suffered in 1981/82 as a result of the adverse international situation, the authorities are confident that the policies being pursued will restore a viable external position over the medium term.

With regard to structural reforms, substantial progress has been made over the past two years, and further important measures are planned for the remainder of the program. The authorities' policy memorandum provides a full account of the wide range of measures that have been and are being implemented. I shall, therefore, deal only briefly with some of the main areas of the reform effort.

An important aspect of structural reform is the reorientation of investment priorities in the development program. A revised three-year development program, prepared in consultation with the World Bank, began to be implemented in 1981/82. The program involves a substantial shift of public development expenditure from industrial projects and fertilizer subsidies toward agricultural and rural development, basic infrastructure, energy, and needed social services. The current policy with regard to industrial development is to leave it increasingly to the private sector. To this end, the authorities have been taking a number of measures to promote private sector investment: these include further simplification of regulatory procedures, adequate availability of local and foreign currency financing, easier access to imported inputs, improved infrastructural facilities, and assistance toward the financial restructuring of ailing industrial units. Recent trends in investment activity show that these measures are bearing fruit. At the same time, in order to improve the operational efficiency of public enterprises, a revised performance evaluation and incentive system, designed with technical assistance from the World Bank, is in the process of introduction, and is expected to be fully in place in 1983/84. Moreover, studies have been completed for the divestiture, closure, or financial restructuring of 17 public manufacturing units. Decisions on 10 of these units have already been taken, and the remaining cases are to be decided later in the year.

A major medium-term fiscal reform goal has been to reduce reliance on international trade taxes and improve the structure of domestic taxation. The system of indirect taxes was reviewed in 1980/81 with technical assistance from the Fund, and a number of measures was taken in the following year to improve the structure and administration of these taxes, especially the sales and excise taxes. Steps are currently being taken to remove certain administrative difficulties that have prevented a further broadening of the sales tax base in 1982/83.

Another important area of structural adjustment is that of cost-price rationalization. Substantial upward adjustments have been made--and are being made--in the producer and consumer prices of energy products (oil and gas) with a view to improving incentives for domestic production and to encourage conservation. Sizable increases have also been made in the producer prices of major crops in order to enhance output incentives. With regard to agricultural inputs, the target being pursued is to eliminate the subsidy on fertilizers by mid-1985 and the subsidy on water by about the end of the present decade. In addition, a more flexible pricing policy is being followed in respect of a wide range of goods and services supplied by government agencies and public enterprises.

In spite of the difficult international situation and increasing protectionism in many countries, the authorities have carried out their commitment to effect a substantial liberalization of the import regime. Following the easing of a number of restrictions during the previous two years, another important stage of the import liberalization program was implemented under the import policy for 1982/83, and a similar action is planned for 1983/84. In order to improve access to imported inputs, greater emphasis is being given to liberalizing the importation of capital and intermediate goods. At the same time, the authorities are keeping the appropriateness of the tariff structure under review, and any needed adjustments will be made under a comprehensive tariff reform to be introduced at the start of 1983/84 on the basis of a detailed study of effective protection that is nearing completion.

Alongside these structural reforms, the authorities have introduced certain measures in line with Islamic principles. An important step taken under the 1982/83 budget is the introduction of a levy on agricultural produce, the proceeds of which will accrue directly to local committees for use in such areas as health, education, and aid to the poor. In addition, the range of profit-and-loss-sharing instruments offered by commercial banks was extended at the start of the year. The authorities believe that these masures will also serve to increase private savings and investment.

In summary, the policies carried out so far under the extended arrangement have brought about a substantial improvement in economic performance. The authorities have adhered firmly to all the quantitative and qualitative performance criteria and have maintained a healthy pace of adjustment, despite adverse external developments and the difficult political decisions associated with certain measures. The policies to be carried out during the remaining period of the arrangement are designed to make further substantial progress toward the medium-term goals of structural reform and a viable balance of payments position. The authorities recognize that the achievement of these goals in the present international environment will require more time, and, therefore, they expect to continue their adjustment efforts beyond the period of the present arrangement.

Mr. Erb commented that, although there had been a number of positive developments, he remained disappointed with the results of the financial arrangement with Pakistan, in light of both the structural adjustments initiated under the program and the magnitude of the resources committed by the Fund.

On the positive side, the continued high rate of growth in Pakistan was encouraging, Mr. Erb noted. The 6.2 per cent increase in real GDP in 1981/82 was remarkable in light of world economic sluggishness, the small rise in the volume of Pakistan's imports, and the disappointing harvest. The apparent sources of the past year's growth were the coming on stream of new manufacturing capacity and a recovery of investment. The relatively high growth rate in 1981/82, coupled with the worsening in the balance of payments, raised the issue of whether the IMF program was primarily aimed at the underlying supply of financial resources or at stabilization and structural adjustment.

The authorities had complied with the quantitative performance criteria, Mr. Erb continued. The growth rates of total domestic credit and of credit to the Government were well within the ceilings for the second-year program. Credit to the private sector had increased by 21 per cent, compared with 18 per cent in the previous year, while the rate of growth of credit to public sector enterprises had declined and credit to the Government had remained at the sharply reduced level of the previous year. Domestic credit expansion appeared to have been ample for the needs of the economy. The commendable decline in inflation to 11.5 per cent from 14 per cent was due in part to world developments as well as to domestic monetary restraint.

There had been good progress in the agricultural sector, Mr. Erb commented. The Government had increased agricultural producer prices for major crops over several years, and most of those prices were at present more in line with world market prices. The benefits could be seen in increased agricultural production. Pakistan had achieved self-sufficiency in foodgrains in 1980/81 and had maintained it in 1981/82 in spite of poor weather. Considerable progress had also been made in reducing fertilizer subsidies, although they were still high.

Macroeconomic policy had played the supportive role that had been expected at the start of the program, Mr. Erb observed. However, as indicated in current and previous staff documents, structural adjustments with particular emphasis on prices and the trade regime were central to the arrangement. His authorities' concerns and criticisms regarding structural adjustments in connection with the program had been elaborated in previous Board discussions. Unfortunately, their concerns about the pace of structural adjustment had been reinforced rather than allayed on the present occasion.

On the negative side, there were factors that caused concern about the prospects for Pakistan's balance of payments position and structural adjustments, and that provoked discouragement with the progress of the arrangement, Mr. Erb remarked. He was particularly concerned about the lack of adjustment in domestic savings and in energy prices. The continued excess of domestic investment over national savings would be reflected in continued current account deficits and increases in external indebtedness. It was worrisome that the excess was projected to be higher at the end of the extended arrangement than at the beginning. Could the staff explain what steps could be taken, especially during the remaining year of the program, to increase domestic savings? It was not clear from the analysis presented in the documents whether the underlying sluggishness in the savings rate was due to an institutional factor, to interest rates, or to some other factor.

In the energy sector, subsidies, mainly for petroleum products, would rise as a share of total current government expenditure in 1982/83, after declining significantly in the previous year, Mr. Erb noted. Pakistan was currently experiencing serious power shortages that could reduce its growth prospects in the future. The extent and timing of energy price reform, however, remained tentative. Perhaps the solution would be to eliminate the distortions caused by the very low price of natural gas, of which Pakistan had sizable reserves and good prospects for new discoveries. The raising of domestic gas prices to two thirds of the international price for the fuel oil equivalent by 1987/88 seemed to be a less than adequate adjustment over a long period of time.

With regard to Pakistan's import liberalization adjustments, which were cited in current and previous staff papers as a major justification for the extended arrangement, Mr. Erb said, the Government continued to take modest steps in the right direction. Key decisions on import liberalization, however, would be taken only after the end of the IMF program, whether Pakistan was faced with net repayments to the Fund or not. The extended arrangement agreement had not specifically requested a great deal with regard to import liberalization; even if the program was fully implemented, the share of total manufacturing industry protected by "bans or equivalent restrictions" would be high at the end of the three years. Moreover, the Government had increased the tariffs on newly liberalized goods, in many cases to what seemed prohibitive levels.

The Government's most significant revenue-raising measure during the second year of the extended arrangement was the imposition of an across-the-board 5 per cent import duty, Mr. Erb recalled. That duty, in effect, would contribute to distortions in relative prices, and ran counter to the specific objective of broadening the tax base for government revenue. The shifting of goods from the Tied List to the Free List "subject to the condition that they are not locally manufactured" seemed to have more practical significance for government revenue than for import liberalization. Comprehensive tariff reform, based on a World Bank study, was due to begin on July 1, 1983. Unfortunately, the larger part of the financial benefits available under the present extended arrangement would by that time have been used up and would not be available to deal with any possible short-run consequences of reducing tariffs. In sum, little progress had been made toward a more liberal trade regime.

He did not underestimate the problems involved in calculating the amount of change in protection, Mr. Erb said. But if the Fund planned to make trade liberalization or other structural changes such as pricing an important part of its programs, it would have to face those problems. In the present case, neither the extent of trade restrictions when the program started nor their extent when it ended was known. In making an assessment of the degree and economic significance of liberalization, it was not sufficient to be told, for example, that cotton yarn was to be taken off the banned list of imports and to be subject to a 50 per cent tariff. In the context of programs emphasizing trade liberalization, greater efforts would have to be made to identify the extent of restrictions at the beginning of the program and to find a method of assessing the degree of liberalization that was taking place, both in the program period and beyond. More such efforts seemed to have been made in connection with the extended arrangement with India.

Structural adjustment might need to be stretched out over time, taking into account the impact on the domestic economy and the need for adjustments in domestic investment consistent with the opportunities opened up by trade liberalization and tariff reduction, Mr. Erb continued. In the present case, since the moves toward trade liberalization and price reform were going to be drawn out for a number of years after 1983, a strong case could be made that the Fund's financing should also have been drawn out. Such an approach would have been consistent with the December 1980 paper on enlarged access to Fund resources (EBS/80/262, 12/4/80).

Some of his comments applied specifically to Pakistan and reflected concerns that he had had with the program from its inception, Mr. Erb concluded. Other concerns, however, were more general. They related to the design of programs under the extended Fund facility, particularly the focus on structural adjustment, and to the use of the policy of enlarged access. He looked forward to further discussion of both on other occasions.

Mr. Salehkhou expressed complete agreement with the analyses and conclusions of the paper, and he endorsed the proposed decisions. Pakistan's economy had, in general, performed well during the past two years, and economic performance under the 1981/82 program had been encouraging. Real output had increased by 6 per cent and manufacturing output by 12 per cent, aided by the coming on stream of new projects, including cement, fertilizer, and steel plants. The fiscal performance was satisfactory except for the overall deficit, which was slightly higher than the program's target. The growth in domestic liquidity was broadly within the ranges specified in the program, and the rate of monetary growth was relatively low, a development reflected in lower inflation for the whole year. Performance criteria were being observed, and the program was generally on track.

However, two areas, the savings and investment performance and the external sector, merited closer attention, Mr. Salehkhou commented. In 1981/82, the national savings ratio had declined, and prospects for the current fiscal year did not seem encouraging. In order to strengthen savings, the further extension of the banking network, particularly to remote areas, simultaneously with a progressive increase in the number of Islamic financial instruments available to the public, could prove helpful.

Gross investment in the manufacturing sector had gradually declined during the past five years, Mr. Salehkhou observed. That development, besides signifying a relative shortage of funds, also called for concerted efforts to improve the structure and efficiency of public and private sector industry, as well as the government machinery that catered to the needs of enterprises. It was encouraging to note that the authorities had taken major steps in that direction. Better collection and consolidation of information on the output and finances of enterprises, the strengthening of the management and control of public entities, and the introduction of performance evaluation and incentive systems were examples of the Government's determination to tackle the problem. The authorities were aware that more needed to be done.

On the external side, Mr. Salehkhou continued, the balance of payments position in 1982/83 was expected to improve, although the export performance was not encouraging. Manufacturing and other exports had made relative improvements, boosted by the central bank's decision the previous year to change the exchange rate system. The future course of exports of jute and rice was uncertain, considering the present situation in the commodity market, but the new figures released by the staff indicated some improvement. There had been a big jump in remittances, and, although exports had remained stagnant, there had been a decline in imports during the first five months of 1982/83.

The Pakistani authorities were to be commended for having pursued sound policies aimed at improving the basic structure of the economy despite adverse external market conditions and the special geopolitical problems of the region, Mr. Salehkhou commented. The financial burden of accommodating Afghan refugees had been considerable, for both Pakistan and Iran. Such humanitarian efforts were laudable, especially in view of the financial constraints on the authorities.

Mr. Nimatallah stated that he was in general agreement with the staff's conclusions. In evaluating Pakistan's performance during the first two years of the extended arrangement, it was useful to review, first, Pakistan's record in implementing the various measures of the extended arrangement, i.e., whether the performance criteria had been met; and second, the achievements regarding the growth, inflation, and balance of payments targets for the program.

Pakistan had broadly implemented the corrective measures that had been envisaged during the first two years of the arrangement, Mr. Nimatallah commented, some of which had affected very sensitive areas. On the supply side, the cost-price structure in the economy had improved considerably. Adjustments included increases in prices for rice, cotton, water, fertilizers, and energy. Other measures, which had already started to have beneficial effects on the economy, were the implementation of a revised program of development expenditure, a liberalization of the foreign trade regime, a new exchange rate policy, and the inauguration of a process to improve the performance of public sector enterprises. On the demand side, the authorities had taken measures that would broadly achieve the fiscal objectives of the program under the extended arrangement. The overall budget deficit had been contained at about 5 per cent of GDP and bank financing of the deficit at about 2 per cent of GDP, despite a decline in revenue, mainly associated with foreign trade, that had been beyond the control of the authorities. Overall credit expansion had also been kept within the ceiling specified in the program.

With regard to the program targets, Mr. Nimatallah continued, output growth in 1981/82 had reached 6.2 per cent, compared with the target of 5.7 per cent. Changes in the GDP deflator were close to the target of 10 per cent for each of the first two years of the program. The current account and overall deficits of the balance of payments were close to program targets despite lower than envisaged export earnings and foreign aid.

In sum, the Pakistan case was one of success: the performance criteria had been met and the program targets broadly attained, Mr. Nimatallah said. He considered adjustment to be in the right direction, and he congratulated the authorities on the success that they had achieved during the first two years of the extended arrangement. He also commended them for showing the courage and determination to continue with adjustment by adopting the program for the third year of the arrangement, which he fully supported. Finally, since the staff had indicated that there were various areas in which adjustment would still be needed after the end of the program period, could the staff comment on the possibility of Pakistan's entering into a new arrangement with the Fund following the expiration of the present one?

Mr. Malhotra stated that his chair supported the proposed decisions. The growth in output in Pakistan over the past five years, including two years under the extended arrangement, had been healthy and robust. In 1981/82, the rate of growth had been 6.2 per cent, and for 1982/83 a rate of 6.7 per cent was envisaged. Gains in output had been achieved in both agriculture and industry. The growth in industrial production was substantial, ranging between 10 per cent and 12 per cent. Pakistan had attained self-sufficiency in food production, which was a matter of great satisfaction.

During the past year, Pakistan had made a number of far-reaching changes with respect to the external sector--especially in connection with the exchange rate--which had improved the competitiveness of exports to a considerable extent, Mr. Malhotra noted. Exports of manufactures had risen by 22 per cent, but, due to the poor external environment, the envisaged growth of exports had not materialized, and exports of commodities, especially sugar, had been greatly affected by the slack demand in the world market. The adverse effect on Pakistan's export receipts was reflected in the balance of payments. Still, for 1982/83, a considerable improvement in the current account deficit was expected.

The authorities' success in control of inflation had been remarkable, Mr. Malhotra commented. The rate of inflation had fallen from 15 per cent to about 10 per cent, and the latest figures indicated that on a point-to-point basis over a 12-month period, the rate of inflation could be as low as 4.3 per cent.

In the monetary field, Pakistan had followed a policy of restraint, with the rate of growth of money supply remaining well below the growth in nominal GDP, thus correcting the effect, especially on prices, of high rates of monetary growth in the period prior to the extended arrangement, Mr. Malhotra observed. Considerable progress had also been achieved in reducing the fiscal deficit and government borrowing from the banking sector. The 1982/83 program envisaged a significant reduction in government borrowing to 1.8 per cent of GDP. However, he hoped that the high rates of growth over the past five years, and the still higher rate of growth envisaged, would be used by the authorities to improve savings. Although much remained to be done in that field, he believed that the authorities considered increased savings an important policy objective.

With regard to foreign trade, Mr. Malhotra noted that in the staff's assessment Pakistan had liberalized its import regime considerably. In the present difficult times, especially when the current account deficit continued to be a problem area, and when exports were confronted with slack demand and often with protectionist barriers, it was hard for the country to throw open its doors. The Board would have to take a realistic view of how far developing countries could be expected to go. Pakistan was faced with real constraints that could not be wished away and would not change overnight. He was heartened that the Pakistan authorities, despite all those difficulties, were sticking to their course and had planned further liberalization.

Mr. de Groote stated that, following satisfactory external and internal performances in 1980/81, Pakistan had encountered external difficulties in 1981/82, particularly a decrease of about 75 per cent in export earnings. However, those difficulties had not prevented Pakistan from continuing to implement its program successfully, as stressed by several other Directors. Performance output, in inflation, in monetary policies, and on the supply side of the economy had been quite remarkable. Output growth had been rapid at 6.2 per cent, and the inflation rate had been comparatively low. The important structural reforms and balanced monetary growth reflected the efforts of the authorities to get the economy on the right track. Externally, however, poor demand, the appreciation of the rupee, and speculation about depreciation had had negative effects on earnings, and the current account deficit had increased to 4.5 per cent of GNP. But he believed that the Pakistan authorities had limited scope with regard to the different elements of the balance of payments.

As to public finance, Mr. de Groote stated, differences between total expenditure and total revenue, expressed as a percentage of GDP, were expected to increase substantially in 1982/83 over 1981/82. The staff had explained that the sharp growth in expenditures was due to a 50 per cent increase in interest payments on external debt. He wished to stress the impact of debt repayment, both principal and interest, on public finance and on the allocation of expenditures in Pakistan, and in developing countries in general. Such countries had to find the counterpart for external public debt payments and their only source was budget revenue. With the general acceptance of flexible exchange rate policies, the share of that type of expenditure as a percentage of total expenditure had generally increased. The impact on the development efforts of Pakistan and on other countries in the same situation was extremely negative. Pakistan illustrated a situation where, despite projections that the total rate of growth of development expenditure would increase, the percentage share of development expenditure in total expenditure was shrinking because of the debt repayment problem. It would be beneficial if the staff, before the scheduled Board discussion in late March 1983 of deficits in developing countries, could analyze the effect of debt repayment on the public finances and income distribution, in order to bring out more clearly that fundamental choice. In the present case, the debt repayments implied that the targets for growth had to be revised, especially in light of recent exchange rate movements.

The decline of the national savings ratio in 1981/82 and the staff's belief that there was a need to increase the willingness to hold money balances suggested that the Government should take further steps in that area, Mr. de Groote said. It would be useful to have further information about policy issues relating to means of increasing the retention of money balances, since interest rates might not have as direct an effect as in some other countries. He wondered whether it was reasonable to believe that changes in interest rates might influence the retention of money balances in Pakistan.

On the external side, Mr. de Groote observed, changing the exchange rate tended to create an atmosphere of uncertainty and speculation about future exchange rate levels. Such a situation, which had arisen in Pakistan following the introduction of the managed floating rate in early 1982, had had a negative impact on export earnings and on workers' remittances.

Table 66 in the paper on recent economic developments indicated that the total annual value of re-exports had changed little since 1977, but that the relative share of re-exports in total exports had declined, Mr. de Groote noted. Due to relatively low labor costs and high value added, re-exports were a profitable area for enhancing the foreign exchange earnings of Pakistan. Like Turkey, Pakistan had the ability to benefit greatly from such transactions. To conclude, he commended the efforts made by the Pakistan authorities, despite a shortfall in export earnings and workers' remittances in 1981/82 due to external factors.

Miss Le Lorier recalled that the program had started with the recognition by the authorities and the Fund that structural problems, resulting from severe distortions in the economic system, represented a major stumbling block to the authorities' efforts, undertaken as early as 1977, to promote balanced economic growth. In particular, it had been recognized that a desirable rate of growth could be made sustainable in terms of external constraints only if a number of weaknesses were addressed in a decisive and consistent way. Those weaknesses were present on the demand management side as well as on the supply side of the economy, and the design of the program had adequately reflected those two preoccupations. It had also been recognized from the start that although the program was geared to freeing the economy from an excessive balance of payments constraint, the successful implementation of the various measures was not expected to lead to a sizable improvement in the relative size of the balance of payments deficit. One central aspect of the program was to use the balance of payments support from the Fund and other sources to finance the current account during the adjustment period with the objective of putting the current account in better shape by the end of the program. Those considerations were crucially important in assessing the progress made. It was also important to take into consideration not only the original aims of the program but also the developments in Pakistan and, more important, in the world economic setting.

Both fiscal performance and monetary policy seemed to have been in line with, or even beyond, expectations, Miss Le Lorier stated. Both the overall deficit and the volume of bank financing of budgetary operations had thus been kept below, or only slightly above, the targets in 1980/81 and 1981/82, while the monetary policy objective had been broadly met. On the supply side, the authorities had implemented measures in various areas: producer prices had been increased and subsidies reduced, while consumer tariffs had been adjusted in a number of key areas, such as energy. Expenditure priorities had also been reviewed with emphasis placed on agriculture, rural development, and energy. Most important, decisive action appeared to have been taken to strengthen the financial position of ailing firms in the private and public sectors. Results were encouraging and should enhance the objective of promoting industrial investment.

The combined effect of the actions taken over the past two years were summed up in the expansion of real output by over 6 per cent annually, Miss Le Lorier commented. With regard to the balance of payments, the external performance in 1981/82 had been disappointing, but mainly in comparison with the results achieved the previous year. Considered in the broader perspective of the medium-term program, the widening of the current account deficit in 1981/82 to the equivalent of 4.5 per cent of GDP did not appear to be out of line with original expectations. If the projected current account deficit of $1,345 million for 1982/83 was added to the actual results of the two previous years, the cumulative deficit would amount to a little more than $3,800 million. According to expectations for the current year, the cumulative current account deficit would be at least SDR 700 million below initial projections, indicating that the deterioration in 1981/82 could be viewed as a setback rather than a departure from the path of the adjustment process. The weakening of the external position in 1981/82 did, however, show that a less than complete adherence to the program could have severe consequences, especially as the international environment could not be expected to make things easier during the period ahead.

It was encouraging to read that the authorities appeared fully committed to the continued implementation of the main reforms under way and to the further adjustment of the economy, Miss Le Lorier said. She endorsed the thrust of the staff appraisal and the idea that in spite of the progress made so far, there were considerable distortions still present in the economy. The full implementation of the measures embodied in the third year of the program should go a long way toward alleviating some of them.

The outlook for Pakistan's exports in 1983 and the behavior of capital flows and remittances were causes of immediate concern, Miss Le Lorier noted. While the prospect of a further weakening of oil prices was generally viewed as a positive development for many oil importing countries, it was less clear to what extent Pakistan would benefit in view of its strong links with oil exporting countries, and she would appreciate the staff's comments in that respect. The importance of maintaining an adequate competitive position through an exchange rate that not only promoted exports but maintained a proper balance between imports and domestic prices of substitutable goods could not be overemphasized. Another important element was the impact of the exchange rate on the flow of workers' remittances. The exchange rate regime adopted in January 1982 seemed to provide some guarantee that delays in adjusting the exchange rate, like those that had occurred in 1981 would be avoided in future. She urged the authorities to monitor the exchange rate position closely.

The extended arrangement appeared to be evolving along the lines agreed upon in 1980, Miss Le Lorier commented, and for that reason should be regarded as highly satisfactory, although it might be possible to become impatient with the pace of adjustment. Perhaps that impatience was in part due to a failure to appreciate the time required for new policies and reforms to produce their effects. The essence of an extended arrangement was that the measures took time to work themselves out; in the particular case of Pakistan, the deeply embedded nature of some of the problems facing the economy and the political and cultural context in which they had to be addressed, might require even longer. In view of developments so far, she reaffirmed her support for the broad strategy adopted in 1980.

Mr. Laske commented that Pakistan had made progress under the extended arrangement, as could be seen from the observance of the performance criteria. However, in some important respects, progress achieved so far had fallen short of the objectives of the program. On the positive side, a satisfactory rate of real growth had been maintained, the rate of inflation had been progressively reduced, the ratio of investment had increased slightly, and monetary expansion had decelerated. Less satisfactory, however, were the underachievement in the budgetary area, the deterioration in the external situation, and the relatively slow progress in important aspects of structural policy.

The first year of the program period had brought an improvement in the balance of payments, which had, however, been largely lost in the second year of the program, Mr. Laske noted. The current account deficit/GNP ratio for FY 1981/82 had been the same as that for 1979/80; it was therefore not only substantially higher than during the first program year, but also higher than the target set for 1981/82. One could argue that the detrimental effects of the world economy were responsible for the disappointing performance. But the failure to record continuing progress in the current account should be ascribed in large measure to the long-delayed reform of the exchange rate system, which had prevented the rate from moving in a way consistent with the maintenance of Pakistan's competitiveness. The correction of the appreciation that had occurred during the first two years of the program was welcome and could help Pakistan's exports in the period ahead. Meanwhile, the effects of the latest exchange rate adjustment on domestic prices could make it more difficult to consolidate and extend the progress made in the area of inflation.

The marginal reduction in the current account deficit projected for the third year of the program was also worrying, especially as it was based on perhaps overoptimistic assumptions, Mr. Laske continued. He could not be certain that the relatively mild recovery foreseen for the main industrial countries would, in fact, support an increase in export receipts by Pakistan of 12.5 per cent. Even more doubtful was the projected 15 per cent increase in the flow of remittances in view of the uncertain prospects for the region in which most of Pakistan's nationals working abroad were located. On the other hand, Pakistan might benefit from decreases in oil prices and international interest rates.

In the budgetary field, the provisional results for the past year and projections for the current year were only mildly encouraging, Mr. Laske commented. The previous year's considerable shortfall in revenue and the overshooting of the budget and program targets in current expenditure were disappointing. He strongly supported the staff's suggestion that the authorities should press ahead with the reform of the tax system in order to make it less dependent on import taxes and more responsive to the development of the domestic economy. The staff report seemed to indicate that the authorities had abandoned for the time being any intention of rationalizing the tax system to close loopholes by withdrawing exemptions and strengthening the administration of the tax system. The position was unsatisfactory, especially as current expenditure was expected to rise by 28 per cent when the rate of inflation was forecast to reach no more than 8 per cent. It was also disconcerting that the ceiling on bank financing of the budget deficit had already been reached halfway through the fiscal year. If expenditure controls were not as strict as planned and if the planned adjustments in energy prices were not to produce additional revenue, overshooting of the budget and the bank financing targets might become inevitable.

The authorities had been successful in the past year in keeping monetary expansion within the projections, Mr. Laske remarked. The risks inherent in the budget called for a continuation of tight policies in the hope of further reducing the rate of inflation. The authorities would have to be ready to tighten policies further in case prices refused to fall.

An important part of the authorities' supply-side policies was concerned with pricing, Mr. Laske noted. Although major steps had been taken in that field, notably in agriculture, significant distortions remained in the structure of relative prices. For example, prices for petroleum products had been adjusted upward in November 1981 and June 1982 by a total of 9 per cent, while the rate of inflation in 1981/82 on average for the year had amounted to 11.5 per cent. A further increase in petroleum prices of 11 per cent was planned for February 1, 1983, and he wondered how those price increases would affect the adjustment of the entire economy. The same question could also be asked with regard to the price of natural gas, which would still be substantially below world prices even after a forthcoming increase. Water charges were reported to cover only half of the operating and maintenance costs; the large discrepancy might have to be reduced more speedily than the authorities envisaged at present. Furthermore, the price for fertilizer was still below the international level. Although the price level had been raised and subsidy outlays correspondingly reduced, further price increases seemed to be indicated.

He agreed with Mr. Erb that the rate of savings achieved in Pakistan was low, Mr. Laske said. With regard to import liberalization, although some progress had been made, to some degree it had been counteracted by substantial increases in taxes and duties. The staff had explained that progress in the liberalization of imports had strengthened both the competitiveness and the productivity of Pakistan's economy. That analysis should encourage the authorities to proceed further and faster in the direction of liberalization, and to continue with the other needed adjustments in the structural field.

Mr. Sangare stated that it was gratifying to see the extended arrangement with Pakistan enter its final year. The authorities deserved commendation for staying the course to bring about the necessary structural and financial adjustments in the economy. The results over the past two years had been satisfactory on the whole and went beyond just meeting performance criteria: real growth in GDP had exceeded 6 per cent in both 1980/81 and 1981/82; the country had attained self-sufficiency in foodgrain production; inflation as measured by the consumer price index had declined from 15 per cent in 1980/81 to 8.5 per cent in 1981/82; government expenditure had shown a shift away from consumer and producer subsidies toward investment projects aimed at improving the productive base of the economy; and the ratio of the budget deficit to GDP had declined from 6.2 per cent in 1979/80 to 5.5 per cent in 1980/81--an outcome that would have been better had it not been for a shortfall in import tax revenues. Progress had also been made in improving the efficiency and the performance of management in public enterprises, reflected in an increase in returns on sales from an average of 4.6 per cent in 1979/80 to 5.3 per cent in 1981/82.

Performance in the external sector, however, had been below expectations, Mr. Sangare commented. The balance of payments deficit had widened from $24 million in 1980/81 to $556 million in 1981/82, reflecting, among other things, weak world demand for Pakistan's exports and the erosion of competitiveness as a result of the appreciation of the rupee. He therefore welcomed the authorities' response, which had been to introduce a managed floating system that had led to a 14.4 per cent real effective depreciation of the rupee between January 1982, when the measure was introduced, and

June 30, 1982. Taking the year as a whole, the rupee had depreciated by about 23.3 per cent in terms of U.S. dollars and by about 17 per cent in real effective terms.

Looking to the future, there were grounds for optimism that the program for 1982/83 would lead to further progress in Pakistan's economy, Mr. Sangare remarked. For example, the authorities were continuing to rely on the price mechanism to give incentives to producers and influence the allocation of resources; priority was also being given to increasing the involvement of the private sector in the economy. In addition, the recovery in the agricultural sector, the rise in fixed investment, and the projected expansion in industrial production should sustain the rate of growth of 6 per cent achieved on average over the past five years. Given the extensive role of the Government in the productive sector--with over 55 manufacturing establishments employing more than 81,000 persons in July 1982--he wondered whether any slack was expected to develop in economic activity in the immediate future, when the Government began to implement its decision to withdraw from direct investment in that field. Total real manufacturing investment had apparently declined since 1979/80 owing to the drop in public sector investment. He would appreciate further staff comment on that point.

He welcomed the authorities' intention to continue to pursue a prudent course in public sector finances by adhering to a policy of expenditure control, while seeking ways to increase revenues, Mr. Sangare commented. However, he noted that the budget deficit was expected to increase to 5.7 per cent of GDP, compared with 5.5 per cent in 1981/82. Although the increase was marginal, the authorities should look for ways of improving the tax system--perhaps by broadening the tax base--and restraining the growth in expenditure.

With regard to monetary policy, the authorities were taking the right approach by restraining the growth in liquidity so as not to reverse the gains made in fighting inflation, Mr. Sangare observed. Government borrowing from the banking system would be held to 1.7 per cent of GDP, compared with 2 per cent in 1981/82, while the growth in credit to the private sector would be limited to 18 per cent as opposed to 21 per cent in the past fiscal year.

In the external sector, the staff expected some improvement in the balance of payments, with the overall deficit projected to decline by about $300 million, Mr. Sangare continued. However, that outcome depended on a recovery in exports and higher growth in foreign remittances than in 1981/82. The Board's recent discussion of the World Economic Outlook made it clear that there was still some uncertainty about the strength of recovery in the world economy and of export demand in 1983. There was also the possibility of remittances being adversely affected by the slowdown in economic activity in the oil producing Gulf states, where many Pakistanis working abroad resided. The authorities might therefore find it helpful to have contingency plans to prevent the emergence of payments difficulties if the assumptions relating to exports and remittances did not materialize.

The Minister's letter attached to the report indicated that the authorities were aware of the need to monitor developments in external debt closely, Mr. Sangare noted. Meanwhile, the staff had expressed its concern that the burden of maturing debt could strain Pakistan's balance of payments in the second half of the 1980s. Perhaps Pakistan might investigate the desirability of seeking debt rescheduling.

Mr. Taylor commented that Pakistan had achieved a high average rate of economic growth despite stagnant world trade and declining per capita incomes in the developing countries. Moreover, the growth was projected to be 6-7 per cent in 1982/83 and healthily distributed throughout the economy. The authorities had prudently restrained domestic demand, made some progress in liberalizing import restrictions, and taken the important step of unhooking the rupee from the dollar.

On closer inspection, Mr. Taylor remarked, it appeared that most of those major policy actions had been taken in the early years of the arrangement, and it was difficult to avoid the impression that the momentum of adjustment was slowing down. Nevertheless, the observance of performance criteria could not be faulted, and the authorities had done most of what had been asked. Perhaps the criteria were not sufficiently vigorous. The external environment had deteriorated, and exports had been less favorable than expected. In response, should there not be at least some adjustment of the program's objectives, if not actually a tightening of the requirements?

The progress in reducing the deficit had been encouraging but modest, Mr. Taylor commented. The overall deficit, previously 6.25 per cent of GDP, had fallen to 5.5 per cent of GDP in 1981/82, and was projected to remain at about the same level in 1982/83. He did not entirely share the opinion of the staff that reliance on strict expenditure control and increased receipts from higher energy prices would be sufficient to eliminate the need for bank financing of the government deficit in the second half of the fiscal year. The slippages in progress toward broadening the tax base and reducing the system's dependence on import duties were worrying, as was the measure in the budget to levy a 5 per cent tax on virtually all imports. The tax elasticity in the system seemed low, and there seemed scope for action to stimulate revenue more broadly.

With regard to monetary policy, Mr. Taylor continued, he commended the authorities for the success in meeting their credit targets and in reducing inflation more rapidly than expected, perhaps owing partly to the exchange rate action that they had taken. However, adherence to firm policies to counter increased pressures stemming from the continued effective depreciation of the rupee would be necessary.

In an extended arrangement, one had to look carefully at the structural adjustment side of the program, Mr. Taylor observed, and it was there that doubt was particularly likely to arise in Pakistan. Earlier speakers had described the important social and political limits to the pace at which reforms could be carried out. Fundamental economic reform would take time, and far-reaching structural reforms needed to be carefully phased if they were to succeed. Nevertheless, the degree of adjustment required in the present program had been fairly gentle, and it was evident that the slippage could be difficult to remedy. At the end of the program, the availability of further Fund financing could be limited, with only a modest recovery in the world economy and a generally inhospitable environment. The authorities had to consider whether they ought not to be taking tougher measures in the context of the present program. In more detail, he agreed with others that more progress should have been made in reducing subsidies. For example, progress toward reaching realistic levels for domestic gas prices had not been rapid.

The staff had been optimistic with regard to balance of payments projections, Mr. Taylor considered. For instance, the growth rate projected by the staff of 15 per cent for overseas remittances seemed high, compared with only 6 per cent the previous year. The majority of expatriate workers were in countries in the Middle East; as noted in the Board's earlier discussions on the world economy, prospects for most of those oil producing countries were not good.

He shared other speakers' concerns about the progress toward import liberalization, Mr. Taylor said. Although some progress had been made, it had been hesitant, and he would have welcomed more specific proposals for actions to be taken in the next fiscal year. He would appreciate the staff's clarifying what aspects of the economy would be covered by the mid-term review. He welcomed the greater degree of exchange rate flexibility that had been achieved. It would be important to retain the improved competitiveness that had been brought about, by adjusting the exchange rate promptly if the need arose.

Progress under the program had been good in many respects, and real growth had been impressive, Mr. Taylor concluded. Nevertheless, he endorsed the staff's view that it was important to retain the impetus of adjustment to capitalize on that progress.

Mr. Hirao noted that the real sector of the economy was likely to show rapid growth due to expansion in both agricultural and industrial production. In the area of cost-price rationalization, the authorities had recently implemented a series of upward adjustments in prices for wheat, fertilizer, natural gas, and petroleum products. Consequently, the prices of wheat and nitrogenous fertilizer came close to the international level. However, for some products, notably natural gas, even after the latest price increase a large differential still remained between the domestic price and the international price. The authorities' continued efforts toward price adjustment should be encouraged. Another major objective of the extended arrangement had been the encouragement of private investment. Despite financial provisions for private investors and the simplification of regulatory controls, the increase in gross private investment in the manufacturing sector had not been large enough to offset the slowdown in gross public investment. Further efforts by the authorities to promote private investment were needed.

With regard to public finance, he noted that the overall deficit in 1982/83 would be brought slightly below the budget estimate, despite unfavorable circumstances such as lower than expected debt relief, Mr. Hirao continued. The domestic bank financing of budgetary support and commodity operations in relation to GDP was also likely to decrease from the previous year's level. However, the expected overall deficit in 1982/83 was still well above program projections. Like Mr. Taylor, he noted that in the absence of new revenue measures, the basic tax elasticity would have been about 0.7. The figures suggested a need for revenue enhancement, especially through a broadening of the tax base and an improvement in the responsiveness of indirect taxes. In that context, he welcomed the authorities' continued intention to reduce exemptions from the sales tax, to enhance administrative capacity, and to rationalize the tax treatment of cottage industries. He hoped that substantial progress would be made on those fronts in the 1983/84 budget. The expected August review would be a useful occasion to monitor developments in that area.

The authorities' general stance on monetary policy was the correct one for containing monetary expansion at a moderate level and thus reducing excess demand pressures, Mr. Hirao commented. Within the tight credit plan, credit to the private sector was projected to increase more rapidly than bank borrowing by the Government. The authorities had also established a firm limit on bank borrowing by public enterprises so that the private sector would not be crowded out. Concerning the level of interest rates, he would welcome a more detailed analysis of the possible role of interest rate policy in ensuring financial stability and promoting savings in the context of a gradual Islamization of the financial system. On page 41 of SM/83/14 it was noted that annualized rates of return paid to "profit-and-loss-sharing" term deposits seemed to be higher than the minimum annual rates on interest-bearing term deposits of similar maturity. Although a simple comparison between the two rates might be misleading, he wondered whether there was also a significant differential between the returns actually paid on those two types of financial instrument and, if so, whether the differential was a reflection of the authorities' policy.

The authorities were to be commended for maintaining a flexible exchange rate policy that had resulted in a real effective depreciation of the rupee amounting to 17 per cent during 1982 and had contributed to higher than expected export growth of manufactured goods late in 1982, Mr. Hirao said. He was encouraged by the authorities' intention to continue with current policy, and he hoped that external demand for Pakistani exports would pick up as projected in the paper. In order to promote exports, the authorities had extended and standardized the compensatory export rebate system, of which the staff had been somewhat critical in the previous consultation paper. As the exchange rate policy had become flexible, he hoped that the scope of the export rebate system would gradually be reduced.

Mr. de Vries remarked that while he supported the proposed decision on the extended arrangement from a more general point of view the experience with the extended arrangement with Pakistan was not fully satisfactory, and caused some concern about Fund policies. Mr. Finaish and other speakers had noted that there had been more adjustment internally than in the external sector. While the weakness of savings was a feature that needed attention, there had been little trade liberalization, and the external situation was especially disapointing. With regard to the balance of payments, figures for the year before the program and projections for the last year of the program indicated an increase in the trade deficit from $2.5 billion to $3.5 billion, and in the current account deficit from $1.1 billion to $1.3 billion. More significant was the financing of the final payments gap, using substantial amounts of Fund credit. At some point, Pakistan would need to generate a trade surplus if the Fund were to be repaid.

The case of Pakistan raised a question of general Fund policy, Mr. de Vries continued, namely, how did a country that had pursued a program approved by the Board repay the Fund? The basic assumption seemed to be that the Executive Board no longer took the revolving character of the Fund's resources seriously. Another possible explanation was that when the Board had approved Pakistan's program, it had not fully realized the extent of the adjustments needed there, an error it had also made in many other countries. Since the Board had agreed to a particular policy approach with the Pakistani authorities, and since they had basically followed that policy, further extension of the program, which perhaps had not been altogether appropriate, had been approved. He would very much appreciate comment on that basic question, because it dealt with a very central policy issue for the Fund. Many Directors had said that it might have been difficult for Pakistan to adjust more quickly. On the other hand, if the revolving character of the Fund's resources could not be guaranteed, the Fund might find itself always short of resources. The apparent implication was that the difficulties of adjustment were so great that the revolving character of the Fund's resources could not be maintained. If that were so, the Fund would be in major difficulty.

It was indicated in paragraph 3(b) of the proposed decision on the extended arrangement that no drawings beyond the stipulated amount could be made after August 1983 if any understandings deemed by the Fund to be necessary had not been reached, Mr. de Vries remarked. It was not clear from the text of the decision whether understandings were needed. On the other hand, the last phrase of paragraph 3 of the letter from the Minister of Finance stated that the authorities "will reach agreement with the Fund concerning domestic credit and external debt ceilings applicable to drawings after August 1983." He wondered whether there was not an inconsistency between the two texts, and he would appreciate some clarification.

The staff had indicated that Pakistan had "missed" two drawings, Mr. de Vries noted, and that they could be made available at present. Could the staff explain how Pakistan had missed them? To conclude, he supported the thrust of the proposed decision because he believed that the authorities had followed the policy agreed with the Board two years previously. But if the decision were to be proposed anew, perhaps in the light of its experience with the case, the Board would come to a different conclusion.

The Executive Directors agreed to resume their discussion in the afternoon.

APPROVED: July 14, 1983

LEO VAN HOUTVEN
Secretary