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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 81/148

10:00 a.m., December 2, 1981

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

Executive Directors	Alternate Executive Directors
	O. Kabbaj
	C. Taylor
A. Buira	M. A. Senior
J. de Groote	H. G. Schneider
R. D. Erb	
M. Finaish	T. Alhaimus
T. Hirao	
	R. T. Salazar
R. K. Joyce	M. Casey
	J. R. Gabriel-Peña
B. Kharmawan	
	F. Sangare
G. Laske	
G. Lovato	C. P. Caranicas
P. Mentré de Loye	A. Le Lorier
	C. Bouchard, Temporary
	C. J. Batliwalla, Temporary
Y. A. Nimatallah	
J. J. Polak	T. de Vries
A. R. G. Prowse	B. Legarda
J. Sigurdsson	
	Tai Q.
	Wang E.

L. Van Houtven, Secretary
R. S. Franklin, Assistant

Also Present

Asian Department: P. Chabrier, I.-S. Kim, T. J. Rommel, M. R. P. Salgado, D. Villanueva. European Department: H. Vittas. Exchange and Trade Relations Department: S. Mookerjee, Deputy Director; D. K. Palmer, Deputy Director; S. J. Anjaria, D. J. Donovan, H. M. Flickenschild. External Relations Department: A. F. Mohammed, Director. Fiscal Affairs Department: V. Tanzi, Director; G. Blöndal, M. R. Kelly, K. W. O'Connor, A. A. Tait, C. A. Yandle. Legal Department: R. C. Effros. Middle Eastern Department: A. S. Shaalan, Director; A. S. Ray, Deputy Director; A. K. El Selehdar, Deputy Director; G. T. Abed, A. D. Crockett, F. Drees, S. H. Hitti, H. E. Jakubiak, A. Kayoumy, M. Shadman, E. M. Taha, G. Tomasson, M. Yaqub. Treasurer's Department: A. M. Al-Samarrie, D. S. Cutler. Finance and Development: S. Nawaz. Personal Assistant to the Managing Director: N. Carter. Advisors to Executive Directors: E. A. Ajayi, S. E. Conrado, M. A. Janjua, G. Jauregui, P. D. Peroz, F. A. Tourreilles, F. Yeo T. Y. Assistants to Executive Directors: L. Barbone, L. E. J. Coene, M. K. Diallo, J. M. Jones, P. Kohnert, S.-W. Kwon, J. E. Leimone, J. S. Mair, V. K. S. Nair, J. R. Novaes de Almeida, J. G. Pedersen, M. Z. M. Qureshi, J. Reddy, J. Schuijer, D. I. S. Shaw, H. Suzuki, O. Üçer, J. F. Williams, A. Yasseri, A. A. Yousef.

1. PAKISTAN - 1981 ARTICLE IV CONSULTATION, AND REQUEST FOR EXTENDED ARRANGEMENT

The Executive Directors began their consideration of the staff report for the 1981 Article IV consultation with Pakistan together with a proposed decision concluding the 1981 Article XIV consultation; in addition, they took up Pakistan's request for a new extended arrangement equivalent to SDR 919 million (EBS/81/222, 11/13/81). They also had before them a report on recent economic developments in Pakistan (SM/81/219, 11/19/81).

The staff representative from the Middle Eastern Department noted that, since the staff papers had been circulated to the Executive Board, the Pakistan authorities had provided additional information relating to economic developments in the first few months of the current fiscal year. Data for money and credit developments through end-September showed that both total net domestic assets and banking sector claims on the Government--the two aggregates to which ceilings applied under the program--had been virtually unchanged in the first three months of the fiscal year. As there had been a decline in net foreign assets, the total money supply had declined by approximately 2 per cent over the period July-September 1981, a somewhat surprising result; however, the factors producing it were essentially temporary in nature and, indeed, had begun to be reversed in October and November.

The figures for the Government's recourse to the banking system during July-September had been affected by a substantial inflow of short-term borrowing totaling about PRs 2 billion, the staff representative observed; the situation would be reversed in the second quarter of the year because of a scheduled repayment of PRs 3.1 billion. It was therefore expected that credit to the Government would begin to rise after the first quarter. Private sector credit, which had also been flat in the first three months of the year, had been affected by delays in harvesting the cotton crop and the late arrival of cotton at the ginning mills. In general, the pace of credit expansion during the harvesting season tended to vary from year to year.

The new data also showed a somewhat lower level of foreign trade than had been projected in the program, which meant lower requirements for trade financing, the staff representative continued. Insofar as it was possible to project into the second quarter, the staff expected credit to pick up; nonetheless, there appeared to be no reason why the authorities should not comfortably be able to observe the ceilings for end-December set forth in the staff paper.

The estimate for total exports in 1980/81 had been revised upward by about 2 per cent, the staff representative said. Total exports in the period July-October of fiscal year 1981/82 were about 2 per cent higher than in the corresponding period in 1980/81. However, there were certain special factors that made it difficult to interpret the figures with any confidence. In particular, agricultural exports in the first four months of the fiscal year were normally exports of stocks carried over from the previous year and did not reflect crop yields or crop production in the current year. The latest estimates from the authorities showed that the cotton crop currently being harvested would be approximately 7 per cent larger than the staff had originally projected. In the circumstances, there was no reason to expect the volume of cotton exports to be any less than projected; indeed, they might be somewhat higher for the year as a whole.

Apart from agricultural commodities, exports in the first four months of 1981/82 had been about 10-11 per cent higher than in the corresponding period of the previous year, which was slightly below earlier projections of the growth rate for the year as a whole, the staff representative remarked. However, within the overall projection, different categories of exports had performed quite differently in the first four months of the fiscal year. Certain manufactured exports--for example, rugs, carpets, and cotton textiles--had been somewhat disappointing during the period.

The staff had no firm data for imports for the first three months of the fiscal year, the staff representative continued, although preliminary indications from the central bank of Pakistan suggested that the level of imports would be slightly below the projection implied by the figures in the staff paper. Receipts of remittances for the period July-September had been 7 per cent less than those in the corresponding period in 1980/81; the staff had projected a 10 per cent growth for the year as a whole. It should be noted that the period under discussion was influenced by factors such as Ramadan and the Pilgrimage. In fact, the Pilgrimage in 1981 had affected the September figures considerably; it had not done so in previous years because the Pilgrimage had occurred later in the calendar year. In sum, it was perhaps too early to interpret a trend for remittance receipts based on the figures that had been provided thus far.

Data on wholesale and retail prices generally had a rather marked seasonal pattern in Pakistan, and a meaningful interpretation of the figures could only be made by comparing them with the equivalent increase in prices in the corresponding period of the previous year, the staff representative commented. Such a comparison showed that both wholesale and retail prices had increased in the first three months of 1981/82 by about 1 per cent less than in the corresponding period of 1980/81; in those terms, the figures were not inconsistent with the authorities' objective of holding the rate of inflation below that experienced in the previous year.

Finally, the staff representative noted the authorities' indication that they had increased consumer prices for petroleum products by amounts ranging from 1 per cent to 10 per cent, with an average of about 3 per cent. The increases had taken effect on November 9, 1981 following an increase in the posted price of oil exported from Saudi Arabia. Taking account of the pattern of Pakistan's oil imports, the price increases were consistent with the authorities' objective of passing through oil import costs to consumers; indeed, in some cases, the increases might have been greater than needed for the purpose.

Mr. Finaish made the following statement:

I would like to express my appreciation to the staff for the two comprehensive papers on Pakistan (EBS/81/222 and SM/81/219).

The objectives and policies of the Pakistan Government's economic reform program, as well as the background against which it is being implemented, are fully set out in the authorities' policy memorandum and in the staff documents. In this statement, therefore, I will concentrate on a few salient features of the economic situation.

For some time now, the Government of Pakistan has been pursuing a policy of economic reform aimed at promoting growth and restoring domestic and external financial stability. As a result of the measures taken, the performance of the economy improved appreciably in the late 1970s. But while the growth of output and exports accelerated, the budgetary position and the balance of payments remained under pressure. In 1979/80, the authorities adopted a more comprehensive stabilization program, supported by a drawing on the first credit tranche, that led to a substantial improvement in the financial picture. Nevertheless, it was recognized that many of the structural weaknesses in the economy were of a kind that could be tackled effectively only within a medium-term framework. Accordingly, a three-year program of economic reform was initiated in 1980/81 which, with the support of an extended arrangement with the Fund, aims at a sustained improvement in domestic economic performance and the achievement of a viable external position.

As the staff's report makes clear, the fiscal year ended in June 1981, the first year of the program, was a very successful one for the Pakistan economy. Economic growth was close to 6 per cent, a rate that has been maintained, on average, for the past four years. At the same time, the current account of the balance of payments was markedly stronger than expected so that, despite lower levels of official aid, the overall payments position was in approximate balance. This was achieved despite an adverse international environment, with increasing protectionism and deteriorating terms of trade, and despite the burdens placed on the economy by the need to absorb and care for over 2 million refugees from Afghanistan.

These gratifying results were due in large measure to the prudent economic policies pursued by the Pakistan Government. They have chosen to follow a strategy of fiscal and monetary restraint, while embarking on a series of comprehensive structural reform measures. These measures are being carefully framed, so as to generate substantial improvements in the economy's productive potential while remaining consistent with the Government's domestic social and political objectives. In the first year of their program, the authorities have succeeded in holding the fiscal deficit to about 5 per cent of GDP, and the bank-financed deficit to just over 2 per cent of GDP. These figures compare very favorably with those of other countries in similar situations, and the small excess over the program ceiling is, as the staff points out, more than accounted for by the financial consequences of bumper wheat and sugar harvests. Since financing for budgetary support proper was well within the authorities' indicative guidelines, this small excess over the government borrowing ceiling is more a cause for satisfaction than for concern--particularly as it augurs well for Pakistan's goal of sustained self-sufficiency in foodgrain production.

The balance of payments has turned out better than was foreseen at the time the Executive Board approved the extended arrangement last year. The current account deficit has been reduced to only 3 per cent of GNP, well below the average for non-oil developing countries as a group. Exports have continued to perform well, growing by 20 per cent during 1980/81, despite the doubts expressed by a number of Directors at our meeting last year; and import growth has been controlled through restrained demand management policies. The Pakistan authorities are well aware that troubling uncertainties remain in the external situation and, as noted in the staff report, they will review their balance of payments position at the time of the mid-term review scheduled for next February. In this context, however, it should be noted that the principal problems they are facing stem from factors essentially outside their control: protectionism in their major markets; sluggish growth in the industrial world; adverse movements in their terms of trade; currency instability; and geopolitical developments in the region.

I turn now to the program the authorities have adopted for the current fiscal year. On the demand management side, the overall budget deficit is expected to be at the previous year's level and the Government's access to bank financing will be consistent with the original program target. The authorities have already taken measures on both the revenue and expenditure side to tighten fiscal discipline. The subsidy bill is expected to decline from 9 per cent of total expenditure in 1980/81 to 6.6 per cent in 1981/82. In th field of policy changes, the authorities are introducing structural reform measures, further administrative improvements, and discretionary revenue measures.

The restrained fiscal stance will contribute to holding the rate of monetary expansion to approximately that of last year. While it is true that inflation in 1980/81 was slightly higher than had been hoped, this outturn was due mainly to external causes, and did not reflect monetary laxness. As the staff points out, available evidence concerning the determinants of velocity is ambiguous, and the targets that have been set for the coming year are, in the authorities' view, consistent with a further absorption of the excess liquidity built up in earlier years of higher monetary growth. In any event, the authorities will be monitoring credit and inflationary developments during the year and will make whatever adjustments seem appropriate if price pressures are greater than expected.

As far as structural reforms are concerned, the authorities' policy memorandum and the staff paper amply show the broad scope of the measures that are beginning to be implemented. In my view, this program of action fully justifies the authorities' strategy of thoroughly reviewing the structural difficulties facing the economy before embarking on major measures which, once implemented, will be hard to reverse. I recall that some Directors were skeptical of a program which, they felt, included relatively little in the way of concrete measures in the first year. The program that is now before us shows that the first year has been well used.

An important element of the authorities' structural reorientation of policies is the changed emphasis in the development program. The Government is determined to use the scarce investment resources available to the public sector in a manner which makes best use of them, both in raising the productivity of the existing capital stock and in providing the needed infrastructure to promote self-sustaining capital formation by the private sector. Development expenditures for industrial investment and for fertilizer subsidies are being curtailed, and the resources thus released are being used for agricultural projects and programs, energy development, basic infrastructure, development of backward regions, and needed social programs. Although the volume of public investment spending is planned to rise only moderately, the Government believes, and the World Bank agrees, that improvements in the quality of investment will yield substantial benefits in higher growth potential. Private sector confidence is reviving in Pakistan, and with the authorities' efforts to improve the availability of finance and appropriate technology, private investment in the manufacturing sector is expected to fill the gap left by the de-emphasis of this area in the public investment program.

Energy is a sector in which Pakistan still has considerable untapped potential. The authorities have demonstrated their desire and their will to undertake the necessary policy measures to encourage greater private participation in this sector and to achieve a higher level of self-sufficiency. They have had extensive discussions with the World Bank over the past year, and have now reached agreement with the Bank on a framework in which improved production incentives can be implemented. To continue encouraging energy conservation, the policy of passing on to the consumers all increases in the cost of domestic and imported oil will be maintained.

A major element of the program supported by the extended arrangement is the liberalization of Pakistan's import policy. As the staff paper makes clear, a number of important steps toward liberalization have already been taken, so that we can have confidence in the Government's commitment to major reforms in this area. The further measures proposed for the remaining two years of the program represent a further major shift in the authorities' foreign trade strategy. These measures have not been adopted lightly: they involve difficult political judgments, and they have implications for the competitiveness of industries that have been established and developed under a different and more proected environment. I hope that the Board will recognize the importance of the steps that the Pakistan Government is undertaking--particularly in a world environment where the example set by many industrial countries is in the other direction.

In summary, I believe the program that is now before us demonstrates Pakistan's commitment to maintain the pace of economic reform and to build on the good results of the last year. The support that the proposed arrangement can provide will enable the authorities to implement ambitious structural reforms despite the difficulties presented by an uncertain international environment.

Mr. Nimatallah indicated his warm support for Pakistan's request for a new extended arrangement in the amount of SDR 919 million for the remaining period of the existing arrangement. In passing, he noted that the request had been made to effect a reapportionment of resources in line with Pakistan's current quota and that the original amount of the arrangement as a percentage of quota would not be changed if the Board acceded to Pakistan's request. In addition, the phasing of purchases over the remainder of the program would remain the same.

The economy of Pakistan had experienced both domestic and external difficulties throughout the second half of the 1970s, Mr. Nimatallah continued. In order to tackle the problems, the authorities had adopted a financial stabilization program for 1979/80, supported by the use of Fund resources in the first credit tranche. As a result, the financial situation had improved, although it had become obvious that, if the gains made by the economy during that year were to be sustained or increased, a comprehensive program addressing the structural and financial weaknesses of the economy had to be adopted. On that basis, an extended arrangement had been agreed by the Executive Board in late 1980.

Developments during 1980/81 under the program had been encouraging and reflected to a great extent the corrective actions taken by the authorities, Mr. Nimatallah considered. Domestic output had increased by 6 per cent in real terms based, inter alia, on improvements in incentives in the agricultural sector. Tight demand management policies had been followed and credit ceilings adhered to, except for minor deviations in domestic bank borrowing by the Government. Pakistan's balance of payments position had improved significantly, with the ratio of the current account deficit to GDP declining to 3.5 per cent, and the overall balance of payments position showing only a small deficit, despite a reduction in capital inflows. In the circumstances, the Pakistan authorities should be commended for the policies they had implemented.

In 1980/81 a number of important changes had been introduced in Pakistan's financial system that entailed some movement away from a system influenced by the interest rate and toward one influenced by profit sharing, Mr. Nimatallah remarked. Those changes made sense for two reasons. First, Pakistan was a developing country and, as he had noted on several occasions, the interest rate was not a particularly effective policy tool in countries in which the financial institutions were not well developed. The vast majority of the population in such countries might not react to changes in interest rates because the population was not fully incorporated in the financial system. While it might be argued that, in the long run, the interest rate could be used as a tool to develop the financial and banking systems of a country, its use for that purpose was far less important in the context of short-term and medium-term programs with the Fund. Second, following Islamic principles, the people felt at ease in conducting financial transactions involving profits and losses but not those involving the charge or receipt of interest. In that connection, the steps taken by the authorities were both meaningful and acceptable to the general population, and he agreed with the authorities that the changes would help to encourage savings and increase productive investment.

Emphasizing the policies he felt were important for the success of the program under the extended arrangement, Mr. Nimatallah observed that it was important for the authorities to pursue realistic pricing policies with greater vigor in order to ensure a proper balance between supply and demand and to improve the allocation of resources. Continued improvement in the efficiency of the public sector was also important, although the authorities should be encouraged to maintain their effort to allow the private sector, where possible, to play a greater role in the conduct of the economy. Finally, the gradual opening up of the foreign trade sector would be an important element in the success of the program; the measures taken by the authorities to promote exports and liberalize imports were welcome.

Mr. Erb, beginning with the positive steps that the Government of Pakistan had taken during the past year in the context of the Fund program, noted that performance with respect to fiscal and monetary policies had turned out better than had been expected at the beginning of the program. The overall public sector deficit of 4.6 per cent of GDP for 1980/81 had been significantly lower than the 6.2 per cent recorded in 1979/80 and lower than the 5.2 per cent of GDP forecast when the program had been agreed; and total government expenditures as a percentage of GDP had turned out to be lower than expected. On the monetary side, the rates for each of the financial targets in 1980/81 had also been below the original projections. He could support the proposed shift in investment strategy from capital-intensive industry toward greater efficiency in the use of existing industrial capacity and greater emphasis on agriculture, energy, social services, and regional development. Indeed, a more efficient use of existing capacity appeared to have been an important element in Pakistan's relatively high real growth rate for 1980/81.

Pakistan had in addition taken a number of positive steps toward structural adjustment during the first year of the program, Mr. Erb continued. Some modest liberalization efforts had taken place, together with price adjustments at both the consumer and producer levels and improvements in the tax structure. Considering the structural adjustment necessary to achieve the objectives set forth in the program, he found the efforts of the authorities to have been somewhat tentative in the first year of the program, although that was perhaps understandable first the magnitude of the efforts on the fiscal and monetary fronts.

Focusing on the remaining two years of the program, Mr. Erb indicated that he had a number of concerns. On the fiscal side, it was to be hoped that the Government of Pakistan would be able to achieve its budgeted targets for expenditure and revenue for 1981/82; in that connection, the staff estimates for a higher expenditure level, a lower revenue level, and a higher budget deficit for the period represented cautionary signals. With respect to monetary policy, he was somewhat worried that money and fiscal growth rate targets projected for 1981/82 were higher than the actual growth rates in 1980/81. In the circumstances, it might be better for the authorities to attempt further to reduce the money and financial growth rates, particularly given the unfavorable inflation developments during the previous three years. As reported in Table 19 of the paper on recent economic developments, consumer prices and the implicit GDP price deflator had been on the rise since 1977/78 and, while some of the increase in 1980/81 might have been tied to the necessary adjustments in administered prices, the inflation trend should serve as a warning of the effort that would be needed in the area of monetary policy. For that reason, he would have preferred growth targets for 1981/82 that were equal to or lower than targets for the previous year. While he hoped that the statement by the staff that inflation during the first few months of the current fiscal year appeared to be at a lower rate than in the previous year was a sign of a change for the better, he noted that the inflation rate for the previous year had been significantly higher than the 10 per cent average forecast in the program.

He had more serious difficulties with the structural adjustment elements in the program, Mr. Erb continued. Both the original document requesting an extended arrangement (EBS/80/243) and the paper under discussion emphasized the need for significant structural adjustments that would enable Pakistan to attract private and official financial resources sufficient to keep the current account deficit in the range of 3-4 per cent of GNP and to enable the economy to achieve and sustain a higher real growth rate over time. But, there were five main areas in which the efforts toward adjustment appeared insufficient.

First, not enough attention had been paid to the regulatory and pricing policies affecting investment, particularly in the private sector, Mr. Erb considered. In EBS/80/243 the authorities had stated that they were conscious of the need to raise significantly the share of resources devoted to investment. Recently that share had averaged about 16.5 per cent of GNP, a percentage lower than that of most developing countries in a situation similar to that of Pakistan. The authorities had gone on to state that, by 1982/83, they hoped to increase the share of resources devoted to investment to about 17.3 per cent of GNP. In its appraisal in EBS/80/243, the staff had indicated that "investment is projected to rise only moderately relative to GNP." And, in EBS/81/222 it had been noted that "investment fell somewhat short of expectations in the first year of the program, and the forecast of the investment ratio has been revised downward for the remainder of the program period." He recognized that the downward revision reflected in part the new emphasis on improving the efficiency of investments rather than pushing for large capital-intensive projects. However, the staff had also pointed out that "the shortfall in private sector investment in the first year of the program...suggests that further action may be needed to reduce some of the impediments to private capital formation such as cumbersome regulations and pervasive price controls." Given the high priority that the Government had earlier placed on improving private investment, greater attention should perhaps be paid in future reviews to assessing what regulations and price controls were in fact constraining private investment and perhaps to developing proposals for further reducing the regulatory constraints.

While he was not suggesting that the authorities embark on a massive investment program, he believed that growing investment over time would be critical to the achievement by the authorities of their overall growth objectives, Mr. Erb commented. The real GNP growth rate for 1980/81 had turned out to be higher than forecast, and the Government had increased its forecast of the real GDP growth rate during the remainder of the program to something over 6 per cent. For that forecast to be realized, greater attention would have to be paid to investment. It should be noted in that connection that during 1980/81 the increase in overall investment had taken place mainly through an increase in stocks; in real terms, investment in both the private and public sectors had been relatively constant.

A greater effort was also necessary to increase the relatively low domestic savings rate, Mr. Erb considered. It had been noted in EBS/80/243 that, concomitantly with the investment objective, "a major objective will be to increase the ratio of gross national savings to GNP from 12 per cent to about 14 per cent by 1982/83 in order to contain domestic and external financial pressures." Although the gross national savings rate has risen somewhat over the last two years, the target for 1982/83 has been revised downward. That change in direction was somewhat troubling; if anything, an effort should be made to increase the savings rate.

On the energy front, the staff had pointed out in EBS/80/243 that rapidly rising costs for imported petroleum and petroleum products had contributed to growing pressures on Pakistan's balance of payments, Mr. Erb remarked. The Government had stated in its objectives that "we will accelerate our petroleum exploration and development effort with a view to at least doubling domestic production during the program period." At the same time, the Government had been projecting a decline in net imports of petroleum and petroleum products in volume terms of about 1 per cent a year on average during the program period, compared with an average annual increase of 7 per cent during the period 1978/79-1979/80. In its latest report, the staff had noted that technical difficulties and weak financial incentives had constrained production increases from privately operated oilfields, and Table 46 of SM/81/219 showed that net imports had actually risen by 5.8 per cent during the first year of the program. The staff report stated that, for all petroleum from new wells in proven fields, the fixed price policy would be replaced by a system providing for domestic oil to be sold at a specified discount from international prices. In addition, there was to be a substantial increase in producer prices, although he wondered whether either increase had been sufficient to encourage production. There was also the possibility that the procedure to be followed would result in shutdowns or lower production levels of oil wells and wasted investment in new wells where the higher price could be obtained. Something of that sort had happened in the United States in connection with its price deregulation program.

Natural gas resources in Pakistan were sizable, Mr. Erb observed, although substantial investment was needed to increase output over time. As noted by the staff, weak financial incentives had also been a general factor in limiting gas output. The Government was moving toward a base price that would be tied to the international price of fuel oil, but he had the impression that the base price remained quite low--in the range of $0.20-0.30 per thousand cubic feet--and that the gas price adjustment formula did not apply to the large Sui field or to the existing contractual arrangements covering the supply of gas from the Mari field to the fertilizer plants. Hence, while some progress had been made on the energy front toward the objectives set out by the Government at the beginning of the program period, much more needed to be done, particularly given the importance of increased oil and gas production for improving Pakistan's balance of payments position over time.

On the import liberalization side, the program called for a reduction--from 66 per cent to 40 per cent--in the number of items in the manufacturing sector that were subject to an import ban or equivalent restriction, Mr. Erb noted. The reductions were scheduled to take place in two balanced stages with particular attention to intermediate and investment goods, although it was anticipated that liberalized items would become subject to tariffs or quotas. He had two main problems with the overall effort toward import liberalization. First, even when the effort was completed, a high percentage of manufactured items would remain banned. Second, despite the Government's statement to the contrary, there was the danger that new tariffs or quotas would render the import liberalization efforts ineffective. An earlier commitment to provide a study of tariff reform by mid-1981 had been delayed until December 1982 and implementation of the reform was not scheduled until July 1983. In the circumstances, it would be impossible for Executive Directors fully to assess the effect of the tariff and quota changes on the import liberalization scheme.

Another major area of concern related to exchange rate policy in Pakistan, Mr. Erb stated. When the original program had been approved one year previously, the United States--through its Executive Director at the time--had expressed some worry about the adequacy of the exchange rate. There had been a review in the first year, although no action had been taken. The staff had calculated that the rupee had appreciated about 13 per cent on a trade-weighted, price-adjusted basis between December 1979 and June 1981, although the subsequent decline of the dollar and changes in relative prices had probably reduced the appreciation to about 10 per cent at present. The Government of Pakistan had argued that export performance, with a 20 per cent growth in 1980/81, showed that devaluation or more flexible adjustment of the exchange rate was not necessary, although there were some special factors that might undermine that argument. First, the year had seen very good harvests of rice and raw cotton, exports of which accounted for two thirds of the export growth since 1978/79. Second, in January 1981, a 12.5 per cent compensatory export rebate or subsidy had been introduced for a number of minor exports, which partially accounted for some of the growth in that sector. Third, a 7 per cent decline since 1979/80 in a number of important exports--including cotton yarn, cloth yarn, handmade carpets, and rugs--had led to the introduction of a 12.5 per cent rebate for leather and handmade carpets in July. Finally, there was the likely possibility that the lagged effect of the exchange rate appreciation on Pakistan's exports had not yet been fully felt.

Of the factors he had mentioned, the growth of export subsidies was particularly troubling, for both general trade and fiscal reasons, Mr. Erb said. About 75 per cent of manufactured exports were currently subject to rebates and interest subsidies on export financing. Those subsidies were projected to increase by about 82 per cent in 1981/82 and by a further 7 per cent in 1982/83, an increase that was in conflict with the overall goal of reducing subsidies. Failure to take steps to make the exchange rate more adjustable over time would have detrimental consequences for Pakistan's trade position, and continued expansion of export subsidies would have an adverse impact on the fiscal position.

Regarding the balance of payments objective, Mr. Erb noted that the Government had set for itself a relatively ambitious external borrowing target, as reflected in its current account deficit target for the end of the program and beyond. While a current account deficit in the range of 3-4 per cent of GNP was not out of line with what other countries had been able to finance, the target seemed to leave little room for mistakes on the fiscal and monetary policy front in the case of Pakistan. Hence, continued efforts would be needed to reduce both the fiscal deficit and the growth of money and credit in order to bring down the rate of inflation. The current account deficit target also seemed to increase the urgency of implementing the sorts of structural reforms he had mentioned earlier as a way of bringing about greater flexibility in the economy. Eliminating some of the price and regulatory restrictions would help to accomplish that goal. In view of his comments, he wished to record his abstention with respect to Pakistan's request for a new extended arrangement. He would reserve his support for the program at present and wait to see how it evolved in the later stages.

Mr. Hirao said, first, that he could agree with the thrust of the staff appraisal in the consultation papers and could go along with the new extended arrangement for Pakistan. It was encouraging to note that, under the existing extended arrangement, the economy had showed a better than expected performance in 1980/81, and most of the performance criteria had been observed. Those achievements had been partly due to the authorities' success in strengthening demand management policies and partly to favorable exogenous and nonrecurrent factors. Good weather had contributed to the expansion of agricultural output, which had helped to sustain growth and increase export earnings from raw cotton and rice, and nontax revenues had increased significantly as a result of improved monitoring and control of public enterprise finances. Since such favorable developments could not necessarily be expected to continue, however, a sustained effort by the authorities toward better adjustment was highly desirable.

The major exception to the generally encouraging performance in 1980/81 had been in the area of price developments, Mr. Hirao continued. In spite of a shrinkage in the overall government deficit and a rapid decline in domestic liquidity, the GDP deflator had not shown any decrease, even though more recent signs were encouraging. Noting the staff view that, in Pakistan, there had been some disparity between monetary and price developments owing to the authorities' strong influence on price behavior, he wondered whether the increase in the GDP deflator in 1980/81 had been mostly due to adjustments in administered prices. He also inquired whether tight financial policies had actually been effective in reducing inflationary expectations.

The authorities had been successful in the past year in using pricing policies for expansion of output, especially in the agricultural sector, Mr. Hirao observed. The continuation of producer incentives through appropriate pricing for 1981/82 was highly desirable and, in that context, it was important that a reduction in subsidies for agricultural inputs should go hand in hand with an increase in producer prices for agricultural products. He welcomed the substantial increase in producer prices for domestic petroleum and natural gas. While production had not yet shown any marked increase, the staff had indicated in its opening statement that there were some positive signals in the most recent data on consumer prices for oil products. In that connection, the staff paper had reported that domestic oil from new wells in proven fields and domestic natural gas were being priced at a specified discount from international prices. It would be useful to know the level of the discount and whether, in the staff's view, the new producer prices for oil and natural gas represented sufficient producer incentives. Another point to be addressed in the area of supply policy was the existence of any impediments to private capital formation in the form of government regulation and price controls. As he had noted on the occasion of the previous year's consultation discussion with Pakistan, it was desirable to rely mainly on financial policies and to reduce the Government's pervasive price controls to achieve price stabilization.

In the area of fiscal policy, it was discouraging to note that the overall public deficit was estimated to rise from 4.6 per cent of GDP in 1980/81 to 5.1 per cent in 1981/82 because of a weakening on the revenue side, Mr. Hirao commented. Although the authorities' efforts at improving tax administration had been commendable, he shared the staff's view that structural measures were necessary to deal with the inelasticity of the tax system. In that context, he welcomed the authorities' intention gradually to introduce a general sales tax. A shift from specific to ad valorem rates for customs and excise duties would also be desirable. With respect to nontax revenue, continued efforts should be made to improve government control of public enterprise finances.

On the expenditure side, the authorities should be commended for their success in reducing subsidy expenditures in both absolute and relative terms in 1980/81, Mr. Hirao said, and he encouraged them to make further reductions in future. External financing was projected to increase substantially in 1981/82, even though the level of such financing in 1980/81 had been far short of expectations. He hoped that another shortfall in external financing would not occur in 1981/82; if it did, it would be desirable to try further expenditure reductions and to avoid increased recourse to short-term external borrowing or domestic bank borrowing.

In the area of monetary policy, Mr. Hirao observed that, in 1978/79 and 1979/80, mandatory fixed industrial investment targets had not been achieved, mainly because of the limited availability of foreign exchange. In light of that discouraging experience, the authorities had assigned to commercial banks an allocation for fixed industrial investment lending for 1981/82 together with an allocation of foreign exchange to private sector projects. It would be useful to hear the staff's view on the likely effects of the new approach on private fixed investment.

With respect to the balance of payments forecast, it was unfortunate that the revised figures projected no major improvement in the current account and a continued deterioration in the overall deficit during the program, Mr. Hirao commented. In that context, the revised projection showed a larger overall deficit for 1982/83 than the original projection, mainly because the two projections were based on different assumptions, with the revised projection taking into account only the debt relief already granted. He would appreciate seeing the results yielded by the two projections for the overall deficit, using the same basis for comparison.

The rapid appreciation of the rupee since mid-1980 was striking, Mr. Hirao said, and it was unfortunate that the authorities were unwilling to use a more flexible exchange rate policy; indeed, there appeared to be no reference to exchange rate policy in the Economic Policy Memorandum of the Government. At the same time, he had become concerned about the recent introduction and expansion of export rebates, which could lead to a deterioration in public finance. He urged the authorities to give greater consideration to the use of a flexible exchange rate policy as a way of improving the external position and reducing export rebates as soon as possible.

Mr. de Groote observed that Pakistan's request was for a new extended arrangement for the two remaining years of the existing program as a means of effecting a reapportionment of resources in line with Pakistan's present quota. The program had been successful in its first year, largely because of the authorities' ability to adhere closely to the adjustment path they had outlined. They had followed an effective policy of demand management together with a gradual implementation of liberalization measures intended to open the economy and make for a more efficient use of disposable scarce resources.

An essential feature for the future growth prospects of the economy was the behavior of private investment, Mr. de Groote considered. Developments thus far had fallen short of expectations, and it might be useful to look more carefully at the underlying reasons for those developments, in view of the important role of private investment in the manufacturing sector. While an easing of regulations and price controls might be important factors in promoting private sector activity, it was mainly profitability that would stimulate private investment. The staff report seemed to suggest that some uncertainties persisted in that respect; indeed, the need to introduce compensatory rebates to improve profitability of certain export industries showed that a problem existed. While the relatively favorable balance of payments situation suggested that only a small adjustment in the exchange rate would be needed to facilitate the liberalization of imports, it was regrettable that such a policy option would only be envisaged by the authorities when the balance of payments situation had deteriorated to the extent that a more substantial adjustment became necessary; the side effects of a small adjustment before that time would be less harmful.

The fundamental problem in the structural adjustment process seemed to be that the authorities were more interested in the favorable effects of import substitution than of export promotion, Mr. de Groote remarked. While any transition from a heavily protected economy to a more open one must be gradual, the staff had indicated that a substantial proportion of domestic industry might remain protected even at the end of the program period. The structural adjustment would thus be incomplete and the Government would be under pressure from the protected industries to maintain or even increase that protection when competitiveness deteriorated. Such an approach could only lead to a misallocation of resources. It should be noted that his observations were not intended to diminish the merits of the adjustment measures thus far implemented but only to increase the understanding of the problems in Pakistan.

In view of the substantial improvement in the balance of payments position of Pakistan, it would be helpful to know what the staff considered to be a viable current account position in the years ahead and what adjustments beyond those contemplated in the program period would be needed to achieve that goal, Mr. de Groote said. Finally, he had been interested in hearing how the authorities had circumvented the problem of interest payments on deposits and credit. The new system based on profit and loss certainly seemed to attract the necessary additional savings, and it was interesting to note that the different risk distribution of the system led to a higher yield than would occur with fixed interest rate deposits. Moreover, the participation of the lender in the case of loss might ease the borrower's problems in difficult times instead of aggravating them as was the case with fixed interest rates, which seemed to justify some kind of premium in normal times.

Mr. Laske welcomed the innovation of combining the Article IV consultation and the request for an extended arrangement in one report as an economical way of dealing with two overlapping issues. In the case of Pakistan, the combination was particularly useful because the request for use of Fund resources was based on an existing arrangement. If the procedure were to be applied to other cases, however, it might in principle be better to discuss the Article IV consultation in advance of a proposed arrangement in order to give the staff and Executive Directors the opportunity to look closely at the economy of the country before financial assistance was considered.

Commenting on the case in question, Mr. Laske observed that the size of the proposed new arrangement was identical to the difference between the existing arrangement and the drawings that had thus far been made. To that extent, there was no change except in the composition of the use of ordinary and borrowed resources. As mentioned in the paper, the reapportionment between the two categories of resources would bring the use of ordinary resources into line with Pakistan's new quota. He assumed that that meant that ordinary resources would contribute to the two arrangements up to the equivalent of 140 per cent of Pakistan's new quota. In the circumstances, it might have been advantageous to Executive Directors if the paper had expressly shown the transition from the old apportionment to the new one.

Progress made by the authorities in the first year of the program appeared satisfactory, Mr. Laske continued, although there were a number of elements in Pakistan's policy approach and implementation that had raised questions. It was remarkable, for example, that the current account deficit had been reduced to 3 per cent of GNP much sooner than had been originally forecast. Table 5 of EBS/81/222 showed that that positive development had been due to a combination of factors, which might or might not continue in future. What was decisive for the current account of Pakistan was the behavior of foreign trade. Exports had performed extremely well in 1980/81, rising far more quickly than had been projected under the program. The increase had mainly been due to a substantial rise in exports of agricultural commodities, which had been made possible by a record harvest. Given the vagaries of the weather, such an excellent harvest might well not be repeated.

Less gratifying had been the performance of exports of manufactured goods, which had actually shown a decline, Mr. Laske noted. Subdued economic activity in the industrial world had no doubt played a role in that decline, although the international competitiveness of the products had probably been a more important factor. In the circumstances, a thorough re-examination of Pakistan's exchange rate policy seemed to be indicated, and he hoped the exchange rate would be a subject for discussion on the occasion of the next review.

Deliveries of manufactured goods had fared well during 1980/81, rising over a ten-month period by close to 30 per cent, Mr. Laske remarked. However, many products in that category had benefited from compensatory rebates that, incidentally, had also increased by 30 per cent over the level recorded in the previous fiscal year. In addition, provision had been made in the budget for the current fiscal year for an 82 per cent rise in export subsidies, which, according to Table 7 of the staff report, would be extended to goods that had not done well in the previous year. As noted by the staff in its opening statement, those same goods had again shown a disappointing export performance. The budget appropriation for export rebates was also much higher than had been projected under the program, and the increase would be repeated in 1982/83. In the circumstances, it appeared that the approach of the authorities in dealing with insufficient international competitiveness in a sectoral way did not really address the core of the problem.

A strong increase in remittances had benefited the current account in 1980/81, and a further increase was projected for the current fiscal year, Mr. Laske observed. While the projection implied a slowdown in the percentage increase, it presupposed a rise in nominal terms over the previous year, and he was not fully convinced that such an increase would be realized. Moreover, the current account deficit would apparently increase substantially in nominal terms, although it had been projected to remain at the previous year's level in relation to GNP. It might be asked whether such an increase was sustainable, particularly as experience had shown that official foreign aid and debt relief did not necessarily become available in the amounts projected. Indeed, in the previous year, the authorities had had to resort to short-term external borrowing to close the financing gap. Because capital flows were uneven, the authorities should pay close attention to the situation in order to ensure that the current account deficit was kept at a level that was financeable through ordinary means.

The macroeconomic objectives of the program as presented in Table 2 of the staff paper seemed realistic and should be achievable if the authorities firmly adhered to the adjustment strategy they had adopted in the first year of the program, Mr. Laske continued. In certain areas, however, close monitoring and a readiness for further corrective action would be required. While the fiscal performance in 1980/81 had turned out to be better than expected, there were a number of uncertainties for the coming year that were built-in features of the fiscal structure. Revenue suffered from an inelasticity in the tax system, which was based to a great extent on income from indirect taxes levied on goods and services and on movements in international trade. Revised projections for a decrease in revenues from import duties showed the precariousness of the situation; while those revenues contributed in only a minor way to overall revenues in the budget, the necessity for a downward revision was nonetheless significant. The program to reform the tax system and improve its administration should therefore be implemented speedily and carried out with determination. On the expenditure side, the proposed reduction in the subsidy burden was certainly a welcome and necessary move, although he found the substantial increase in export subsidies to be worrying. The sectoral approach preferred by the authorities had the inherent weakness of inhibiting an optimal allocation of resources and preventing full recognition of the apparent problems in the area of international competitiveness.

Another striking feature of Table 2 was the low level of investment and domestic savings in relation to GNP, Mr. Laske remarked. As reported by the staff, investment--especially by the private sector--had fallen far short of projections in 1980/81. The staff had gone on to indicate that the shortfall might be less the result of a lack of investment opportunities than of the persistent overregulation of economic activity in Pakistan. He noted that imports representing as much as 65 per cent of all manufacturing activity were either banned or subject to restrictions of some sort. While the authorities had taken some measures to reduce the level of import restrictions, progress so far was not particularly impressive. By maintaining a highly protective system of import regulations, the authorities were not only depriving the economy of the chance of benefiting from advanced technology; they were also helping to create bottlenecks in essential inputs for necessary investment and for industries with a promising export potential. He therefore urged the authorities to press ahead with the process of import liberalization, which had already fallen behind the originally envisaged schedule. In that context, he noted that the completion of the study of protectionism in the industrial sector had been postponed some 18 months, from the middle of 1981 to the end of 1982.

With respect to monetary policy, Mr. Laske observed that credit expansion in 1980/81 had been constrained to a level that had remained well below program expectations, despite the fact that a large grain harvest had had to be financed. Nonetheless, inflation had risen somewhat faster than had been hoped and led him to wonder whether an 18 per cent growth in total domestic credit during the current fiscal year would exert sufficient restraint. Since the economy still appeared to be enjoying a measure of excess liquidity from previous periods of monetary expansion, a tighter rein on monetary developments did not seem inappropriate.

An interesting new element in monetary policy was the intended reorientation of the financial system along Islamic lines, Mr. Laske remarked. However, from the short description in the staff paper, it was unclear how the substitution of loan participation for interest-bearing financial instruments would actually work. Who, for example, would determine the spread between profits to be distributed and to be charged? What would happen if losses were incurred, and what would be the effect on the behavior of individual savers if the expectation of uncertain profits was substituted for the ex ante knowledge of a specific interest rate? There may well have been compelling reasons for the authorities to have initiated the shift toward a financial system based on Islamic principles, but there might be as many compelling reasons not to move too quickly into unknown territory. He would be interested in hearing the staff's tentative assessment of Islamization on the performance of financial savings and on financial institutions in general.

In the area of investment policy, Mr. Laske said that he welcomed the shift in priorities from large industrial projects to agriculture, energy, and social programs. It was reasonable to assume that such a reorientation of investment priorities would improve the growth potential if supported by appropriate pricing policies, particularly for agricultural products and energy. In that connection, the retention of the old pricing system for specific supplies of natural gas seemed to result in an indirect subsidization of fertilizers, thus preserving somewhat the basic distortions in the price structure. As for the pricing of oil, it was unclear whether a two-tiered system--one for imported and one for domestically produced oil--was being retained, and he would be interested in staff comments on that subject.

Finally, on the question of the reapportionment of ordinary and borrowed resources under the proposed extended arrangement, Mr. Laske recalled that, when the Seventh General Review of Quotas had become effective and the policy of enlarged access had been reviewed, it had not been decided that all existing arrangements using borrowed resources would automatically be reapportioned. Indeed, Executive Directors had not even come to a view on whether a country using Fund assistance could request a replacement of an existing extended arrangement by a new one to get the benefit of a reapportionment. The immediate effect of any reapportionment was twofold: average charges would be reduced, while the maturity of Fund assistance would be extended. He would appreciate comment from the staff on those two effects and their respective significance for the Fund's liquidity and income position.

Mr. Polak considered that, while the first year of the extended arrangement with Pakistan had proved a successful one, there were enough danger signals to warrant close scrutiny of the economy's performance. On the positive side, the authorities had tackled the problems of demand management with vigor, meeting or exceeding fiscal targets, exercising expenditure control, and cutting many subsidies. Those elements of fiscal policy had been matched by control of credit, which had also remained below targets, although part of the authorities' success in that area had resulted from the failure of private investment to perform as well as had been hoped. On the supply side, a number of positive measures should be noted: the favoring of agriculture; the attempts to increase private investment; and the intention of the Government to withdraw partially from the public enterprise manufacturing sector and to increase the effectiveness of those enterprises from which the Government was not withdrawing. Still, it was difficult for an outsider to judge what effect those measures would have, and he would be grateful for a staff appraisal of the situation.

The negative aspects of economic performance also deserved consideration, Mr. Polak continued. What had thus far been done in terms of structural reform in the area of foreign trade seemed inadequate; in particular, insufficient effort had been made to allow the price mechanism--including the exchange rate mechanism--to play its proper role. On the import liberalization side, Pakistan had done what it had promised to do in the first year of the program, although that was little more than a reversal of the previous antiliberalization policy. What was promised for the future appeared modest, since a large proportion of industry would apparently remain subject to bans or equivalent restrictions even by the end of the program period. In that connection, he had been struck by the sentence at the end of the first full paragraph on page 28 of EBS/81/222 that the authorities "intend to give proportionately greater emphasis to removing bans/restrictions on intermediate and investment goods." The implication was that restrictions on those goods were still severe and that their removal remained uncertain. On the import side, the extent to which controls would apparently continue to be relied upon by the authorities led him to the tentative conclusion that there must be something wrong with the exchange rate.

On the occasion of the discussion of Pakistan's request for an extended arrangement one year previously, the question of the exchange rate had been raised by his predecessor in connection with exports, Mr. Polak recalled. Chart 3 (SM/81/219) showed that, since 1973, the real exchange rate for the Pakistan rupee had risen through 1979-80 by 20-25 per cent, an increase on which a number of Directors had expressed reservations when the request for an extended arrangement had been discussed a year previously. Since that time, the competitive position in terms of the real exchange rate had further deteriorated by about 13 per cent.

The staff had questioned the consumer price index figures in the paper and had suggested that the underlying inflation rate was about 10 per cent, Mr. Polak noted. That suggestion had been based on a reference by the staff to the GDP deflator, which unfortunately appeared somewhat out of date, based as it was on real GDP at 1959/60 prices. On the occasion of the next review, he hoped the staff would pay some attention to whether or not the GDP deflator in use was particularly worthwhile in terms of current price movements. The paper showed that almost all prices in Pakistan were controlled, and it was those controlled prices that entered into the price indices. In the circumstances, one might question the reliability of those indices, particularly since there remained some liquidity overhang in the system.

It might be better to rely more on available evidence about what was necessary on the import and export side in terms of restrictions and subsidies to get an impression of the appropriateness of the exchange rate, Mr. Polak commented. There were of course some encouraging figures for the overall trade balance and the overall current account, but they were subject to certain qualifications, some of which had already been mentioned by others. In any event, the development of Pakistan's position in international trade depended highly on its promotion of exports, which was currently being achieved to a great extent through export subsidies. The staff had referred to the policy of the authorities of dealing with problems of individual export industries on a selective basis, and he was surprised to find such a statement in a Fund paper without some staff reaction to it. Fund experience had shown that approaching export industries on an individual basis was a singularly ineffective way of dealing not only with exports but also with the development of the economy; it was also, incidentally, squarely against the principles of the Articles. Moreover, if the overvaluation was of a general nature, it could not be handled well by dealing with individual industries except with costly delays; and, in fact, the export subsidies currently covered about 75 per cent of Pakistan's industrial exports.

In sum, Mr. Polak considered that Pakistan should continue with its strong efforts in the area of demand management, on both the budgetary and monetary side. While the measures might be reinforced somewhat, they were basically on the right track, and adherence to them would be essential to the achievement of a viable current account deficit in the long run. With respect to foreign trade and Pakistan's somewhat restrictive mechanism, a change in approach was long overdue. The staff had stated that "more generally, from a medium-term perspective, the staff believes that the liberalization, together with further policies to sustain export growth, should aim at achieving a foreign trade regime which is somewhat more neutral as between export promotion and import substitution and thus avoid the disadvantages associated with excessive reliance on the latter approach." However, the message should be sent to Pakistan in language that was less opaque and euphemistic. Pakistan should be advised that there was every evidence that the present exchange rate was too high and that the country's structural reform would greatly benefit from adjustment of the exchange rate at the earliest possible date.

Miss Le Lorier expressed her support for the staff initiative in combining the information and data associated with both an Article IV consultation and a request for use of Fund resources in one document. Reducing the amount of reading material issued for the Executive Board's consumption seemed an eminently sensible move, and she joined Mr. Laske in welcoming it.

On Pakistan's economy, prospects for the success of the financial program agreed in 1980/81 seemed much better at present than they had a year earlier, Miss Le Lorier continued. In addition, the adjustment process appeared to have been carried out without impairing the growth pattern, as had been demonstrated by the 5.7 per cent expansion of domestic output in 1980/81. In spite of those improvements, however, there was little doubt that the difficulties to be addressed by the authorities over the next few years remained formidable and that any further progress would depend on a strong and timely implementation of the measures announced in the framework of the financial program. Performance in the first year suggested that there was little room for concern about the appropriateness or orientation of policies implemented thus far, although one might question the pace of implementation of some of the measures at the heart of the adjustment process, such as the liberalization of imports, private sector incentives, and exchange rate policy.

She welcomed the expressed intention of the authorities to reduce by 40 per cent by the end of the program period the proportion of manufactures currently banned or restricted, Miss Le Lorier remarked. However, she was unclear about how that intention would be implemented in the remainder of the fiscal year or in 1982 as a whole. It did not appear that further liberalizing measures were envisaged at present for 1981/82 beyond those made effective on July 1, 1981. Uncertainty also arose with respect to the scope of the first of two consecutive stages of liberalization beginning on July 1, 1982, particularly because the comprehensive study of the degree of effective protection in the industrial sector was not expected to be completed before the end of December 1982. At the same time, the possibility of implementing additional protective tariffs or quotas, if the need to do so were felt, had not been ruled out. In that context, the chances of attaining the announced targets might not be assured, and the contribution of the liberalization effort might not be as large as had been hoped, particularly in view of the far less favorable than anticipated results observed during the first year of the program.

Another matter important to the outcome of the program was the prompt return of private sector confidence and the development of productive investment, Miss Le Lorier considered. Progress along those lines seemed to have been slower than expected, especially with respect to investment. While the authorities were clearly aware of the importance of promoting private sector activity, constraints continued to exist with respect to the availability of financial resources and imported goods, and price determination continued to weigh heavily on growth prospects of private firms.

She wished to associate herself with the staff opinion on the need for a close review of the contribution of the current exchange rate to the external balance, Miss Le Lorier commented. The particular structure of the balance of payments--which included an unusually large share of workers' remittances--had in some way clouded the problem and, to that extent, may have made a full examination of the issue less urgent. However, there was evidence that exports of certain manufactures had been adversely affected, and the extension of compensatory rebates, covering up to 75 per cent of all manufactured exports, had been felt necessary. A gradual decline in the relative rate of inflation in Pakistan as currently envisaged, together with the evolution over the coming months of the U.S. dollar--to which the rupee was pegged--might modify the current picture somewhat; for that reason, she would refrain from making a definitive judgment on the issue. Nonetheless, it seemed important for the next review that the exchange rate question be monitored closely by the staff in cooperation with the authorities. Finally, with the qualifications she had mentioned, she could fully endorse the staff appraisal, and had no difficulty supporting the two proposed decisions.

Mr. Taylor remarked that, like others, he felt that the experiment of combining the request for an extended arrangement with the Article IV consultation had been successful and represented a step forward in the efficient organization of the work of the Executive Board. While he hoped the procedure could be repeated, he would prefer, where programs were being reapportioned or augmented, to have a tabular presentation of the annual figures to allow for an easier tracing of the changes. In addition, he noted that reapportionment was not a subject that had been explicitly discussed in the Executive Board and, like Mr. Laske, he had a number of questions on the matter. He presumed, for example, that the supplementary financing facility resources released by the reapportionment would become available for recommitment, and he would appreciate confirmation by the staff. He would also be interested in hearing whether there were many other arrangements eligible for a similar reapportionment and, if so, whether the implications for the Fund's liquidity and borrowing had been fully taken into account. It would also be useful to know whether reapportionment was likely in the case of any member eligible to make purchases under the interest Subsidy Account.

Another somewhat technical matter raised by Pakistan's request concerned the performance criterion on government borrowing under the proposed arrangement, particularly in light of developments in 1980 and 1981, Mr. Taylor commented. The shortfall in net external financing of PRs 2.9 billion below the budgetary forecast had been offset or compensated for by what had been termed "nonbank domestic financing." However, that financing appeared to have been composed primarily of unprogramed sales of equity by the Government to the state bank and of compulsory loans from the public enterprises. Both means of financing fell outside the scope of the performance criterion on bank financing to the Government but their economic effects were broadly the same. He would be grateful if the staff could reassure him that the performance criteria under the new arrangement were sufficiently comprehensive to take both types into account. If not, it might be better to consider a ceiling on total public sector credit; in any event, it appeared that the time had come to examine the operation of performance criteria on government credit more carefully than in the past.

The Government had overshot the ceilings on government borrowing under the program on two occasions, Mr. Taylor noted. Both cases had been the result of exceptional demand for commodity financing associated with good harvests, and the Executive Board had rightly granted waivers in March 1981. However, in the event of a bad harvest, a reduced need for commodity financing would imply unexpected headroom within the limits on government borrowing and, in such circumstances, there might be an effective although unintended relaxation under the program ceiling, which would be undesirable. It was not clear how the difficulty could be avoided, although one possibility would be to exclude crop financing credit from the borrowing ceilings. If the staff had given any thought to the technical problem he had mentioned, he would be grateful for some comment.

With respect to the extended arrangement itself, Mr. Taylor stated that he could support the proposed decision, although he shared many of the doubts and reservations expressed by his colleagues on the implementation of the structural side of the program, especially for 1981/82. Pakistan had of course made encouraging progress under the existing arrangement, particularly given the difficult external environment; but the revised projections of certain key economic variables suggested some slippages from the adjustment foreseen under the original arrangement. For example, the projections for the trade balance had been revised downward, and the current account deficit through 1982/83 was projected to deteriorate rather than to improve. Furthermore, little progress was foreseen in containing the rate of inflation. While he accepted the need for gradualism in the face of the very fundamental adjustment and liberalization being undertaken, he was not convinced that the degree of adjustment contemplated at present would be sufficient to produce a sustainable external position at the end of 1982/83. In the circumstances, he welcomed the inclusion of a review clause as a performance criterion in the program. On the occasion of the review, Executive Directors should pay particular attention to the adjustment that had been achieved in 1980/81 and to whether a further strengthening of the program seemed justified for the remaining years. In passing, he had the impression from the staff papers that the World Bank had not been closely involved in the assessment of the extended arrangement. It would have been useful to have the Bank's views on the pace of adjustment as well as on the thrust of the program, and he hoped that the World Bank would be associated fully with the scheduled review.

The intention of the authorities to maintain a tight fiscal stance was appropriate, Mr. Taylor continued, and he welcomed their recognition of the need to introduce greater flexibility and elasticity into the tax system. On the expenditure side, the steps toward tighter control were to be commended, particularly in the finances of the public enterprises and for supplementary budget allocations. However, current expenditures in 1982/83 were projected to increase by 20 per cent over current year levels and would by then significantly exceed the original projections under the extended arrangement. He would welcome staff comment on that particular point.

In broad terms Pakistan's monetary policy stance seemed appropriate, and he welcomed the authorities' objective of containing the growth of broad money to about 15 per cent, Mr. Taylor said. However, even that projection represented a distinct increase over the growth of broad money in 1980/81, and he wondered whether it might not have been better to aim for a decrease in the rate, particularly bearing in mind the disappointing progress that had been achieved on the inflation front.

He commended the authorities' cautious approach to the Islamization of Pakistan's financial system, Mr. Taylor remarked. Like others, he would be interested in knowing how the staff viewed the process in terms of the incentives that it would offer to private savings and investment. It was clearly desirable that returns to domestic savings should be positive in real terms, and he wondered how the real returns to profit and loss sharing accounts would work out in that respect.

On the supply side, progress toward economic pricing in key sectors had been rather disappointing, Mr. Taylor considered, and he joined others in urging the authorities to implement the proposed restructuring of the pricing system--particularly for domestic petroleum and natural gas--as rapidly as possible. Since the aim of the authorities was to expand the industrial base, and given the fact that Pakistan had limited foreign exchange, energy pricing in the domestic market should fully reflect developments in international prices. Similarly, it was important for the authorities to supplement their efforts with a more rapid development of domestic hydrocarbon production. The fact that petroleum output in 1980/81 had been constrained by financial and technical factors seemed to indicate that incentives needed to be improved.

The intention to place greater reliance on the private sector in industrial development was appropriate and the objective appeared to be a feasible one, Mr. Taylor remarked, although supporting measures to develop adequate infrastructural services would be required. The shortfall in private investment in 1981 suggested that there was a need to ease regulations and price controls as well as excessive subsidies. He welcomed the reductions already budgeted for 1981/82, although he noted that they did not cover the sensitive area of export subsidies.

Progress in the area of import liberalization had been hesitant, and he agreed with others that the steps contemplated for the remainder of the program appeared to be rather partial, Mr. Taylor said. For example, the target of reducing the extent of protection in the manufacturing industry to about 40 per cent seemed modest; he would be interested in hearing the staff's view of the pace of the liberalization measures contemplated. It was difficult for an outsider to know just what was attainable, although he had noted that some of the restrictions had been justified for social reasons rather than protective ones, and he wondered about the extent to which the social element in the import restriction regime was an important obstacle to further liberalization. In any event, it was vital for the authorities to accelerate the import liberalization process, not only because of the disadvantageous effects of import restrictions for adjustment but also because, given the current slow pace of liberalization, the full effect of the impact on imports might be delayed until after the resources available for the extended arrangement were exhausted.

With respect to the exchange rate, Mr. Taylor said that he could fully endorse the staff's view that, if poor competitiveness remained a problem, it should be tackled on a broad front rather than through the selective use of export rebates, an approach thus far favored by the authorities. He joined others in hoping that the 1982 review would focus on exchange rate developments, with full consideration given to the possibility of an exchange rate adjustment. All in all, the authorities were to be congratulated on their progress thus far, even though the situation in Pakistan remained fragile. If the success achieved by the authorities was to be sustained, a more vigorous approach to adjustment over the coming years of the program would be required.

Mr. Erb, recalling that a number of Directors had registered concerns about the slow pace of adjustment in Pakistan, noted that a related question concerned the sequence of steps that should be taken by the authorities. Different Directors obviously attached different priorities to the various elements of adjustment, and he recognized that it was impossible to accomplish everything at once; he wondered whether the staff had given any thought to the appropriate sequence of steps to be taken.

Mr. Lovato joined those who had had a positive reaction to the concept of combining in one paper the Article IV consultation and the request for an extended arrangement. He had no objection to the cancellation of the existing program and the approval of a new one, since no essential features were being changed.

On the whole, the first year under the extended arrangement had been satisfactory, and almost all the performance criteria had been met, Mr. Lovato continued. Still, the very fact that many objectives had been reached or exceeded seemed to show that more might have been done in a number of important areas. The better than expected results for the current account of the balance of payments, for example, seemed to suggest the need for more courageous action. The consequences of the limited import liberalization enacted in the previous year had proved to be less troublesome than anticipated, and the actual increase in imports had been modest, bringing about a smaller current account deficit and lower fiscal revenues. In the circumstances, he commended the decision of the Pakistan authorities to reduce the list of banned items, although he noted with others that there would still remain a large proportion of commodities excluded from international competition. In all, he shared the view expressed by the staff that less reliance should be placed on import substitution, although he wondered how that view had been received by the Pakistan authorities themselves.

With respect to monetary policy, Mr. Lovato noted with satisfaction the reduction in the rate of growth of money and credit aggregates and the ensuing increase in the velocity of circulation. However, great caution would need to be exercised if the envisaged further increase in velocity should be realized.

The staff had argued that it was yet too early to determine with precision the effects of the Islamization of the financial system in Pakistan, Mr. Lovato recalled. The authorities apparently believed that such changes would help in mobilizing additional resources and encouraging investment projects, although it was difficult to see how that would come about. He would appreciate staff comments on the measures, and the extent to which the Islamization of the financial system would involve credit availability to the private sector. That point was particularly important given the shortfall in private investment recorded in 1981, which had caused a downward revision of the overall investment projections. The shortfall was worrisome because it appeared to be inconsistent with the targets for high growth and for improvements in the efficiency of the economic system that were among the purposes of the extended arrangement.

On other points, Mr. Lovato stated that he broadly shared the staff views, particularly with respect to the need to carefully watch developments in the fiscal sector and to continue with the removal of rigidities and obstacles that might impair the efficiency of the private sector. In general, the program under the extended arrangement had thus far met with some signs of success; much remained to be done, however, since the problems being tackled were deep rooted and could not be solved in a short period of time.

Mr. Prowse stated that, while he welcomed the new procedure by which the Article IV consultation and the request for use of Fund resources had been combined in one paper, he had felt that the number of pages to be reviewed had nonetheless been somewhat overwhelming. In future, it might be useful to give greater consideration to the precise nature of the papers produced, or at least to continue with the idea of incorporating a table of contents when the staff papers were extensive.

On matters of substance, Mr. Prowse observed that the Pakistan case was among the minority of current extended arrangements that remained operative and that had in fact been successful. In the circumstances, he supported the proposed decision. However, as had been clear from the discussion, there were a number of issues that had aroused concern among his colleagues, and it was interesting to see that the issues were the same as those that had been brought up in November 1980 when the Executive Board had first approved the extended arrangement. The most important issue was import liberalization and the related question of exchange rate policy in the trade regime, and the detailed arrangements--such as compensatory rebates and export promotion measures--associated with it. Discussion of the matter in EBS/81/222 had been less than full, which made it difficult to assess the various benefits and disadvantages for the Pakistan economy arising as a result of those complex arrangements. He welcomed the staff's intention to discuss the matter further with the authorities, and he hoped that, on the occasion of the forthcoming review, it would be possible to have a more extensive commentary on the nature of the foreign exchange trade regime and its costs and benefits. In the meantime, he would say only that he recognized the problems of transition faced by the authorities and the fact that time would be required to achieve results. At the same time, he urged the authorities, as others had done, to give maximum priority to the import liberalization effort, which was, after all, at the heart of the adjustment process being supported by the extended Fund facility. He also urged them to give further consideration to the sort of flexible approach that appeared to be required for the exchange rate and the trade regime as a whole.

On a related presentational matter, Mr. Prowse indicated his agreement with others that some of the language used in the staff paper had been so diplomatic that it was difficult to know what was being said. For example, on page 33, the staff had stated that "if competitive difficulties persist, they should be tackled through action that has a broader impact on external performance." He wondered whether the staff had been referring to the exchange rate in that statement. In addition, with respect to the statement on page 34 that had been pointed out by Mr. Polak, he wondered whether the staff could be more precise about what sort of balance it was looking for between export promotion and import substitution and how that balance might be achieved.

Another matter that deserved attention was the difficulty with private investment, Mr. Prowse considered. As noted by Mr. de Groote, the central issue was the matter of profitability, which in the Pakistan economy was a complex and difficult one, fundamentally affected by what the staff had diplomatically called "socioeconomic considerations." Without presuming to offer any policy suggestions about what the authorities might do to improve private investment, he would urge them to place the problem high on their list of matters to be tackled.

On the Islamization of the financial system, Mr. Prowse said that he had found the arrangements for financing of housing to be particularly interesting. He saw no difficulty in achieving positive real returns with the arrangements that had been outlined for housing finance under the Islamization process, although it was not clear that it would be as easy to achieve real positive returns in the more essentially financial areas; at the same time, it was not evident that such returns could not be achieved.

Mr. Wang said that he was pleased to note from the staff paper that the Pakistan economy had performed well in 1980/81. The aggregate and sectoral targets for real economic growth had been broadly achieved, the overall fiscal deficit had been smaller than projected, and the balance of payments deficit had been contained well within the program targets. The authorities should be congratulated for their efforts, particularly since, as noted by Mr. Finaish, they had achieved a great deal despite both an adverse international environment--with increasing protectionism in the industrial countries and deteriorating terms of trade for Pakistan--and the burden placed on the economy by the necessity to absorb and care for over 2 million refugees from Afghanistan.

In general, the policies and measures contemplated for the second year of the program were also commendable, Mr. Wang continued. For instance, on the supply side, a relatively high priority had been given to agriculture, energy, rural development, and the social services sector. In the area of fiscal policy, the authorities had stressed improvement in the structure of revenues and expenditures in order to curb the overall budget deficit. Moreover, the authorities intended to continue with a policy of monetary restraint in order to further contain inflation, and increased efforts through the provision of incentives would be made to stimulate export growth.

He shared the staff view that the program for 1981/82 represented further important progress in the efforts of the authorities to improve resource utilization and to restore a viable balance of payments position, Mr. Wang commented. It appeared that the authorities were moving in the right direction and that a gradual, step-by-step approach to overall structural adjustment was appropriate. In the circumstances, he offered his full support to both proposed decisions in the staff paper.

Mr. Kabbaj observed that the performance of the economy had been satisfactory in all aspects in 1980/81. The rate of growth of GDP had been 5.7 per cent, which reflected good performance by both the agricultural and industrial sectors. In fact, because of the weight of agriculture in the overall economic structure, the good performance of the agricultural sector had contributed significantly to the development of the economy. A bumper harvest and high international prices, together with the agricultural policy of the authorities, had resulted in the recent expansion of agricultural output. That policy had led to improved farming practices, irrigation and water management systems, and continued investment in agriculture, as well as increased farming incentives and adjustment of producer prices.

The manufacturing sector, which had contributed about 16 per cent to GDP in 1980/81, had also performed well, growing by 9 per cent over the year, Mr. Kabbaj continued. The growth rates of the industrial sector and of GDP had, however, been less than those registered in 1979/80. In general, it appeared that the authorities were gradually adopting a policy of transferring the bulk of manufacturing to the private sector while retaining close involvement with agriculture, particularly with respect to pricing and investment. In fact, gross manufacturing investment in the public sector had declined by 17 per cent in 1980/81, while that of the private sector had not risen sufficiently to prevent total manufacturing investment from declining. Manufacturing investment, both public and private, had declined steadily since 1977. While he agreed with the staff that the shift in policy would have a beneficial impact, especially on economic growth, there was a need to earmark additional public investment outlays to the manufacturing sector, particularly as there had been relative weakness in private sector capital formation in recent years. The fact that the authorities had targeted a 10.5 per cent annual increase in real terms in gross fixed investment in the Fifth Five-Year Plan seemed to suggest the important bearing that industrial investment had on the growth of the economy. As pointed out by the staff, the transition of the manufacturing sector should be supported and supplemented by careful planning to see to it that the appropriate financial resources and technology were made available to the private sector.

One reason for the gradual shift toward the private sector was the current lack of profitability and relative inefficiency in the public enterprises, Mr. Kabbaj remarked. While the reasons for poor performance of the public enterprises tended to vary from industry to industry, it was possible that labor problems were common to all. In that connection, he wondered whether the problem had to do with a distinction in wages--

which were usually higher in the private sector--or with the lack of skilled labor that had arisen because of the large number of Pakistan workers abroad. Another problem with the public enterprises was that, whether despite or because of price adjustments, there had been large swings in the sales of manufacturing public enterprises from year to year, and he wondered whether those swings had been the result solely of supply constraints or had also been due to fluctuations in demand.

The price rationalization measures proposed in the program should be monitored carefully, Mr. Kabbaj considered. Indeed, with wide-ranging increases in administered prices, especially for fuel, wheat, sugar, and electricity, the authorities' intention to reduce inflation in 1981/82 might prove difficult to carry out and could lead to a disparity between monetary and price movements, particularly in the short term. Coupled with supply shortages, that disparity could exert continued upward pressure on prices.

The authorities' effort toward price rationalization had manifested itself in the area of monetary and credit policies, Mr. Kabbaj remarked. In fact, the strong improvement in fiscal performance, together with other favorable factors such as high domestic nonbank financing, had resulted in a greatly reduced reliance on the banking system for budgetary support during 1980/81. The authorities were to be commended for that positive achievement, particularly because during the same period there had been a sizable reduction in external financing. In addition, the rate of monetary growth had declined appreciably in 1980/81 to the lowest rate that had been recorded in many years. The success on that front had been due entirely to the implementation of demand management policies and the unceasing efforts of the authorities to control the growth of net domestic assets. The Government had also been successful in implementing the 1980/81 credit plan and in observing the ceilings set forth in the program. Quarterly ceilings established on net domestic assets and on net claims on the Government should prove helpful in limiting the rate of price increases and were, in his view, in complete conformity with overall government policies.

Exports had grown by 23 per cent in 1980/81, Mr. Kabbaj observed. While less than the 38 per cent increase registered in the previous year, the growth of exports had nonetheless been significant, indicating an increase in Pakistan's market share. A major factor in the performance of exports had been the buoyancy of the market and high international prices for cotton and rice, which together accounted for nearly 63 per cent of Pakistan's total rise in export earnings. Indeed, in 1980/81, about 53 per cent of all Pakistan's exports had consisted of rice, cotton, and cotton products. As mentioned in Table 65 of SM/81/219, unit prices for Pakistan's main export items were subject to significant annual fluctuations, and heavy dependence on only a few such items might undermine export performance in future.

As a result of good trade and income performance, the deficit on current account for 1980/81 had declined to 3.1 per cent of GNP from the previous year, and the balance of payments had remained almost in equilibrium during the period. Moreover, the ratio of debt service payments to exports of goods and services had declined in 1981.

Developments on the fiscal side in 1980/81 had been admirable, Mr. Kabbaj considered, and the authorities should be commended for the bold measures they had taken during the year. The overall fiscal deficit had been limited to 4.6 per cent of GDP, compared with a deficit of 6.2 per cent of GDP in 1979/80. Also, bank financing for budgetary support had fallen from 2.7 per cent of GDP to 0.8 per cent during the same period. It was clear that the authorities had performed well in managing the economy, consolidating earlier gains, and laying the groundwork for sustained growth. In the circumstances, they should be encouraged to pursue their efforts. At the same time, the Fund should avoid placing too much pressure on the authorities by asking them to do everything at once. He supported the proposed decision on the use of resources under an extended arrangement and the decision concluding the 1981 consultation with Pakistan.

Mr. Joyce said that he wished to begin by joining Mr. Laske and others in commending the staff for having incorporated both the report for the 1981 Article IV consultation with Pakistan and the request for an extended arrangement in one document. On the substance of the discussion, he congratulated the Pakistan authorities for the success they had achieved in 1980/81. Although the good performance of the economy had in part been due to exogenous factors, particularly good wheat and cotton harvests, it had also resulted from the policies pursued by the authorities. He welcomed the steps they had already taken and the indication that they were prepared to pursue existing policies aimed at effective management of demand, maintaining or increasing the degree of import liberalization, providing greater incentives to emphasize priority areas for investment, stimulating exports, and providing for greater participation of private enterprises in the economy, especially in manufacturing. For all those reasons, he could support the general thrust of policy as well as the request for a new extended arrangement designed to bring the existing program more into line with Pakistan's current quota and to enable the authorities to draw to a greater extent on the ordinary resources of the Fund.

Despite his support for the program, Mr. Joyce indicated that he had a number of concerns about the viability of the Pakistan economy and the sustainablity of its balance of payments position once the program was terminated in 1983. For 1981/82, the authorities were looking toward a somewhat higher rate of increase in productivity in real terms than had been achieved in the previous year. To a great extent, the achievement of such growth rates would depend on continued success in export performance. In 1980/81, success on the export side had largely been based on higher earnings from rice and raw cotton but, as noted by the staff, performance in other areas had been less than satisfactory. The real issue was whether or not one could expect continued good performance or even an improvement in volume terms in raw cotton and rice exports. He also wondered how the staff could be so optimistic about prospects for some other commodities, such as textiles, particularly given the world economic situation, the degree of protectionism for some of those commodities, and the likelihood that Pakistan exporters would be disadvantaged by the appreciation of the rupee that had already taken place in both nominal and trade-weighted terms. He had not been especially reassured by the staff's opening statement concerning performance during the first four months of the current year.

For the longer term, his concerns were similar to those that had been expressed by many other Directors, Mr. Joyce continued. They related mainly to the savings and investment prospects, the fiscal situation, and the more general outlook for the balance of payments. Investment performance for the first year of the program had been disappointing and had fallen short of the original targets. It had been noted that the weakness in investment performance had been particularly apparent in the private sector and, if structural changes in the economy were to be achieved, it would be necessary to maintain and redirect public investment flows while at the same time ensuring a greater degree of private involvement. Current levels of investment representing 16-17 per cent of GDP were low by comparison with those in most developing countries, and they had remained at a low level for some time. He urged the authorities to continue working toward greater efficiency in the public investment program. While the new emphasis on energy and infrastructure and on an improvement in modernization programs was commendable, he felt that the authorities should pursue policies designed to make private investment more attractive both by providing investment incentives and, more important, by facilitating private entrepreneurship through the cutting away of the existing network of regulations, price controls, and import restrictions inhibiting that initiative.

The pace of import liberalization also appeared to be quite slow, Mr. Joyce remarked. He could appreciate the social and political concerns in taking such fundamental economic steps too quickly, but if they were not taken, the effects on the economy were likely to be adverse. Competitive growth would be inhibited, and the entire process of structural change would be delayed; if that were to happen, the social and political concerns currently held by the authorities might be magnified. The steps taken to date were of course to be commended and, as noted by his chair when the original program had first been considered, such fundamental changes needed to be implemented as early as possible precisely because it took some time for their effects to work their way through the system.

On the savings side, he was troubled by the continuation of low savings ratios, Mr. Joyce commented. He had no quarrel with the intention of the authorities to introduce systems of savings and investment that were more in accord with Islamic tradition, but the laws of economics knew no boundaries, and it would always be true that increased savings would require greater stimuli and incentives to the savers. He had noted that the real rates of return on the new profit and loss sharing deposits were better than on the interest-bearing accounts; however, they were still negative for short maturities and barely positive for longer ones. If that situation were to persist, it was unlikely that greater flows of savings would be produced. Indeed, the staff projections did not look for any increase in the savings ratios over the life of the program.

In general, he would be interested in any further information on the likely impact of the Islamization program on the economy as a whole, and particularly on government revenues, Mr. Joyce said. He continued to be worried about the slow growth in revenues and the inelasticity of the tax system, points that had been raised by many speakers when the program had first been considered in 1980. Despite the steps already taken by the authorities, it was still projected that tax revenues would grow more slowly than GNP and that tax revenue as a proportion of GNP would be lower in 1982/83 than at the beginning of the program. In the circumstances, it was possible that a more radical reform of the tax system was called for than the authorities were currently contemplating; if so, the changes should be made quickly.

His concerns about the balance of payments situation related both to immediate prospects and to the longer-term outlook, Mr. Joyce commented. The staff projections envisaged a continued worsening of the current account balance and of the overall balance, at least in nominal terms, during the program period, and it was debatable whether the high levels envisaged at the end of the program were likely to be sustainable. Indeed, his concerns would be compounded if further restraints on the growth of international aid flows, particularly through some of the international development agencies, were anticipated.

The success of the export program continued in his view to be tied unduly to artificial export incentives through the system of compensatory rebates, Mr. Joyce observed. The system, already highly selective and costly, could become more so, with adverse effects for the fiscal outlook. The authorities' approach appeared to be a rather expensive alternative to increased exchange rate flexibility. In light of developments since the extended arrangement had first been approved in 1980, he had little doubt about the need for changes in the exchange rate at present, particularly given the recent strength of the U.S. dollar and the consequential depreciation of the rupee. The fact that compensatory rebates continued to be required seemed in itself to imply the need for greater exchange rate flexibility. In general, he wondered whether it was wise to continue to tie the rupee to the value of the U.S. dollar, since experience had shown that developments that led to a strengthening or weakening of the dollar did not necessarily justify equivalent changes in the value of currencies in other countries. Such ties could become rather rigid and, as might be the case in Pakistan, could inhibit the adjustment program. He supported the proposed decisions while urging the Pakistan authorities to pursue the process of structural change with greater vigor and urgency, and he looked forward to further reviews of the progress achieved in those areas.

Mr. Kharmawan stated that he wished to deviate from his usual practice and to praise the staff for its well written, well balanced, and consistent paper. Unlike some of his colleagues, he welcomed the sophisticated language that the staff had been able to use in dealing with certain sensitive issues such as the matter of the exchange rate. The message of the staff had been clearly conveyed to the authorities but in a gracious manner.

In his view the Executive Board had always been somewhat doubtful about the possibility of improvement in the Pakistan economy, Mr. Kharmawan continued. Such doubts had been expressed the previous year when the authorities had embarked on the three-year program. It was time for Executive Directors to confess that their doubts had turned out to be wrong, because the first year of the program had proved successful. The authorities should be congratulated for that success and for the courage they had shown in following the measures outlined in the program and abiding by the performance criteria. He had occasionally doubted whether a country's ability to meet performance criteria was any guarantee of the achievement of targets, but he had no doubts in the Pakistan case. Based on the determination of the authorities to continue with their policies, he warmly supported the proposed changes for the remainder of the extended arrangement.

One year was of course a very short time, Mr. Kharmawan noted, and it was important to look into the history of the performance of the Pakistan economy to see the significance of what had been accomplished. The country had gone through a difficult period politically and had even changed systems. The authorities had now adopted a policy under which they believed they could combine the involvement of government--which was necessary in all developing countries--and the involvement of the private sector with the necessary effort to diminish regulations and introduce incentives. They appeared to have followed responsible fiscal and monetary policies geared toward restraint, and they had adopted measures to provide incentives to production, to rationalize pricing, and to encourage private enterprise.

One could argue that the adjustment measures might have been implemented more vigorously, Mr. Kharmawan remarked. However, with regard to the first year of the program, Executive Directors should be content with what the authorities had accomplished. For the future, wise counsel had been provided to the authorities to pursue their policies in the fiscal and monetary field and in the areas of production and supply. While the advice had been well taken, it should not be forgotten that the authorities should be given some leeway in deciding when and to what extent certain measures to which they were committed could be implemented within the framework of their political and social situation. He understood that a faster pace in implementing some of the measures might have been desirable, although there were limitations based on the country's situation that had to be taken into account.

There were three important and basic issues that the authorities had to face, Mr. Kharmawan considered. The first was the problem of activating the private sector in order to improve economic development, and decisions toward that end had been taken. At one time, the private sector in Pakistan had been buoyant, but the pendulum had swung to the other side. It was thus understandable that the private sector itself might be cautious in responding to the invitation to play a greater role in the economic development. Certainly, the capacity of the Pakistan people to develop the appropriate entrepreneurial skill was not to be contested and, assuming an appropriate environment and incentives, he had no doubt that the private sector would in time play an important role in the economy. However, one could not expect such a role change to materialize over only one or two years.

The second problem confronting the authorities was the matter of import protection and liberalization, which had to be faced not only by Pakistan but by all developing countries that were attempting to diversify their economies by opening up the manufacturing sector, Mr. Kharmawan remarked. It was well understood that infant industries needed protection so long as they were gradually exposed to international competition. If a country had decided on a policy of import substitution exclusively, the danger was that the temptation to continue to protect the industries might be quite strong. That was not, however, the case in Pakistan. The authorities wanted to follow a balanced approach, providing their home markets with the products of their home industries while at the same time allowing the burgeoning manufacturing industries to enter into the export markets. But that could not happen without a decline in protectionism in the industrial countries. It was not reasonable to ask Pakistan to free its home industries from all the shackles mentioned by Executive Directors while at the same time preventing its industries from entering the external markets. Hence, while he believed the authorities were committed to liberalization, he could fully understand their caution.

A third important issue facing the authorities was the matter of the exchange rate, Mr. Kharmawan stated. He agreed with the authorities that, during the first year, it had not been necessary to devalue the rupee. However, a devaluation might be necessary in future, particularly given the recession in the United States and Europe, in order to improve competitiveness and access to markets and to maintain a sustainable balance of payments. The matter of the exchange rate should therefore be examined by the authorities in conjunction with the staff, and he looked forward to the results of that examination on the occasion of the next review.

Having listened to the advice of his colleagues, Mr. Kharmawan said, he had come to feel that the Executive Directors were driven by the desire to ensure that performance criteria were met by employing certain standards and measures that would lead to the fulfillment of those criteria. While not opposed to the idea, he cautioned his colleagues not to be overprotective in that respect. Governments needed some flexibility to introduce and implement certain measures, and it was only the Governments that could judge the actual situation in their own countries and decide whether there might be other ways than those favored by the Fund to fulfill the performance criteria. Finally, he hoped that the advice given to Pakistan by his colleagues would be reflected in the consultation reports of the member countries represented by the Directors providing that advice. After all, one was far more likely to listen to someone who practiced what he preached than to one who did not.

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

2. EXECUTIVE DIRECTOR

The Chairman bade farewell to Mr. Mentré de Loye at the conclusion of his service as Executive Director for France.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/81/147 (11/25/81) and EBM/81/148 (12/2/81).

3. MAURITIUS - RESCHEDULING OF REPURCHASE

Mauritius has proposed that a repurchase equivalent to SDR 2.5 million due not later than December 1, 1981, in accordance with Executive Board Decision No. 6607-(80/126) adopted August 12, 1980 be rescheduled to be made not later than May 1, 1982. The Fund agrees to the proposal of Mauritius. (EBS/81/228, 11/25/81)

Decision No. 6996-(81/148), adopted
December 1, 1981

4. EXECUTIVE BOARD COMMITTEES

The Executive Board approves the proposal set forth in EBD/81/308 (11/25/81).

Adopted November 30, 1981

5. PENSION COMMITTEE

The Executive Board approves the nomination set forth in EBAP/81/365, Supplement 1 (11/25/81).

Adopted November 30, 1981

6. RELATIONS WITH GATT - CONSULTATION WITH CONTRACTING PARTIES - FUND GUIDANCE

The Executive Board approves Fund representation at the next round of GATT consultations to be held in Geneva, as set forth in EBD/81/276, Supplement 2 (11/25/81).

Decision No. 6997-(81/148), adopted
November 27, 1981

7. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/81/366, Supplement 1 (11/30/81), EBAP/81/368 (11/24/81), EBAP/81/369 (11/25/81), and EBAP/81/370 (11/27/81) and by an Advisor to Executive Director as set forth in EBAP/81/372 (11/30/81) is approved.

APPROVED: April 16, 1982

LEO VAN HOUTVEN
Secretary