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IMF Concludes Article IV Consultation with Pakistan

The IMF Executive Board on October 20, 1997 concluded the 1997 Article IV consultation[1] with Pakistan at the same time as it approved the authorities' request for financial support under the Extended Fund Facility and the Enhanced Structural Adjustment Facility (see Press Release No. 97/48).

Background

In recent years, Pakistan has made several attempts to address its macroeconomic imbalances and deep-rooted structural problems. However, slippages in policy implementation have muted the supply response and hampered improvements in the fiscal and external positions. Economic growth over the past five years has averaged 4 percent per year, significantly slower than in past decades. Growth in the industrial sector has been weak, with large-scale manufacturing contracting in 1996/97. Fiscal imbalances contributed to greater inflationary pressures and large external current account deficits in 1995/96-1996/97, with a rise in inflation to a peak of 13.8 percent in February 1997 and a concurrent deterioration in the external reserve position to the US$500–600 million range (about 2 weeks of imports).

The government that took office in February 1997 endorsed the adjustment efforts and structural reforms initiated by the caretaker administration (November 1996-February 1998) and supplemented them with a wide range of initiatives aimed at raising the efficiency of the economy and improving social indicators. Parliamentary approval was secured for key legislation providing for taxation of agricultural income by the provinces and enhancing the autonomy of the State

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. In this PIN, the main features of the Board's discussion are described.

Bank of Pakistan (SBP). This and other financial sector reform measures were complemented by the enactment, in June 1997, of a new law aimed at simplifying the legal processes for loan recovery and foreclosure/sale of collaterals.

The Pakistan authorities also launched tax and tariff reforms which, taking into account the new revenue sharing arrangement adopted in early 1997, are designed to broaden the domestic tax base, to improve tax compliance, and to shift the revenue base from imports to consumption and income over the medium-term. At end-March, the maximum import tariff was brought down to 45 percent (from 65 percent), the 10 percent regulatory duty that had been introduced in October 1995 was eliminated for most imports, and the tariff structure was simplified by reducing the number of slabs from 14 to 6. On domestic taxes, rationalization took the form of reduction and simplification of the rate structure. With effect from April 1997, the Government reduced the standard rate of the General Sales Tax (GST) to 12½ percent (from 18 percent) while eliminating the 23 percent rate. At the same time, personal and corporate income tax rates were reduced with effect from the assessments beginning in July 1998.

In the macroeconomic area, the out turn for 1996/97 as a whole showed mixed performance, with activity slowing down and inflation picking up, but also with improvements over the preceding year in the fiscal and external positions. The budget deficit was reduced to 6.1 percent of GDP (from 6.9 percent in 1995/96) reflecting a decline in the ratio of budgetary expenditure to GDP. In the monetary sector, the growth in the banking system's net domestic assets decelerated to 14.4 percent of initial stock of domestic liquidity—a marked slowdown in relation to 1995/96, when they grew at a rate of 18.5 percent of initial domestic liquidity. This contributed to a narrowing of the external current account deficit (before official transfers) to 6.4 percent of GDP in 1996/97, from 6.8 percent in 1995/96. Following the initial decline, gross official reserves recovered markedly, exceeding US$1.5 billion by end-August 1997. This was accompanied by a substantial reduction of the premium in the kerb foreign exchange market and recovery in the index of the Karachi Stock Exchange.

The Government's medium-term program incorporates a significant adjustment effort and progress on the broad range of structural reforms. The program both builds on existing initiatives (such as the furthering of the tax and tariff reform process, and banking sector reform) and breaks new ground, most notably in the areas of tax administration, government downsizing, public enterprise reform, and liberalization of the foreign exchange market.

The macroeconomic program for the three-year period 1997/98–1999/2000 will seek to raise the annual growth rate of real GDP to the 5–6 percent range; progressively reduce annual inflation to about 7 percent; and reduce the external current deficit (excluding official transfers) to the range of 4.0–4.5 percent of GDP. The targeted reduction in the current account deficit would provide for a substantial strengthening of the external reserve position. The key intermediate policy target would be a reduction in the overall budget deficit to 4.0 percent of GDP by the third year of the program, supplemented by improvements in the operating position of the major public enterprises. For 1997/98, the program seeks to raise the growth rate of real GDP to 5.5 percent; reduce year-on-year inflation to 10.5 percent; and bring down the external current account deficit to 5.1 percent of GDP. To achieve these objectives, the budget deficit would be contained at

PRs 148 billion (5.0 percent of GDP), and the composition of net domestic asset expansion would be redressed in favor of the private sector.

Executive Board Assessment

Directors were encouraged by the important steps undertaken by the new government to arrest the deterioration in macroeconomic balances, and to carry forward a wide range of structural reforms aimed at opening up the economy and raising its efficiency. They welcomed the observance of most of the targets under the staff-monitored program.

Directors noted that the adjustment and reform steps already implemented are an encouraging sign of ownership of the proposed program. They welcomed the implementation of the new federal/provincial revenue-sharing arrangement and the initial actions that had been taken in the areas of tax and tariff reform, banking reform, and public sector restructuring and downsizing, which demonstrated the government's commitment to reforms. At the same time, Directors emphasized that the macroeconomic situation remains fragile and structural weaknesses are still pervasive. In particular, the budget deficit continues to be too large and the structure of taxation and expenditure is distorted. Also, there had been a deterioration in the finances of major public enterprises and monetary policy remained constrained by weaknesses of the banking system.

Moreover, pointing to Pakistan's poor track record under past Fund-supported programs, Directors stressed the critical importance for the authorities of implementing their adjustment and reform program steadfastly and of correcting promptly deviations from the program. They observed that a repeat of the stop-and-go policies entailed a high cost to the Pakistan economy, including negative effects on the confidence of donors and investors. Directors emphasized the need for close monitoring of policy implementation under the program.

Directors thought the authorities' envisaged adjustment and reform strategy is ambitious and comprehensive, and would need to be implemented in a timely basis. They attached critical importance to a reduction in the budget deficit which is a major source of macroeconomic imbalances in Pakistan. Accordingly, Directors emphasized the need to strengthen tax administration and to improve the structure of taxation. Directors felt that it is crucial to extend the General Sales Tax to the retail sector and to accelerate the transition to full reliance on the invoice-based system in order to promote greater documentation and tax compliance. Directors also attached importance to the planned review of the income tax and to the ongoing efforts to enhance the taxation of agricultural income.

Directors also stressed the need to strictly control government expenditures. They welcomed the further reduction in non-development expenditure and also in low-priority development spending in 1997/98. More generally, attention should be paid to the quality and effectiveness of government spending.

Directors emphasized the need to make decisive progress on improving the financial position of the major public enterprises. In this regard, they stressed the importance of expenditure containment, rationalization of tariff structures, stepped-up efforts to collect overdue receivables, and the imposition of hard budget constraints. These policies, combined with the development and implementation of a strategy to rationalize employment, were viewed as key in setting the stage for privatization.

Directors urged the authorities to implement banking reforms without delay, stressing the need to make progress in the privatization of the state-owned banks. Directors welcomed the ongoing efforts to strengthen the supervisory capacity of the State Bank of Pakistan and urged that the planned strengthening of prudential regulations be implemented in a timely manner.

Directors stressed the importance of the planned further trade liberalization, including simplification of the tariff structure. They welcomed the recent exchange rate action and stressed that this must be backed by tight macroeconomic policies and structural reforms to ensure competitiveness and export diversification.

Directors felt that the privatization program would contribute significantly to promoting productive efficiency and encouraging competition. They noted that an appropriate regulatory framework would be an important enabling condition for moving to the envisaged larger scale of privatization. Directors stressed the need to make sure that privatization revenue does not lead to a relaxation of the efforts to strengthen the fiscal and external current accounts, and a suggestion was made to use privatization proceeds to reduce the public debt.

Directors welcomed the importance the authorities attach to improving governance. They encouraged the authorities to continue with their efforts to improve the transparency of government operations, accountability, and the regulatory and supervisory framework.

Directors took note of the ongoing efforts of the authorities, in collaboration with other international institutions such as the International Labour Organization and UNICEF, to ameliorate the child labor problem. Directors encouraged the authorities to persist in addressing this problem decisively.

Press Information Notices (PINs) are a new series of IMF press notices (see Press Release 97/21). PINs are issued, at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies.

Pakistan: Selected Economic Indicators

	1993/94	1994/95	1995/96	Prel. 1996/97	Prog. 1997/98
	Annual percentage changes				
Output and prices					
Real GDP at factor cost	4.5	5.2	4.6	3.1	5.5
GDP deflator at factor cost	12.6	13.6	10.9	11.3	11.0
Consumer price index (annual average)	11.3	13.0	10.8	11.8	10.5
	In percent of GDP				
Investment and savings					
Total investment	19.4	18.4	18.6	18.2	17.8
Gross national savings	15.8	14.5	11.8	11.8	12.6
Budgetary operations					
Budgetary revenue	17.2	17.0	17.0	15.3	15.7
Budgetary expenditure	23.2	22.6	23.8	21.5	20.8
Budgetary balance	-6.0	-5.6	-6.9	-6.1	-5.0
External sector					
Exports	12.9	13.2	13.3	12.7	13.5
Imports	16.6	16.8	18.5	17.7	17.1
Current account excluding official transfers	-3.6	-3.9	-6.8	-6.4	-5.1
External public debt 1/	48.2	44.5	42.5	43.8	45.3
Gross reserves 2/ (in weeks of imports)	12.6	12.7	8.2	5.2	7.0
	Changes in beginning-of-period domestic liquidity				
Monetary sector					
Net foreign assets	5.6	3.8	-4.7	-3.6	1.3
Net domestic assets	12.4	13.4	18.5	14.4	14.4
Domestic liquidity	18.0	17.2	13.8	10.8	15.7

Sources: Data provided by the Pakistan authorities; and IMF staff estimates and projections.

1/ Excludes foreign currency deposit liabilities.
2/ Excluding gold.