November 19, 1999
Approval: 11/29/99

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 97/104

10:00 a.m., October 20, 1997

Contents

Executive Board Attendance

S. Sugisaki, Acting Chairman

Executive Directors	**Alternate Executive Directors**
A.A. Al-Tuwaijri	S.M. Al-Turki
M.-A. Autheman	R. Fernandez
	C.X. O'Loghlin
	T. Turner-Huggins, Temporary
B. Esdar	W.-D. Donecker
E.R. Grilli	
D.Z. Guti	L.J.F. Erasmus, Temporary
	W. Szczuka
	O. Issaev, Temporary
A. Kafka	
	N. Goffinet, Temporary
K. Lissakers	B.S. Newman
A. Mirakhor	M. Daïri
	A. Vernikov
	A. Lushin, Temporary
G. O'Donnell	J. Shields
	G.M. Iradian, Temporary
M.R. Sivaraman	H.B. Disanayaka
E. Srejber	B. Andersen
G.F. Taylor	O. Kwon
J.J. Toribio	J. Guzmán-Calafell
	A. Lucenti, Temporary
J. de Beaufort Wijnholds	A. Levy, Temporary
	A. Barro Chambrier
	A.R. Ismael, Temporary
Y. Yoshimura	H. Ono
Zamani, A.G.	O. Sein, Temporary
Zhang Z.	Qi J., Temporary
A.G. Zoccali	N. Eyzaguirre

W.S. Tseng, Acting Secretary
A. Mountford, Acting Secretary
S. Soromenho-Ramos, Assistant
S. Bhatia, Assistant

Thailand—Review under Emergency Financing Procedures

Staff representatives: Anoop Singh, APD; Teja, APD; Ferrán, PDR; Lindgren, MAE

Pakistan—1997 Article IV Consultation; Extended Arrangement; and Enhanced Structural Adjustment Arrangement

Staff representatives: Furtado, MED; Ferrán, PDR; Fardoust, IBRD

Also Present

IBRD: S.G. Koeberle, East Asia and Pacific Regional Office; S. Fardoust and J. Williamson, South Asia Regional Office. Asia and Pacific Department: Anoop Singh, Deputy Director; L. Giorgianni, D.J. Goldsbrough, R. Moghadam, L.E. Molho, J.H.J. Morsink, M. Muhleisen, R.S. Teja. External Relations Department: S.J. Anjaria, Deputy Director; A.M. Abushadi, R.R. Brauning, M.E. Hansen. Fiscal Affairs Department: P.S. Heller, Acting Director; G.N. Anulova. Legal Department: W.E. Holder, Deputy General Counsel. Middle Eastern Department: P. Chabrier, Director; M.A. El-Erian, Deputy Director; T.I. Becker, A.C.A.R. Furtado, O. Liu, R. Moalla-Fetini, K. Nashashibi, C. Sassanpour, S.E. Williams. Monetary and Exchange Affairs Department: M.A. Josefsson, C.-J. Lindgren, C. Pazarbasioglu. Policy Development and Review Department: J.T. Boorman, Director; J. Ferran, Deputy Director; S. Ishii, J. Le Dem. Research Department: E.M. Jadresic Marinovic, R. Sahay. Statistics Department: K.W. O'Connor. Treasurer's Department: M.G. Kuhn. Office of the Managing Director: M. Russo, Special Advisor; B.V. Christensen, J.A.P. Clément, O.J. Evans. Advisors to Executive Directors: W.F. Abdelati, M.A. Ahmed, O.L. Bernal, J.A. Costa, P.M. Fremann, C.M. Gonzalez, R. Kannan, M.F. Melhem, S. N'guiamba, M. Sobel. Assistants to Executive Directors: N.R.F. Blancher, J.G. Borpujari, P.I. Botoucharov, M.A. Brooke, M. Carlens, J. Chelsky, A.L. Coronel, D.A.A. Daco, D. Fujii, R.J. Heinbuecher, H. Javaheri, K. Kpetigo, Lai K., J.P. Leijdekker, S.D. Melese-d'Hospital, F. Mercusa, D. Merino, I. Moon, L. Palei, J.L. Pascual, L. Pinzani, S. Rouai, J. Salleh, T.T. Schneider, M. Vismantas, A.G. Yakub, Zubir bin Abdullah.

1. THAILAND—REVIEW UNDER EMERGENCY FINANCING PROCEDURES

The Executive Directors, meeting in restricted session, considered a staff paper on the review under the emergency financing procedures under the Stand-By Arrangement for Thailand (EBS/97/187, 10/10/97; and Sup. 1, 10/14/97).

The Executive Directors agreed to consider the matter further at the first review under the Stand-By Arrangement in November 1997.

2. PAKISTAN—1997 ARTICLE IV CONSULTATION; EXTENDED ARRANGEMENT; AND ENHANCED STRUCTURAL ADJUSTMENT ARRANGEMENT

The Executive Directors considered the staff report for the 1997 Article IV consultation with Pakistan and Pakistan's requests for an Extended Arrangement in an amount equivalent to SDR 454.92 million and for arrangements under the Enhanced Structural Adjustment Facility (ESAF) (EBS/97/185, 10/3/97; Cor. 1, 10/17/97; and Sup. 1, 10/17/97). They also had before them a policy framework paper for the period 1997/98–1999/2000 (EBD/97/110, 10/3/97), together with a background paper on recent economic developments in Pakistan (SM/97/253, 10/7/97; and Cor. 1, 10/16/97).

The staff representative from the Middle Eastern Department noted that, according to the latest information, the level of gross official reserves remained at PRs 1.56 billion, close to the amount that had been reported to the Board a few days earlier. The premium in the current market remained very low, below 1 percent. The stock market had gone up that day by 30 points from 1,979 to slightly above 2,000.

Mr. Mirakhor made the following statement:

> The staff has produced a candid and balanced report on Pakistan. My authorities wish to express their appreciation to the staff for their hard work and constructive policy advice.
>
> Against a background of low growth, persistent high inflation, a difficult balance of payments situation, and market uncertainties, the new government moved decisively to implement a structurally based stabilization program. This entailed actions on three fronts: (i) containment of deteriorating macroeconomic balances in 1996/97; (ii) consolidation of the structural initiatives taken by the caretaker government (November 1996–February 1997) in the areas of agricultural taxation, revenue sharing, the financial sector, and governance; and (iii) a broadening of the structural reform agenda in the context of their Economic Recovery Program to include sweeping reforms of the tax and tariff regime and capital market, as well as restructuring of government and public enterprises. The authorities requested the Fund staff to monitor the implementation of their package of stabilization and structural measures under the Staff Monitored Program (SMP).
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> As the staff report indicates, implementation of the SMP has been quite satisfactory, with virtually all targets met. The fiscal deficit in 1996/97 was held to a level just above 6 percent of GDP, primarily through a tight rein on

budgetary expenditures; also monetary growth decelerated sharply. The response of the economy to this policy tightening was favorable. Inflation slowed, the external current account deficit narrowed, and there was a build-up of gross foreign exchange reserves. As uncertainty diminished and confidence grew in the government's handling of the economy, the stock market moved up sharply, and the premium on the kerb foreign exchange market dropped to levels not witnessed for several years.

The staff report provides a comprehensive and detailed description of the authorities' medium-term adjustment program in support of which Pakistan is requesting arrangements under the ESAF/EFF. The program embodies an integrated strategy aimed at: (a) placing public finances on a sound basis through the implementation of structural measures with a lasting impact; (b) a monetary policy stance that focuses on financial discipline in the public sector with adequate credit availability to the private sector to ensure a high level of economic activity with price stability; and (c) wide-ranging structural reforms that lay the foundation for medium-term sustainability to the adjustment process.

A sizable, up-front, and structurally based fiscal adjustment constitutes the core element of the authorities' program. At first glance, the fiscal adjustment of about 1.1 percent of GDP in 1997/98 may seem modest; however, in terms of the primary balance it is larger, about 1.6 percent of GDP. Additionally, the targeted budgetary deficit of 5 percent of GDP for 1997/98 incorporates the significant up-front costs of structural reforms, namely, the projected revenue losses arising from deep cuts in import tariffs and domestic taxes that were announced at end-March 1997. These losses are estimated at about 1.0 percent of GDP. Moreover, the consolidation effort in the budgetary area is to be reinforced by an adjustment of about 0.8 percent of GDP in the seven major public-sector corporations as these enterprises strengthen their financial position through a combination of expenditure containment, tariff rationalization, and efficiency improvement. Considered from this broader perspective, the projected improvement in the overall public-sector deficit amounts to 2.4 percent of GDP. An adjustment of this magnitude is substantial and constitutes a decisive beginning toward reducing demand pressures in the economy, controlling inflation, and strengthening the external position.

More important than the magnitude of the adjustment is the quality of measures taken. There is a significant shift toward expenditure-based consolidation, as demonstrated by the 1997/98 compression of noninterest current expenditure including defense. Such an effort entailed hard choices in terms of prioritization. The authorities have, however, ensured full protection to priority projects in the Public Sector Development Program and the Social Action Program.

On the revenue side, the authorities have undertaken structural policy improvements in the area of the General Sales Tax and income taxation, agricultural income taxation, and tax administration. Following a drop in the first year, the program envisages, in the second and third years, a substantial

strengthening in tax and nontax revenues as the General Sales Tax is extended in two steps to the retail sector, exemptions are further reduced, tax administration is improved, and the agricultural sector makes a growing and meaningful contribution to fiscal revenue. Nontax revenue is also expected to increase, reflecting the projected strengthening of the financial position of public enterprises and the resumption of the petroleum pricing mechanism.

The authorities have also made progress in the financial sector reform, particularly in the banking sector that has suffered from large intermediation spreads, high operating costs, excess staff, and deteriorating quality of assets. Recognizing the importance of addressing the problem at its roots, the financial sector reform component of the government's program aims at an improvement in the legal environment for loan recovery, restoration of good governance and financial discipline including through privatization, and at an enhancement of regulatory and supervisory system. A strategic plan and an improved legal framework for loan recovery, including a new law, are in place. The management of the nationalized banking institutions has been professionalized, the downsizing of these institutions has already commenced, financial intermediation costs have declined, and, in general, governance in the banking sector has improved.

Three other aspects of the program deserve mention. The first relates to the planned reforms in the external sector, which include further trade liberalization with a maximum tariff rate of around 30–35 percent, exchange market reforms, the phased withdrawal of the central bank from the foreign exchange market, and the development of an interbank market for foreign exchange aimed at increasing the role of market forces in the determination of the exchange rate. Implementing these reforms will alleviate the constraint on exchange rate policy posed by the presence of large foreign currency deposits with central bank forward cover.

The renewed impetus given to the government's privatization policy is another key element in reshaping the economy, reducing public debt, and improving economic efficiency. The authorities believe that progress in this area, in line with the timetable of actions set out in the proposed arrangement, will promote deep-rooted changes in the economic structure and the role of the state. While the privatization program is ambitious and may place strains on the capital market's absorptive capacity, the authorities intend to move with all deliberate speed in a wide range of activities.

The program also undertakes to improve economic governance, an important public policy issue for Pakistan. This comprises strengthening the accountability process, improving tax administration and compliance, and enhancing the regulatory and supervisory framework in the financial sector.

Developments in the first quarter of 1997/98 (July–September) have been promising, with the economy proceeding broadly in line with program objectives. A large revenue collection effort in September helped compensate for earlier shortfalls and total federal tax revenues exceeded the indicative target by Rs 3.3 billion. This, combined with continued tight expenditure

restraint, resulted in a level of bank borrowing for the budget that was well below the ceiling. With the trade deficit better than programmed, the external position remains manageable with gross reserves at end-September in the region of $1.3 billion. Inflationary pressures have eased further, and there are early signs of a pickup in economic activity. The agricultural sector appears poised for a strong rebound due to good crops for cotton, rice, and sugarcane. This outcome is expected to have a positive impact on the growth of the manufacturing sector and exports.

The program is comprehensive and demanding. Importantly, it is underpinned by a strong sense of ownership. The envisaged path of adjustment seeks to strike the right balance between the need to garner the credibility associated with strong measures and the transitional costs of major structural reforms. From this perspective, the program is carefully sequenced and realistically targeted. The initial response of the economy has been positive; nonetheless, the authorities are mindful of the fact that their program requires vigilance and readiness to react promptly to emerging economic strains. Their recent policy actions, as noted in the staff supplement—for reinforcing the fiscal adjustment effort and enhancing external competitiveness—demonstrate their willingness to take prompt corrective measures to ensure that outcomes are in line with program expectations and objectives. The recent positive shift in a number of indicators, notably, the budget, monetary aggregates, inflation, the external current account and gross foreign exchange reserves should increase market confidence. With Fund's support under the ESAF/EFF arrangements, the program should pave the way for the emergence of a virtuous circle that leads to higher private-sector investment and, ultimately, faster sustained growth.

Mr. Iradian, speaking on behalf of Mr. Shaalan, made the following statement:

The Pakistan authorities have initiated the implementation of bold structural reform measures that address many of the underlying weaknesses of their economy. At the same time, they have agreed on a fiscal consolidation path that reduces the financial vulnerability facing the economy. If fully implemented, the proposed adjustment and reform program would contribute to a much-needed improvement in Pakistan's economic and financial situation. This would enable the country to maintain high growth rates and reduce its large short-term foreign exchange exposure. I, therefore, support the proposed decision.

As I am in broad agreement with the analysis contained in Mr. Mirakhor's helpful statement and in the staff papers, I will limit my statement to emphasizing three points: the importance of structural reforms; the priority that needs to be accorded to demand management; and the external environment. The message that emerges from the analysis is a simple one. The program put forward by the authorities is appropriate and warrants Fund support. This is not to say that it is not subject to considerable risks. Rather, these risks must be monitored closely and countered by the authorities through determined and timely policy implementation. In doing so, Pakistan will also

start to put behind it the recent unfortunate and costly history of stop-and-go adjustment and reform efforts.

Experience in Pakistan over the years confirms that to be sustained, economic improvements need to be based on a strengthening of the structure of the economy. This observation assumes added importance in the context of Pakistan's vulnerability to exogenous factors, including weather- and pest-induced fluctuations in cotton output. The program for which the authorities are requesting Fund support and which is described by the staff as "comprehensive" home-grown "and credible" has a heavy structural component. I would note in particular efforts directed at the reform of the financial sector, improving the structure of taxation and composition of expenditure, and reforming the structure of the federal government (including the Central Board of Revenue) and the public sector enterprises.

The structural reform agenda is, by necessity, ambitious. In this regard, I welcome the actions that have already been taken by the authorities, especially in the financial sector. Measures to strengthen the autonomy and effectiveness of the State Bank of Pakistan and, through this and other avenues, the integrity of the banking system are much needed. They were attempted earlier but were subsequently eroded by slippages and leakages. As in the past, the road ahead for structural reforms is fraught with challenges which will require commitment and steadfast implementation on the part of the authorities. A further episode of "stop-and-go" policy implementation must be avoided at all costs if Pakistan is to be able to pull itself out of an increasingly adverse cycle of diminishing economic dynamism and heightened foreign exchange vulnerability.

Some of the structural reforms being implemented by the authorities will take time to bear fruit. In the meantime, Pakistan faces important domestic and external financial imbalances. The episodes of near foreign exchange crises experienced in 1995 and 1996 are important reminders in this regard. It is therefore critical that the authorities tighten their demand management stance, with the effort centered on a lasting adjustment of the budget and the public enterprises.

Recent indicators suggest that the authorities' effort to lower the fiscal disequilibrium is on track. I concur with the 5 percent budget deficit target for 1997/98 and agree with the assessment of the staff that the proposed fiscal stance "strikes an appropriate balance between reduction of financial imbalances and progress on structural reforms." I would stress the need to keep budgetary developments under close review. Specifically, the tight expenditure stance, which involves a reduction in nonproductive outlays, needs to be accompanied by the attainment of the tax revenue targets and the imposition of a hard budget constraint on the public enterprise sector.

Tax receipts in Pakistan remain too low relative to the size of the economy, too heavily concentrated in incidence, and too inelastic. Developments in July-August reported by the staff show how important it is for the authorities to respond in a timely fashion to emerging slippages.

I welcome the authorities' rapid response and their readiness to strengthen the fiscal revenue stance as needed. Vigilance will be required given uncertainties about the short-term impact of the reform of the Central Board of Revenue and the evolution of economic activity.

My third point relates to Pakistan's external environment. Fortunately, Pakistan until now has been immune from unfavorable spillovers from the recent currency turmoil in Southeast Asia. Quite the opposite, and as noted in the staff papers, there have been "favorable movements in the external reserve position, stock market prices, and the premium in the parallel foreign exchange market." The latter is at one of its lowest levels historically.

While these are encouraging developments, they should not be taken for granted given the vulnerability of the economy to changes in domestic and foreign investor sentiment. Boosted by the new government's actions in moving quickly to implement structural reforms, investors will now be looking carefully at the durability of the fiscal adjustment effort. It may well be that the implementation of a part of the announced adjustment and reform effort has already been reflected in asset positions. If so, policy slippages would have a large and rapid effect on Pakistan's financial position.

In closing, I reiterate my support for the proposed decision. Fund support under the proposed ESAF/EFF is needed and desirable. It signals to the markets the seriousness of the authorities' adjustment and reform efforts, their specification in a well-defined medium-term framework, and the availability of international financial assistance. I wish the authorities success in the implementation of this important program.

Mr. Sivaraman made the following statement:

At the outset, I would like to record my appreciation of the determination of the authorities of Pakistan to undertake substantial and major reforms covering the entire economy with a view to bringing Pakistan on a path of sustained growth.

It is undoubtedly not going to be an easy task given the fact that the proposed ESAF and EFF lay down a formidable array of 115 action points for Pakistan to comply with during the next three years of the program. They cover a gamut of sectors ranging from energy to environment and taxation to privatization and from legal and judicial reforms to health and agriculture. Of these 115, the authorities have completed five tasks, namely unifying the General Sales Tax rates, implementing the existing land tax in all four provinces, securing legislative approval for Ordinances relating to loan recovery, enforcement of financial contracts, adopting a new bank loan recovery law, rationalization of tax treatment of public and private mutual funds. The completed actions are indeed steps in the right direction.

One of the policy areas targeted is agriculture where phasing out wheat, fertilizer and irrigation subsidies are stated actions during the program period for increased productivity and income generation. Pakistan is a major

wheat producing country of the world, but regrettably, she is slated to import a few million tons of wheat in the current year. Has anyone studied the proposed action of withdrawal of subsidies on fertilizers and irrigation on wheat production? The result in India of even a reduction was altogether unsatisfactory. Subsidies on fertilizers, irrigation and food have to be looked at in a holistic way and not from a mechanical market angle. What they will affect is the psyche of farmers and consumers and surely, they cannot be built into econometric equation. Developed countries are yet to phase out subsidies in this area. Are we not demanding too much without realizing consequences?

The reforms that have been brought about in the direct and indirect taxes are no doubt laudable. However, in view of the fact that the rates have been sharply reduced, particularly on the direct taxes side whether the buoyancy in revenues would be able to sustain the revenue targets indicated remains to be seen. The policy framework paper (paragraph 23) shows that personal income tax rates have been reduced by 50 percent in the case of first three tax brackets and by about 40 percent in the case of highest income brackets. Similarly, corporate tax has also been reduced by 10 percent. If the revenue from direct taxes after such a sharp reduction has to show a growth to meet revenue targets, the effort required on the part of the tax authorities would indeed be phenomenal particularly when the rate of growth of the economy projected for 1997/98 is only 5.5 percent. The staff could elaborate as to whether the performance of the real sector in the last three months after the presentation of the budget gives an indication to this effect.

On the issue of agricultural income tax, it is now clear that what the States have imposed is only a land tax which has been the prevalent form of taxing agriculture in the South Asian region. Repeatedly, I have heard it being mentioned here that agriculture should be subject to income tax and I have been stating that majority of the farmers in this region are subsistence farmers even though there may be a number of large farmers holding very large tracts of land and earning substantial surplus from agriculture. To expect subsistence farmers or those who are only producing nominal surpluses for the market to maintain elaborate sets of accounts as would be required under any income tax law is impractical. I would once again caution that we should not place undue emphasis on this becoming a major source of revenue to the provinces in Pakistan. I would however wish luck both to Pakistani authorities and to the World Bank in their enthusiastic attempt to introduce agricultural income tax over the medium term.

The unification of rates under the General Sales Tax is undoubtedly a major step forward in the reform of indirect tax system. Its progressive extension and widened coverage to sectors including electricity would undoubtedly enable Pakistan to make this a significant source of revenue in the future. However, as this General Sales Tax is presumably following the principles of value-added tax from the initial stages itself, it would be necessary to have computerized accounting procedures with a view to preventing leakage which is bound to happen. This would be particularly felt when there are a number of exempted categories. Priority oriented expenditure, with determined action to contain the size of the government would assist Pakistan in reducing

fiscal deficit. The steps proposed to be taken in the financial sector and capital market when implemented would provide a solid framework for building up their investment strategy. The targets set for privatization and the action initiated by the government in this regard appear satisfactory.

In regard to projected rates of growth given in Table I, the policy framework paper, staff may kindly indicate as to why the capital output ratios that are derived from anticipated real GDP growth, and investment and savings vary so much from year to year. This requires a second look. In regard to financing of the proposed program, it is seen that the Fund would account for only a small percentage of the estimated requirement of $24.3 billion over 1997/2000. The only uncertain element in this package seems to be the $5.7 billion expected to be mobilized through medium- and short-term commercial loans. It is not clear whether the amounts expected from the World Bank, Asian Development Bank and OECF have already been negotiated. The external debt of Pakistan is close to 45 percent of GDP. Out of this, only 2 percent is shown as short term debt. If this position is correct, Pakistan is in a very happy position of not having to contend with any short-term volatile flows

Pakistan has a formidable task to achieve in the coming years. In many areas, there are bound to be obstructions, particularly when it involves downsizing of enterprises, government, imposing market-related prices, privatization of units which hitherto enjoyed government protection and enforcing of tax laws. One missing area in both the papers is; to what extent the management of provincial finances will affect Pakistan's overall fiscal deficit, and whether the task set in the policy matrix involved the cooperation of the provincial governments, and to what extent the federal government would be in a position to enlist their cooperation.

Ms. Lissakers made the following statement:

Let me begin by saying that one can be encouraged by the performance of the new government to date. They have taken some very important steps, including implementation of structural reforms initiated by the previous caretaker government in areas of taxation of land, financial sector reforms, and revenue sharing. They have also themselves initiated several reforms of taxes and tariffs, as well as measures to foster capital market development and to restructure public enterprises. In deciding whether to go forward with the proposed blended program, I think one must balance the short but generally positive record against a long-run track record of failed programs and broken promises by previous governments of Pakistan. I must say that I was torn on this decision, but I have come to the conclusion that we must support the program while making absolutely clear that we will have very low tolerance for waivers and modifications, and that we must insist that the second and year's arrangements be made far stronger than the first year. My unease at this moment is largely based on what I see as weaknesses in the current program, not so much in the longer term program that is laid out in the PFPs, but a lack of desirable specificity and teeth in the conditionality for the first year. Before I go on, let me just say a couple of things about the performance under the staff-monitored program.

First, regarding Pakistan's adherence to the end-September SMP targets, I note that on the fiscal side federal revenue, which was an indicative target, came in at PRs 71 billion versus a programmed PRs 68 billion. I am sure that many others on the Board share my sense of unease when they read in the supplement to the staff paper distributed on October 17 that the 0.7 billion PRs shortfall in CBR revenue collections was, "more than offset by an over performance in oil surcharges." I would like to query the staff on the exact size of the over performance, and what the revenue figures at end-September would have looked like without it. If the program is starting out with the government skating by on its revenue targets by virtue of oil price windfalls, we should know. I would also like to query the staff, in light of the staff statement in the supplement that, "Available information indicates that domestic and external developments are in line with the program, whether the staff has received data yet regarding the external stock of debt, information which it seems we should have before making a final decision on the program. I would welcome the staff's comments on this issue.

On the program itself, I will just note two or three areas that particularly concern me.

One is financial sector reform. The staff report is very clear on the problems and the danger points, both in terms of very large and mounting nonperforming loans in the state-owned banks, is approaching 20 percent of assets, and secondly, the very large exposure on short-term foreign exchange deposits and the manner with which the government ensures that those deposits remain in Pakistan. First, with regard to conditionality regarding reforming the banking sector, the paper says that the cost of recapitalizing the three large state-owned commercial banks would be perhaps as high as $6 billion, but the papers are largely silent regarding how this problem will in fact be resolved and how the resolution will be financed. In addition, there are, in fact, no performance criteria regarding privatization of these large banks. There is a structural benchmark regarding the divestiture of the government's remaining shares in four smaller commercial banks, but no benchmark for the first year of the program regarding actions on the biggest state-owned banks, which are the source of much of the problem. The PFP talks about bringing these banks up to point of sale, but that is all. To bring the banks in line with BIS capital standards, the staff hopes foreign investors would put up on the order of $3.3 billion, which seems like a fairly optimistic scenario. I also note that such transactions could only take place if all were to go well with proposed banking supervision and related reforms over the next few years.

Regarding the World Bank's proposed banking sector adjustment loan, which represents an important piece of the near-term concessional financing for Pakistan, the Bank staff tells us that there remains one key sticking point before that item can be brought to the Bank Board and that is the issue of the reform of the banking court system. Budgetary funds have already been provided by the MOF for the required reforms and all that is needed to break through bureaucratic resistance. I wonder if the staff or the World Bank representative could update us on the status of these reforms. Injecting more the Fund conditionality into this area, it seems to me, could help guarantee

timely implementation of measures called for under the bank's loans. I would like to invite the staff to comment on the potential for inserting benchmarks on banking sector reform early in the second year, such as full privatization of one of the three nationalized commercial banks, bench marking the national savings scheme to the treasury bill rate to reduce distortions in the interest rate structure, which is another area of significant concern that is not addressed clearly in the structural benchmarks, and winding up the central bank's forward cover scheme. The papers lay out steps toward achieving that goal, but, again, the conditionality does not seem to be there. And given Pakistan's track record, it seems to me there is every reason for a good deal of specificity in the structural benchmarks that is currently lacking.

I also wonder if the staff could explain a little bit more about the forward cover situation. The paper notes that there is some $10 billion on short-term deposit both by nonresidents and residents in Pakistani banks, which is about 50 percent of the total deposit base of banks, and more than eight times foreign exchange reserves. I note that banks are offered 17 percent post-tax rates of return on these deposits. Now, the question is, who finances this high rate of return? Is this a fiscal cost? Is this a quasi-fiscal cost? That is unclear from the papers. This is a very high cost to somebody, and seems to me there should be a certain amount of urgency in addressing this. Again, greater specificity is needed on the conditionality so that there won't be slippages in this area. I realize the situation is complex, but all the more reason to tie the authorities to a specific time frame for dealing with these problems on an urgent, urgent basis.

There are other areas, I think, of concern on the structural side of the proposed program. I would draw particular attention to civil service reform, where there are, again, no benchmarks, and also privatization of the search major public sector enterprises, which are presumably to some extent related to the banking sector—there appears to be no commitment to actually privatize these enterprises. There is a benchmark to develop an action plan to restructure them by the end of June 1998, that is to say there would be an action plan, but no action by the end of June 1998. I would like to have some assurances from the staff that there will be stricter benchmarks in this area in the second year of the program.

I am also troubled by the institution's approach to trade liberalization. The lauded trade reforms initiated this spring reduced the average tariff by 1.6 percent, from 18.2 to 16.6 percent, and the maximum tariff rate from 65 percent to 45 percent. It also left quantitative restrictions on imports in place, in sectors such as textiles, inputs for automobiles and tractors and petroleum products. Meanwhile, the program commits the authorities to little more than discussion with the staff regarding the merits of further measures in the direction of liberalization. And in the absence of strong Fund conditionality, there is every likelihood that important reforms in the trade area will be left undone.

I would also point out in addition to its obvious development and human rights aspects, that the elimination of bonded child labor in Pakistan

would be an important part of improving the overall trade picture for the country, since this practice, if left unchecked, increasingly threatens international acceptance of Pakistani products.

On the fiscal side, revenues are not even projected to attain the 17 percent level hit in 1995/96. The deficit is project to decline somewhat from 6.1 percent to 5 percent, and 4.5 percent in 1998/99. It seems to us that more needs to be done, though, noting in particular that on a consolidated basis, the public deficit will still exceed 5 percent of GDP by the end of the program. Meanwhile, interest costs will continue to increase, and extra budgetary capital outlays for the seven major public sector enterprises already mentioned will continue through the program period at an annual 1.9 percent of GDP. It is one thing to say, all right, we'll accept a higher fiscal deficit early in the program in return for radical tariff reform, but we are not getting radical tariff reform. We are getting a weak set of fiscal targets, it seems to me.

As regards the external accounts, at the end of the program period Pakistan's current account, excluding official transfers, would still remain at minus 4.2 percent of GDP, and two thirds of the adjustment in the current account deficit between 1995/96 and 1999/2000 will come through reducing imports, which seems somewhat at odds with the accounts we have heard of strong trade liberalization. External debt is programmed to continue to rise as a percent of GDP through 1999.

On the monetary side, increases in international reserves will come almost exclusively from the Fund, and staff apparently envisages no change in the velocity of money or other indicators, which could be expected if there is an increase in public confidence in the currency and in the banking system.

Finally, I would note that the appropriate back loading of the EFF component (10 percent, 20 percent, 30 percent of quota) appears to be staff's attempt to implement the Board's stated wishes, although I think frankly, given the weakness of at least the first year of the program, we should have gone further, for instance, back loading the ESAF components, which currently stands at 30 percent, 30 percent, and 30 percent of quota. The whole theme, as we first began discussing yet another program for Pakistan was that this time there would be strong structural adjustment up front, which would be supported by strong financing from this institution. It looks to me like we are still providing relatively strong financing, but we are not getting the other half of the bargain.

Mr. Autheman made the following statement:

I start this discussion exhausted, not so much by the long and sometimes confusing discussion we just finished, but because we are replaying the same game for the fourth time. Three times already, since 1994, the Board has been promised by Mr. Mirakhor and the staff a radical change, and three times this change has proven elusive. We are now invited to a program which, for the fourth consecutive time, may not even complete its first review. The only differences between these four experiences is that, depending on whether

they were on odd or even years, they relied either on elected government with the argument that they have a greater capacity to implement reform, or on World Bank caretaker governments with the argument that they were free from political influence and therefore had the capacity to initiate bold changes.

The main new feature of the present program is the supply-side Pakistani rhetoric which underlies it, the argument is that since the long-delayed structural reform will be finally implemented, a less aggressive fiscal and monetary stance should be accepted in order to maintain a business-friendly environment. This rhetoric has already been severely hurt both by Mr. Sivaraman and by Ms. Lissakers. Mr. Sivaraman in his insightful statement suggests that there are real forces in the region which may resist successfully to some intended reforms. Ms. Lissakers, in her interesting analysis, suggests that there are more promises than firm realizations in the structural program. Of course, Mr. Mirakhor paints a more rosy picture, emphasizing skillfully some important aspects of this program and especially the trade reform which, even if it is not the best of all possible ones, is a significant progress.

My main concern is related to what looks like an extremely lax macroeconomic stance. Although this is not the first time that Fund staff is recommending to the Board some form of trade-off between faster structural reform and macroeconomic policy, I fail to see the argument. We already had this debate, for instance on the tentative Ukrainian program. Where is fiscal adjustment? Ms. Lissakers just pointed out that at the end of the program, tax revenue would have only increased if everything goes well by 1 percent of GDP, not even reaching the 1995/96 level. There is no significant adjustment. The current account is targeted to stabilize at a level which has been considered unsustainable, since the country is unable to secure its financing without turning to the Fund support. Monetary policy appears to follow a course of indulgent tightening. It is difficult to find reliable information in the voluminous documentation provided by the staff on the level of interest rates. Staff briefly indicates that some interest rate tightening had no real impact since Treasury bill rates remained flat or increased marginally. Monetary policy has been characterized in the past by the attempt to be as accommodative as the market would tolerate. Consequently, there has been a sharp demonetization of the economy, a substitution toward foreign currency deposits, which is not expected to be reversed before the third year of the program. Therefore, we are invited to give our support to what remains uncertain, and elusive, bold and sustained structural reform, in exchange with what is clearly not adequate considering the very weak external situation of the country.

Of course, this government has shown during the staff-monitored program period a capacity to deliver what it committed. But it has also shown a major reluctance to undertake the macroeconomic adjustment which is needed. The Board is not left with much choice. If it were to reject the management's proposal, it could be accused of triggering the crisis which the Fund is asked to prevent. Even with this argument, I am extremely disappointed by the haste with which the staff is considering the provision of concessional resources under an ESAF arrangement. Pakistan will have the almost unique privilege, among the members eligible to ESAF, to have

benefited from a shortened track record requirement to get access to our concessional resources. I consider the management proposal to grant immediate access to ESAF resources a major mistake. I would have had no difficulty, in spite of all my reservations, to endorse a program where the ESAF component would not have been introduced until the satisfactory completion of the first review. Therefore, while I acknowledge that the interest of the bilateral creditors of Pakistan is to continue to buy time under the umbrella of the Fund, and therefore I am not willing to take the risk of objecting to this program, I will defer my support as regards the second decision, i.e., the ESAF arrangement, until after the first review.

Mr. Mirakhor observed that it must also be recognized that Pakistan had taken several steps in the past few months to put the reform program back on track. The authorities had met the extremely demanding prior actions. In particular on the fiscal side, he would note that, with the exception of the countries in Southeast Asia, there were few other countries that had kept the budget unchanged from the previous year, and that despite an inflation rate of 14 percent. Pakistan—which had a low level of government spending in comparison with other developing countries—had already undertaken substantial fiscal adjustment. It was true that revenues were not increasing as might be hoped for; however, it should be borne in mind that Pakistan had reduced its maximum tariff from 65 percent to 45 percent, and that the recent increased reliance on the sales tax might not engender immediately the same level of revenues as those from tariffs. Pakistan was recovering from a recession, and it would take some time before revenues increased in line with the tax effort that had already been put in place. At earlier meetings, Ms. Lissakers had called for a reduction in defense spending; he would note that there had been a reduction in military spending of about 2 percent of GDP over the past two-and-a-half years, despite the fact that there had been a 20 percent depreciation in the exchange rate over a 12-month period since October 1996. In light of the above, he found it surprising that questions should be raised about the lack of fiscal adjustment.

Ms. Lissakers noted that in her statement she had said that the otherwise positive performance of recent months must be set against the background of unfulfilled promises by previous governments.

Mr. Mirakhor observed that the present government had reduced the maximum tariff rate from 65 percent to 45 percent, notwithstanding that tariffs were a major source of revenue. Given that the current government had taken significant steps to bring the program back on track, it was inappropriate to ask for stronger conditionality on the grounds that previous governments had failed to deliver.

Ms. Lissakers commented that there had only been a modest reduction in average tariffs. On the program itself, she was concerned that there was a lack of specificity in terms of the benchmarks and performance criteria. In the Board's recent review of ESAF-supported programs, it had become clear that there was a serious flaw in the design of those programs in that there was a lack of specificity in structural benchmarks. In her view, it was not sufficient to have a statement of intentions outlined in the policy framework papers. Given that Pakistan had a history of repeated failures to complete Fund-supported programs, it would have been useful to have had more specific benchmarks and performance criteria as part of the program's conditionality in key areas such as financial sector reform, especially banking reforms.

Mr. Al-Tuwaijri made the following statement:

Pakistan's fragile economic situation underscores the need for strong and sustained policy correction. The measures implemented in the context of a staff monitored program are encouraging but need to be strengthened. Therefore, I support the authorities' request for an ESAF/EFF program which provides the appropriate framework to achieve such a result. The key to success, however, is steadfast and sustained implementation of the agreed policies. A return to stop-go policies of the past will further reduce confidence and undermine the credibility of the reform effort.

Fiscal consolidation remains central to the success of the authorities' program. Slippages in this area have been mainly responsible for the uneven results of previous stabilization efforts. Thus, it is critical that the targeted reduction in the fiscal deficit be fully achieved. The focus of the consolidation effort on enhancing revenue performance is appropriate. In this connection, the importance of strengthening tax administration cannot be overemphasized. The ongoing efforts to address this issue will facilitate the full realization of the benefits of the planned structural measures to broaden the tax base.

On the expenditure side, it is encouraging to note the authorities' emphasis on rationalizing current spending. I also agree with the planned reduction in low priority development spending. Such policies will help tighten the fiscal stance without sacrificing the investments required to enhance growth prospects. These reassuring efforts notwithstanding, the authorities should continue to monitor the situation closely and to implement additional measures, if needed, to stem any shortfall.

Fiscal restraint will also be key to the success of the authorities' monetary and credit policies. Reduction in the budget deficit will allow for adequate credit to the private sector while anchoring the economy on a firm path of declining inflation. The health of the banking sector, however, remains a risk. In this regard, I welcome the measures implemented so far to address this issue. This should facilitate the timely implementation of the policies envisaged under the program. I also welcome the ongoing capital market reform.

Turning to the external sector, I fully support the authorities' efforts to further liberalize the trade system and improve the functioning of the foreign exchange market. Additional tariff reform as well as deepening of the interbank market for foreign exchange are welcome. As for the exchange rate, the recent depreciation should help improve competitiveness. Timely and sustained implementation of prudent macroeconomic policies and structural reform are critical, however, to the effectiveness of this step.

With these remarks, I support the proposed decisions and wish the authorities success.

Mr. Shields made the following statement:

May I first say that I share a lot of the concerns of Ms. Lissakers and Mr. Autheman about this program, based mainly on past record. As Mr. Mirakhor said, it may seem unfair to put all the burden of this poor past record on a relatively new government, at least in terms of the new government in office, although not all the personnel, but I think it is very necessary that the Fund does that. We cannot pretend that the performance of Pakistan over the last decade or so is anything like satisfactory. We have to protect our resources and also our credibility in supporting specific programs. I think what Ms. Lissakers suggests is the right way of squaring the circle between doubt based on past record, on the one hand, but, on the other hand, a desire to give the government some element of the benefit of the doubt, and also some credit for what they have already done. As both Mr. Mirakhor and Ms. Lissakers said, they have put in place some very important actions over the last few months and produced a homegrown program, which certainly goes in the right direction.

Therefore, what Ms. Lissakers said is right—that we should give the government the benefit of the doubt on this program, but we should be very careful in monitoring the program, and that there are specific targets which can be clearly monitored through the program. I do not think this is necessarily part of all the programs that we implement. Often there are cases for not being too specific, for understanding that there may need to be changes in the program and that it is important that governments have some leeway to determine things as time goes on. But, in a case like this, where the record has been so bad, it does seem the sensible way to go—to have very specific benchmarks as well as performance criteria, and make it clear to the government that we are keeping a very close watch on how the program is going on. I think the way the program is designed with, effectively, three-month reviews is very sensible for that; it just needed more specific elements.

On the other issues raised, Mr. Autheman raised the issue about concessionary resources, given this performance. I was attracted by what he said; I could certainly see the wisdom of that. I am not prepared to go all the way in supporting that suggestion. I am not suggesting that we withhold our judgment on ESAF for that, but I can see very much the strength of his arguments and why he would want to hold up the ESAF element of this until the first review.

The important thing about this program, it seems to me, is this question of implementation. Alongside that, it is not just implementation based on current notions of the government on how it is going to proceed, overall, over the three years. The program is not ambitious enough. Despite the ambitious structural elements within it, the program does not leave the economy in a position we would really regard as sustainable. Within that context, it will be a temptation, I think, after taking strong actions now, to become too gradualist. That needs to be clearly guarded against.

On more specific elements, the staff paper does talk about fundamentals beginning to move in the right direction. In terms of policy actions, there is some force behind that. On this important question raised already about tax revenue and total revenue take, I take what Mr. Mirakhor says about that is what happens when you have bold tariff reform. Nevertheless, I think what Mr. Shaalan said in his statement is right that this is a country with a very low base of tax revenues and it is not going to get into a sustainable position that we all want, and support the sort of public expenditure which is actually necessary for this, unless that tax base is raised and that revenues as a proportion of GDP are raised fairly substantially. So, it is disappointing that, by the end of this decade, revenues as a proportion of GDP will still be below where they are in 1995/96, whatever the reasons for that in the short run might be.

The other question about whether things are so far moving in the right direction is looking at recent economic performance. The outturn last year was actually the worst performance since the disastrous year of 1992. The indications we have for the first quarter of the current financial year, as the supplement said, they may be better than programmed but, nevertheless, it is a very sorry performance overall. In those terms, we have still to see really encouraging signs.

Also on specifics, on the way that the fiscal position will be improved, as we have said, it is still too low revenues and still going down in the short run. Everything does depend on the spending side. As Mr. Mirakhor said, this is quite ambitious: freezing spending in current terms with the current rate of inflation is a very tight policy in certain sectors. The question becomes again whether that is actually going to be achieved. Particularly when it comes down to looking at cuts in the development budget, we need to see results essentially on this. We have seen some elements of it so far, but I think it is going to be very tough actually to deliver these spending figures. As always, when we have got rigorous cuts like this, we are looking at what is happening to core expenditure. There is not, I do not think, a benchmark which seeks to protect, for instance, the core development program. I think perhaps we do need a little bit more protection in this sense.

The policy framework paper does identify very well general areas of reform and the broad actions required in each area, and it seems to me particularly that the strategy and timing of the financial sector reforms are good. We have got actions which are clearly time bound and early in the program, and where we have seen good evidence to date. I think that needs to be replicated across the program. As Ms. Lissakers was saying, we need more specific benchmarks in all areas. It may all be, for instance, on the banking sector itself, in order to make sure that we are actually going in the right lines until we get sort of major new actions next year. We want to look at, for instance, past benchmarks on the process of rationalization in the banking sector and enforcement of loan foreclosures through the banking courts. These might be useful benchmarks to see whether we are getting the core activities to properly progress. I think this is the way that a quarterly monitoring process can really be well embedded.

I was encouraged by the section in the staff report on governance issues. I think it was quite discreetly phrased certainly, but I think it was careful and balanced. There have been substantial deteriorations in recent years. I think the staff is absolutely right that what is needed is a frontal attack on governance issues as a cornerstone of the structural reform program. I was encouraged by what Mr. Mirakhor had to say about the authorities' determination to confront what he refers to as an important public policy issue. It is a crucial public policy issue, and I think performance here depends also on performance in the fiscal sector.

A comment about the worries on the current account and the financing gap. The staff estimates show that up to half of the expected flows to cover the financing gap over the program period may be dependent on policy credibility, that is to say, the proportion of aid loans that are in some way conditional, plus, of course, all the nonloan private sector flows. I think the size of this is an indication again of how important implementation is. Of course, credibility really depends on steadfast action.

Finally, on a specific point, we were disappointed that the census was postponed at the last minute. I think that does deprive both policymakers and donors, as well as the public at large, of important data. It is again a rather poor signal about the ability of the government actually to follow through with their commitments on key policy actions.

In conclusion, I have lots of worries about this program based primarily on past performance. But, in approving it, I certainly call upon the authorities both to outline more specifically what they intend to do and crucially to keep to those plans.

Ms. Turner-Huggins made the following statement:

Let me thank the staff for a comprehensive set of papers—(I counted close to 250 pages) which helped to demystify the complex problems facing Pakistan. Staff has carefully noted all of the issues and presented sufficient candor and balance for Directors to reach a reasonable conclusion as to whether or not Pakistan deserves another chance at securing Fund support for its economic program. During the full Board debate of Pakistan last year, this chair was, like others, critical of lending any further support, given their dismal track record of program slippage and the climate of political uncertainty.

The scenario today, presented by staff and affirmed by Mr. Mirakhor, while still complicated and replete with risks, appears materially different in several key ways. That virtually all of the program targets under the staff monitored program were met, is probably precedent setting for Pakistan, and the authorities are urged to continue to pursue their future policies with the same amount of rigor. We are pleased that the new government with its strong majority, appears firmly in control and so far committed to the reform agenda established under the previous caretaker government. We regard this as pivotal to the success of the ESAF & EFF under request, given that domestic ownership of Fund-supported programs cannot be overstated. Furthermore, we

acknowledge that major progress has already been attained, including the crucial reform of central bank legislation, tax policy (notably, the agricultural income tax, trade tariff reductions, and General Sales Tax). We also note that corruption and transparency issues are being dealt with systematically. Finally, the authorities' exchange rate action last week, confirms a keen willingness to concur with prior actions of the program.

These are encouraging steps, and we hope that over the next three years, Pakistan will be able to dislodge the deeply embedded skepticism held by the international financial community by continuing along a path of consistent policy adjustment and structural reform, as embodied in the EFF/ESAF being discussed.

Like the staff, however, we appreciate that there are downside risks associated with such a wide sweeping and ambitious reform agenda. As such, it is vital that the authorities center their attention on the most critical issues, bearing in mind that according to the staff appraisal, the outcome of the program may be constrained by "limited implementation capacity." With the following additional remarks, we support Pakistan's request for an ESAF/EFF program, but remind the authorities that we remain only cautiously optimistic.

On program design, policy implementation and program outcome—At first glance we had concerns that the program could use more back loading of the disbursements to allow Pakistan's commitment to reveal itself. However, we have been convinced by the staff and by recent actions that the right mix of incentive and timing has been struck. Of particular importance we think, is the sequencing of the reforms with respect to the liberalization of the foreign exchange regime and the financial sector. It is important that these processes take place in an orderly fashion in order to minimize jeopardy of the external position.

We fully support the staff's position that liberalization of exchange markets needs to follow structural reforms in the banking sector, and we urge both the staff and the authorities to proceed cautiously to avoid mistakes elsewhere. In this regard, we look forward to reviewing the progress made in the area of the interbank market at the time of the first review. We would appreciate hearing from the World Bank staff as to the progress of the BSAL and the technical assistance being provided in the financial sector and the outcome of their mid-September negotiations.

In the fiscal area like others, we agree with the staff that efforts to consolidate the public finances are paramount to the durability of sustained macroeconomic stability. Government revenue is way too low and we urge the authorities to pursue relentlessly their attempts to broaden and improve revenue collections. We realize that in the past fiscal efforts have repeatedly been hampered by distortions in the tax system, poor administration and enforcement. So earlier, rather than later resolution to these issues is necessary. Public enterprise reforms, inclusive of privatization and downsizing of the public service must proceed as planned. Here we support the suggestion of Ms. Lissakers to have specific targets in the second and third years of the

program beyond the action plans. In this connection, we welcome the efforts already begun to compress the size of public sector employment, through a hiring freeze and voluntary separations.

On banking sector reforms, we urge the authorities to move swiftly with reforms given the key position these have in relation to the success of the economic program. Apart from the critical and fragile state of a large number of banks, there are other unfortunate structural issues to confront. Most troubling is the extent to which foreign currency substitution pervades the banking system—a staggering proportion, with no sign of abatement. This feature alone goes to the heart of economic instability and the lack of confidence that characterizes the banking system. Any recovery in money demand, requires a conjunction of several factors, including further reduction in inflation, positive real interest rates on rupee deposits, and renewed confidence. This will take time, along with persistent and sustained effort as Pakistan meets its fiscal objectives. We wonder whether a tougher approach to the substitution issue may not be warranted especially in light of the need to eliminate losses of the central bank as a result of the forward cover scheme. Could staff comment on the usefulness of imposing restrictions on any new foreign currency deposits and might not an objective of the program have been to cap the level of these deposits?

Finally, in light of Pakistan's limited implementation capacity, we are concerned that the program may be somewhat ambitious, already requiring large scale technical assistance. We see a need for very close collaboration and coordination at home and with outside agencies (the Fund and Bank in particular) and would suggest that an oversight committee, if not already in existence, be appointed to ensure that the program stays on course.

We wish the authorities every success in the difficult tasks ahead.

Mr. Zoccali made the following statement:

The stop and go character of Pakistan's past adjustment record admits a note of caution when assessing the current program. Nevertheless, the strong prior actions encompassing major structural reforms in the trade and fiscal areas and observance of most targets under the SMP for end-June afford the new authorities' credibility regarding implementation of the stabilization and structural transformation strategy to be supported by ESAF/EFF resources. The strong sense of ownership highlighted by both Mr. Mirakhor and staff provide additional assurances in this regard. We concur, therefore, with the recommendation that the Fund support this new attempt to put Pakistan back on the path of sustainable growth.

While cognizant of the many political and economic constraints facing the authorities, including the transitional costs of major structural reforms, the program should be seen as a demanding but first step for fully establishing the virtuous circle of stable macroeconomic conditions, investor confidence and strong growth.

As we are in general agreement with the staff analysis, allow me to emphasize some areas, which we consider critical to mitigate the downside risks to the program.

First, we welcome the structurally-based orientation of fiscal adjustment. However, given the level of the initial imbalance and the high stock of total public debt, the envisaged path of fiscal consolidation seems unambitious for containing the increasing debt-service burden and stabilizing the debt. Since the domestic banking system remains to a large extent geared to meeting budgetary financing requirements, it is difficult to envisage a strong "crowding-in" of private sector activity. The high stock of public domestic debt, in turn, constitutes a disincentive for the liberalization of the financial market and helps perpetuate the misguided notion of a trade-off between keeping low the costs of financing government operations and increasing the efficiency and effectiveness of financial intermediation. Doubts regarding financing the fiscal deficit also affect the prospects of trade liberalization and even increase the risks of backtracking since tariffs will remain one of the main sources of revenue generation even after their recent significant reduction. It is critical, therefore, that the reform agenda remain focused at bringing about more balanced and nondistortionary reduction of the fiscal deficit.

In this regard, despite the commendable freezing of current expenditure it should be kept in mind that almost 80 percent of current outlays will continue, in fact, earmarked for debt service and defense and that even after the increase under the Second Phase of the Social Action Program, such outlays will be less than half the amount allocated to military expenditure. Without a further targeting of the quality and effectiveness of public expenditure, the gains to be derived from the envisaged restructuring of government entities, the rationalization of the civil service and even from the reduction in subsidies, could prove insufficient to significantly alter expectations.

On the revenue side, we particularly welcome the structural improvements. The success of the across the board reduction in tax rates and the broadening of the tax base is predicated on a strong supply-side response which, in turn, depends critically on a sustained pick-up in economic activity and on enhanced tax compliance. In this regard, we are pleased to note from Supplement 1 that staff consider favorable the prospects for achieving the doubling of the real GDP growth rate assumed in the program. Nevertheless, efforts to improve tax and customs administration, including the professionalization of the Central Board of Revenue, should continue to merit highest priority. In any event, we consider it important that the business-friendly economic environment that is beginning to take hold, be spurred not only by tax cuts and liberal loan restructuring facilities but also by a comprehensive set of reforms, aimed at enhancing the functioning of markets, revolving around the privatization of public enterprises and the restructuring of the banking system. It is encouraging to learn, therefore, that the government is fully committed to accelerating implementation on both fronts. A program of privatization that includes the main state-owned enterprises and banks and that is open to foreign investors is seen as instrumental for promoting efficiency and

technological innovation, improved governance, and a deepening of financial intermediation, thus helping to cement the incipient climate of favorable expectations, which are necessary for sustainable growth. The constraint exercised by the Pakistani market's limited absorptive capacity highlighted in the staff paper could thus be overcome in this new environment.

Regarding the intention to deposit privatization proceeds in a special government account with the SBP to build-up official reserves, the risk that such proceeds be used in the future to weaken the fiscal stance should not be downplayed. While we welcome some flexibility to use privatization proceeds to finance costs associated with the restructuring/downsizing of the government and the public enterprises, could staff clarify the extent of the use envisaged and why reduction of the high level of public indebtedness, which constitutes one of the main threats to the stabilization effort, was not similarly targeted? The argument that a larger stock of official reserves would facilitate the liberalization of the foreign exchange market and the exit from the forward cover scheme for foreign currency deposits should be qualified by the experience elsewhere with liberalization of exchange and payments systems in the sense that when accompanied by appropriate macro-economic policies often a smaller than envisaged stock of official reserves will suffice. It could even be argued that a large build-up of official reserves hampers attempts at liberalization to the extent that the authorities might feel more confident of being able to influence the market exchange rate and continue with the practice of providing forward cover.

Second, with regard to monetary policy, is noteworthy that repeated increases in the discount rate have failed to influence key deposit and lending rates in the economy. The unresponsiveness of the banking system to a tightening of monetary conditions points to the need to strengthen the autonomy and the effectiveness of the SBP, including in the regulation and supervision of banks. It also makes evident the importance of rapidly enhancing the efficiency and soundness of the banking system. We welcome, in this regard, the commitment to restructuring, the replacement of bad loans by government securities and the privatization of state-owned financial intermediaries. In the context of continued high fiscal deficits, however, there is little room for exercising monetary policy. Moreover, to the extent that bank borrowing for budgetary support remains high and the government continues to influence credit allocation through special schemes and to provide forward exchange rate cover, the financial system will be hard pressed to deliver the level of savings, investment and credit flow needed for the sustainable development of the Pakistani private sector.

Lastly, on external sector policies, it is mentioned in paragraph 37 of the staff report that the authorities have provided assurances that they will manage the exchange rate in a manner that enhances the competitiveness of Pakistan's tradable goods sector and that, with the same objective, they are developing a targeted export promotion strategy. In a world of globalized real and financial markets, however, the chances of securing permanent gains in competitiveness through nominal exchange rate management alone are at best rapidly diminishing. Moreover, excessive reliance on this policy instrument

could blur the need to correct for slippages elsewhere, and thus end-up undermining the structural reform effort on which the lasting stabilization and modernization of the economy will ultimately depend.

With these comments, we support the proposed decisions and wish the authorities success in their difficult endeavors.

Mr. Qi made the following statement:

The difficulties encountered by Pakistan's economy in recent years call for the need to eliminate the macro economic imbalances in a more urgent and decisive manner. I am pleased to see that the targets in the staff monitored program which had been implemented shortly after the installation of the new government, were all observed. It may be a good indication of the breaking-up of the country's recent stop-and-go history of economic adjustment and reforms.

The authorities' strong determination to address the underlying economic weaknesses and to reverse the unfavorable economic development trends, as reflected in Mirakhor's helpful statement and the set of staff's well written papers, is very encouraging. However, the challenges are tremendous and the task facing the authorities is daunting.

Fiscal policy could play a key role in supporting the structural reforms, in bringing down the double-digit inflation rate, and narrowing the external deficit. In the short- or medium-term, a tight fiscal stance will be quite effective in breaking the vicious circle which is facing the authorities. The envisaged budget deficit reduction from the current 6.1 percent of GDP to 4 percent in three years is in the right direction. To achieve this objective, it should depend more on revenue increase, rather than expenditure containment, although containment is also needed. On the revenue increase, measures are needed to strengthen tax administration discipline at the very start, and to broaden the tax base in the near future together with other structural reforms such as extension of the General Sales Tax to the retail sector, and a review of the income tax system. On the expenditure side, although it is welcome that the authorities have frozen the federal budget in the current fiscal year at last year's level, the very low figures of public capital investment—which will affect the long-term development of the country—should nevertheless be tackled. I also appreciate that the social outlays will be increased, which is an important measure to guarantee the support to the ongoing efforts of adjustment and reform from the general population.

If the fiscal situation improves as envisaged, the authorities could have more room to deal with the monetary problems they are now facing. Half of the credit expansion over the past two years, as the staff pointed out, was attributable to the government borrowing from banks, which in turn, kept inflation high. I am very glad to see that the 12-month inflation rate in the September lowered to 10.3 percent. It seems to me that the issues of the high share of foreign currency deposits and the unresponsiveness of the economy to the interest rate policy is much more a matter of confidence. It usually takes

time to restore confidence but we of course can shorten the period of restoration. The authorities' intention to rely primarily on open market operations to control domestic liquidity expansion is welcome, and the relevant reform measures are quite timely. I also welcome the strengthening of banking supervision and regulations by delegating the full authority to the State Bank of Pakistan, which will ensure both the soundness of the banking sector and the implementation of monetary policy.

The external sector is vulnerable and the reform of the sector is vital. Although the foreign exchange reserves keep on increasing, they are still small, given the need for imports and the concern over the exposure on account of uncovered foreign currency deposits. How to increase exports and attract foreign capital inflows are the key to solving this problem. The recent announcement by the authorities to depreciate the rupees is a welcome action to increase the competitiveness of Pakistan's exports, and I see little risk that the depreciation will fuel inflation if the tight fiscal stance remains. It is very encouraging that the authorities will embark on trade liberalization, exchange market reforms, and reduced reliance on exchange rate guarantees for foreign currency deposits. I am sure these measures, which will give more play to market forces, could ease the external account pressures and reduce the budget burden as well.

This being said, I fully support the proposed decisions and wish the authorities every success in carrying out their ambitious adjustment and reform programs.

Mr. Levy made the following statement:

The newly released data appearing in staff's most recent update of economic activity are certainly encouraging. The fall in the kerb market premium and the continued upper trend in the Karachi stock index following the October 15 devaluation are perhaps an indication that financial markets are indeed expecting an improvement in policy and in the underlying economic conditions. These developments, as we know from the experience of other programs, could also reflect the endorsement of the program by the Fund and expectations of future Fund financial support. However, as financial markets are by definition forward looking and subject many times to the effect of extreme sentiment, and as we have learned from the recent developments in some of the Asian countries, the support of the Fund and others is certainly not enough. While I fully agree with staff that the main challenges that the authorities face are structural and that their main efforts should be directed in this direction as outlined in the PFP, and I therefore support the main elements of the program, I am concerned that the adjustment of the financial imbalances is not ambitious enough. In particular, as pointed out by previous speakers, the reduction in the fiscal deficit, which is at the core of many of Pakistan's problems, seems both too gradual and its final target at the end of the program also seems large in comparison with some other prevailing Fund programs. I would appreciate staff's comments on how this program stands, on the fiscal side, in comparison with other programs.

In view of the complexity of the program, especially regarding its structural elements, its riskiness, the large access of 150 percent of quota, and Pakistan's past track record, I concur with staff that the program requires close monitoring, and I would add to that, timely and relatively detailed reporting to the Board as in past months. I also agree with Ms. Lissakers that there really is no room for slippages, and this only increases the need for close monitoring.

As I generally agree with staff's analysis, I will limit my comments to three additional points: the measures taken to cope with the problem of the uncovered foreign currency deposits; the limited scope for the use of indirect tools for monetary policy given the current structural problems in the banking system; and the down-side risks involved in the program.

On the issue of the uncovered foreign currency deposits, the staff report mentions that in addition to strengthening fiscal and monetary policy which is expected to attract balances in local currency and reduce financing requirements, another element of the program is the development of a private provision of forward coverage to substitute the coverage of the SBP (State Bank of Pakistan). The staff also reported in the latest update released on Friday that recently banks have been allowed to offer forward coverage for allowable capital account transactions and that the uncovered foreign exchange position of authorized banks has been increased. While these actions are welcome, as are all acts of liberalization, they should not be confused with measures that are expected to solve the overall problem of the uncovered deposits, as these actions will simply shift the risk from the SBP to the commercial banks. Moreover, since most of these banks are still nationalized and therefore under the influence of the government, extra caution must be exercised in allowing them more freedom in their risk management. Regarding risk management by banks, if I may turn again to recent events in other parts of Asia, we have learned that a crisis may develop even when the central bank is not directly involved in providing insurance. And if nonbanks are to bear the risk of the uncovered deposits through the development of a forward market, they certainly cannot be expected to do so without a significant premium, as long as these risks are one-sided, which brings me back to my initial remark on the program, that is, there is no way to circumvent the basics of fiscal restraint even at the earlier stages of the program.

My second comment is related to the intended development and use of indirect tools for monetary policy in the program for 1997/98, as reported on page 26 of the staff report. I wonder what is the benefit of such tools in view of the weaknesses of the banking sector, the still prevailing high spreads between the deposit and lending rates, as reported in Box 1 of the report, and the resulting unresponsiveness of the deposit rates to changes in the central bank's rates, an issue already raised by Mr. Zoccali. What alternative tools does staff suggest meanwhile before the more structural problems are solved?

My last comment is on the medium term outlook and the ability of Pakistan to repay the Fund. While I agree with staff that Pakistan has a commendable record in servicing its debt including the debt to the Fund, it is still important to analyze the down-side risks, and I wonder whether the

scenario presented by staff, which is based on an assumption of a 1 percent per year lower growth rate of cotton manufactures, sufficiently captures those risks.

Mr. Kwon made the following statement:

Let me first say at the outset that I support the proposed decision. I will therefore limit my comments to just the fiscal sector, which, as was mentioned by Mr. Mirakhor in his statement, constitutes the core element of the authorities' program.

The reform agenda is no doubt heavy, and several challenges exist on the structural front. Like Mr. Shaalan in his gray, I believe that success of the program is dependent on having no interruptions in the policy implementations. I also think that Fund support for Pakistan is desirable and beneficial, in that it gives the right signals to the markets about the authorities' actions.

On the revenue side, my question is how realistic the revenue targets are? Last Friday, Mr. Chambrier explained that after the authorities adjusted some tax rates, the revenue target for end-September has been met. Revenue targets are central to the program. At a time when revenue is already low, some Directors have wondered about the lowering of the General Sales Tax and customs duties rates. As the fiscal accounts show, the main sources of income are obviously from customs duty and the sales tax. I would expect some revenue loss to occur as the previous General Sales Tax rate of 18 percent is reduced to 12.5 percent, which is the rate originally recommended by the Fiscal Affairs Department of the Fund, even though the unification of the previously concessionary rates of 5-10 percent at 12.5 percent could have some small positive effects on the revenue collections.

I would also like to say that there are a few potential risks to the revenue projections, if the revenue targets are based on successful implementation of structural changes and reforms, such as the strengthening of the revenue board, introduction of an audit program to scrutinize the enterprises, etc., since such reforms may face objections from taxpayers and, therefore, may take time to work successfully.

On the planned introduction of the agricultural tax, I would just like to say that, while agriculture plays a major role in the national development, and cotton and textiles are the primary bases for export, as a source of revenue I think agriculture is not significant. The introduction of a nominal agricultural tax linked to the value of land in the four provinces of Pakistan rather than a tax on small farmers' produce, who maintain no accounting records, as Mr. Sivaraman has highlighted, would be a welcome initiative.

On the expenditure side, I am pleased to note that expenditure on defense, which is a major component of the budget, has been reduced from 5.2 percent of GDP to 4.6 percent of GDP. Interest payments are also a very significant component of the budget. The way I see it, the authorities will have to put some considerable efforts on cutting interest costs so as to improve the

overall fiscal position. This could, of course, be achieved through better external current account performance, as well as further fiscal tightening through right-sizing—not necessarily downsizing—the government, as more public enterprises are prepared for privatization. The belt-tightening policy on current expenditure should also be continued through benchmarking.

Finally, as I stated earlier, this chair supports the proposed decision. I wish the authorities well in their policy implementation.

Mr. Yoshimura made the following statement:

As Pakistan has experienced a chronic macroeconomic imbalance for a long time, it is welcome that the authorities have made a commitment to the design of a broad range of adjustment programs and that ownership of the programs has been demonstrated by the new government.

Since the new government came into power in February, the policy efforts in the areas of structural reform and reducing the budget deficit seemed to be in the right direction. However, this chair also shares some previous speakers' concern about whether this wide-ranging and ambitious adjustment program is achievable, in view of the authorities' weak track record and limited implementation capacity. In fact, a Board meeting was postponed until today, because of the revenue shortfalls in sales tax and custom duties in July and August.

The staff has explained the corrective measures which the authorities committed themselves to in order to meet the overall fiscal targets for 1997/98. I would appreciate it if the staff would further clarify the prospects for the implementation of these measures. Pakistan's economic vulnerability comes basically from its monoculture in production and export; namely, its high concentration in cotton cultivation and related manufacturing. This vulnerability has contributed to the repeated derailment of past Fund programs. In order for Pakistan to achieve external viability as well as sustainable growth in the medium term, I would like to emphasize the importance of promoting industrial diversification.

Let me now turn to specific issues. The most serious challenge facing the authorities is to improve the budget balance, as well as the current account balance, and to strengthen the external position by reducing dependence on foreign currency deposit for financing. In this regard, I fully share the staff's view that the key intermediate policy target a reduction in the overall budget deficit. At the same time, however, as previous speakers pointed out, the target for the reduction has been set at a moderate level that will bring the budget deficit down only to 4 percent of GDP by 1999/2000, compared with 6 percent in 1996/97. The staff paper explains various measures to increase revenue and contain expenditure. If these measures permit only a moderate reduction in the budget deficit, I wonder whether there will be any additional measures that the authorities could take that would lead to a significant improvement in the budget balance. I would appreciate the staff's comments on this point.

As for taxation, the memorandum said that the government is fully committed to initiating implementation of meaningful agricultural income taxation. However, it is reported that large landowners have complained vigorously about the provincial agricultural income taxes, which are one of the core measures to increase budget revenue. I would appreciate the staff's comment on the implementation of these taxes.

On the expenditure side, I would like to know more about the trend of military spending. As the Managing Director pointed out in his speech in Hong Kong, military spending is one of the most unproductive expenditures by national governments. It is also alarming that global expenditure on military equipment has been increasing even after the end of the Cold War. In the case of Pakistan, as Mr. Mirakhor emphasized, the significant reduction in the ratio of defense spending to GDP would be expected in 1997/98. Certainly, I welcome that. However, as Table 3 on page 12 shows, it is not clear whether the government will be committed to further reduction in military spending during the rest of the program period. A further explanation by the staff, including how it intends to monitor the development of military spending, would be highly appreciated.

Pakistan had been actively promoting private investment in order to build infrastructure; in particular, in the electric sector. Consistency and transparency of the policy and management of investment promotion by the government is a necessary condition for the sustainable growth of private investment in this sector. However, it is reported that an ad hoc re-examination by the authorities of ongoing projects has recently shaken foreign investors' confidence. In order to restore the authorities' credibility in the minds of international investors, it is necessary to maintain consistency of the investment promotion measures and promote transparency of government operations.

With regard to external development, the rapid increase in foreign currency deposits is a main factor behind the vulnerable external position. As the recent turmoil in East Asia has demonstrated, excessive sterilization has been a serious problem for many developing and transitional economies, not just for Pakistan. Measures are needed to separate domestic currency transactions from foreign currency transactions and to maintain the credibility of the domestic currency. In this regard, I welcome the authorities' plan to shift residents' portfolio toward domestic currency instruments by strengthening the ability of the central bank to regulate and supervise banks as well as by accelerating bank restructuring. I also commend the plan to develop private provision of forward cover to reduce the official forward cover. I hope the authorities will front-load these reforms.

Regarding external financing, although the staff mentioned in the informal meeting last Friday that the Japanese assistance would be available next March, we note that yen loans and Exim loans are only under consideration by the Japanese authorities at this stage.

Regarding the program conditionality, in view of the authorities' weak track record and limited implementation capacity, I think monitoring should be

strengthened, as most Directors agreed in the ESAF review discussion. The staff proposes implementing close monitoring, but it is unclear exactly what measures the staff will take in addition to the observance of quarterly performance criteria which are needed for the disbursement of an EFF. I would appreciate the staff's comments on this point.

As I said at the outset, this chair is concerned about whether this wide-ranging and ambitious adjustment program is really achievable. I would therefore reiterate the importance of strengthening monitoring in order to prevent the program from going off track. In addition, the authorities should fully understand the seriousness of the present macroeconomic situation and make every effort to implement a comprehensive reform program.

With these remarks, I support the proposed decision and wish the authorities every success.

Mr. Donecker made the following statement:

This is a very difficult decision before us today. We are being asked to agree to two very substantial long-term credits to a government whose predecessors have established a particularly bad track record of weak policy implementation and broken assurances with regard to Fund-supported adjustment programs. Past economic mismanagement, a weak legal framework, and widespread corruption have led to low business confidence, low rates of investment, and a severe worsening of Pakistan's budget, current account, and foreign debt situation.

Against this background, we welcome the fact that the new, apparently much more reform-oriented government that came to power last February has implemented the staff-monitored program during the last six months in an attempt to halt the further economic deterioration of the country, to regain credibility, and to gain time for the preparation of a comprehensive adjustment program that could be supported by the Fund, World Bank, and others. As regards the results of this staff-monitored program, we note from the staff's report that most of the targets for the end of September were reached, although only after some downward corrections, and it appears only with some window dressing with regard to the particularly important fiscal revenue figures.

So here we are again being asked to give the Pakistani authorities the benefit of the doubt in a venture, to put it bluntly, that amounts to walking a tightrope, in view of the very substantial downside risks of the program. We agree with the staff's assessment that, while the initial progress under the staff-monitored program has been encouraging, the macroeconomic situation remains fragile. The structural deficiencies are pervasive, and the challenges facing the authorities will require unwavering determination in the implementation of the adjustment and reform program.

From a central banker's point of view, the odds for the success of the proposed new program seem heavily stacked against Pakistan. In spite of the

fact that this is not an overly ambitious program, particularly in the fiscal area, given her bad track record, administrative deficiencies, and existing fragilities in the budget, public enterprises, the banking system, and the balance of payments. One bright spot, and a very welcome change to the situation before, appears to be the fact that the clearly reform -minded new government enjoys a large majority in parliament and apparently also widespread public support for urgently-needed, wide-ranging reforms. It is also encouraging that the proposed adjustment and reform program that addresses many weaknesses of the Pakistan economy appears to be largely home-grown. Against the background of Pakistan's implementation record, this national ownership of the new program is of particular importance. But are these positive factors and the proposed conditionality in this case enough protection to safeguard the Fund's resources adequately, I wonder. In the final analysis, I suppose we will again, as in similar cases, have to rely heavily on Fund staff's expert assessment of the economic situation and the chances for success of this adjustment reform package. Here it bothers me somewhat that the staff needed 5 1/4 pages of conclusions, with many caveats, which must be close to a record as these things go, to demonstrate to us and to themselves that this program merits our support. Moreover, I, like other colleagues, believe that several aspects of the proposed adjustment reform package need further clarification. So I would like to reserve my final position until I have heard the staff's reaction to our critical comments and questions.

Now a few additional comments. First, as regards the strength of the intended adjustment efforts, we, like other speakers, do not think that the program targets for the second and third year are particularly ambitious. Whereas the first-year targets can be understood as a holding exercise to further stabilize the economy and get it moving in the right direction, in our view it will be very desirable if the program's fiscal targets for the following years, in particular, could be strengthened so as to reduce the so far envisaged fiscal deficit of 4 percent of GDP at the end of the program period further.

In view of the weak revenue performance in the first quarter of the new budget year, we share Mr. Sivaraman's skepticism that the authorities will be able to meet the overall budget deficit targets for the next quarters by overcompensating for the recent lowering of the income tax rates through a considerable widening of the tax base and more efficient tax collection alone, given the central government's constitutionally limited ability to increase the taxation of the high income earners in the agricultural sector. This points to a need for immediate additional efforts to achieve the tax revenue targets.

Regarding the crucial importance of the government's adherence to its revenue and overall budget deficit targets, the authorities will be well advised to give high priority to the strengthening of the revenue collection, to widening the narrow tax base, and to streamlining the civil service. In this context, I should like to hear from the staff or Mr. Mirakhor more about the practicalities of how the government intends to achieve an enlargement of its taxation authority in respect of the agricultural sector. Would this necessitate an amendment of the constitution and, if so, do the authorities contemplate such a move? What are the chances of success of such a move in view of the large

majority the government has in parliament? In view of the existing uncertainties about the government's ability to increase tax revenue collection sufficiently, we wonder about the rationale behind the recent cuts in direct tax rates. In any case, the staff must monitor the development of the budget deficit very closely, and the authorities must avoid renewed slippages in this area.

Secondly, with regard to prevailing interest rate levels, in order to provide sufficient incentives for clearly desirable increased savings in rupee-denominated investments, it appears advisable to aim for sufficiently positive real interest rates on rupee-denominated investments, such as government debt paper.

Thirdly, the increase of the electricity tariffs by 6.6 percent in 1997 and 1998 appears insufficient to cover rising costs in view of the much higher inflation rates. Will this price level really cover costs?

Fourthly, on financial sector rehabilitation, I share most of the views and doubts expressed by Ms. Lissakers, and her and Mr. Shields's and others' demands for stronger specificity with regards to the more binding conditionality for the second and third year.

The fifth point I should like to make today is about the still-existing practice of bonded labor in Pakistan that was also mentioned by Ms. Lissakers. This practice still exists, in spite of the Bonded Labor Abolition Act of 1992. The media have repeatedly reported on bonded labor and bonded child labor in Pakistan and elsewhere. Apart from the basic human rights aspect, this deplorable practice has a negative effect on public opinion and thus on the willingness of donor countries to provide financial assistance to Pakistan. It is furthermore water on the mills of the protectionists—not in my country alone, but in others too—and negatively affects the efficiency of the Pakistan economy. It is thus relevant to the Fund too. Within the framework of the efforts to improve governance, do the authorities plan specific measures to move more forcefully on the issue of bonded labor, particularly bonded child labor? I know that this is a very complex, politically difficult problem, and that there are no easy solutions here, but we would very much welcome further progress and elimination of this practice.

Finally, I side with those speakers who would have preferred a backloading of the ESAF or a postponement of the ESAF disbursements until the time of the first review of the program, in view of the bad track record of the country.

Mr. Grilli made the following statement:

If we look at the 1996/97 record, we cannot avoid noticing that important and welcome progress has been made under the staff-monitored program. An example is the taxation of agricultural income by provinces. This really is a key area and one, I think, most indicative in measuring the progress made by Pakistan. The indicativeness does not only come from the revenue, from the yield, but above all from the difficulty that has always prevented so far

progress in this area. There has been the beginning of a fiscal reform or a financial sector reform. There has been an announcement of the autonomy of the central bank. There have been important trade measures, particularly the reduction of the dispersion in the tariff rate, which is very important. We know that not only the level but also the variance of tariffs needs to be reduced. The government has also reduced certain tax rates to stimulate the emergence of economic activity and to relieve the private sector from a very heavy, at least on paper, fiscal burden. I think these are welcome measures. Also, containment of defense expenditure is remarkable, and important is the enactment of foreclosure law. The proposed program aims at consolidating and broadening the process of structural adjustment and structural reforms to do so on a broad basis, but gradually. I think that on the broad basis there have been differing opinions expressed around the table, although I tend to side with those who believe that this is a broad-based program.

On the gradualness, I think that there is no disagreement that gradualness is a feature of it. On the broadness, and thus on the merits of the program that we discuss today, again I am with those who are rather positively struck by it. As far as structural adjustment goes, there are some positive features, such as, again, the extension of agricultural income taxation and a furthering of trade liberalization, which, I must say, is being conducted in an international context which is not very favorable to Pakistan. Pakistan faces severe limitation of export of textiles—exports to the EU, to the United States, and to other countries which are quantified or regulated under the Multi Fibre Agreement.

I found positive the expansion of the tax base, direct taxation of agriculture and General Sales Tax, and a furthering of financial sector reform, particularly banking. The issue here is really whether in banking, in particular, the government will be successful in restructuring and privatizing some of the main banking concerns there.

On the speed of the adjustment, I am instead struck negatively by the pace of it. A faster rate, I think, would have been preferable and would have improved the credibility—both market credibility and the nonmarket credibility—of the process. And this also because the context in which the program will operate, and the context that Pakistan will have to face in the next foreseeable future, is not a favorable one. Of course, the historical context is almost totally unfavorable to Pakistan, as many have indicated today. This is so in terms of policy; much less so in terms of the ability of the economy to react to stimuli, which has been rather good. We have seen that Pakistan's economy has a capacity to come back very quickly.

The present context, particularly the financial context, is outright dangerous. A country such as Pakistan, which has a sizable external imbalance and a fragile banking system, is really facing grave risks. On both accounts, faster adjustment, particularly fiscal adjustment, would have been preferable. The government instead opted for supply-side stimuli to the economy. They might work to stimulate growth and to improve investors' confidence. If they

work, this will have been a brave call. But certainly the risks connected, the risks incurred, are high. There is no doubt about that in my mind.

In the medium term, the growth of Pakistan will depend very much on factor productivity and on investments. I am not worried per se by the limited taxes and the revenue. Of course, in the short term, this is a problem. I am worried much more in a medium-term context by the limited savings, the low rate of savings, in Pakistan, which means that foreign savings will have to be relied upon, particularly foreign direct investments, which will be and remain critically important. Thus the importance of good policies. Within those enumerated in the program, increasing openness is important and deregulation is important. I wish the program had done more in the field of deregulation.

On supply incentives: tax and price. Tax is coming. On price, the real exchange rate has been managed well so far. Good governance is important in terms of both domestic confidence and foreign confidence, without which foreign direct investments will not come or will not be large enough or of the type that will bring the maximum benefits. So the program goes in the right direction, as far as medium-term growth of Pakistan is concerned, if it is adhered to and implemented.

Pakistan, in my view, cannot go on stumbling, with its stop-and-go policies. The government must stay the course that it has taken, not only to convince us but also to convince its own people and to convince foreign investors. Does the program support the right goals? I think it does. Will it work? This depends on how firmly government will adhere to it. Certainly, the authorities do not have many degrees of freedom or do not have credibility to spare.

Is Fund financing justified in these circumstances? I think it is, on the basis of what the program includes. Obviously, we are fully aware of what happened in the past. Every effort should be made, and it should be made clear to the government authorities of Pakistan, that the program is on credit in many of its aspects. Strict confidence is expected. The staff is very well advised to monitor it continuously, strictly, and to report to us, to the Board, any deviation from it. But, on the basis of what I see, on the basis of the intrinsic merit of the program, and on comparative terms as well, I do not have any other basis but to support it, and I do.

The staff representative from the Middle Eastern Department noted that, unlike earlier programs, the current program included the provinces in the fiscal adjustment effort. In the past, the central government had had very little incentive to mobilize domestic taxes as the bulk of those had gone to the provinces. In addition, with the reduction of trade taxes, the government's ability to collect revenues had been seriously hindered. That in turn had led to cuts in development expenditure, as well as a tendency to rely on the nationalized banks and on the forward cover fee, under the forward cover scheme, as sources of revenue. Indeed, the resolution of the problems between the central government and the provincial governments, particularly the agreement on revenue sharing, was the single most important achievement of

the caretaker government, which had been in power prior to the current government. The new government had continued to implement the terms of the agreement and had designed the budget on that basis. The budget provided for a tight fiscal stance, particularly for 1997/98, the impact of which would be alleviated to some extent by the PRs 12 billion loan to the provinces. In addition, the authorities had resumed the tariff reform, which had been interrupted in 1995, and had decided to broaden the tax base. They had also taken significant steps to remove the distortions in the banking system and had demonstrated their intention to implement a more realistic exchange rate policy.

On the growth assumptions of the program, while the target was feasible, the composition would likely be different from what the staff had originally envisaged, the staff representative continued. In particular, certain segments within the manufacturing sector were showing a slower response than expected, which in turn would affect revenues. With respect to the question on the fluctuations in the incremental capital output ratio, he would note that, in the discussions with the authorities on the medium-term scenario, the authorities had pointed out that, during the 1980s, the incremental capital-output ratio had been 3.2 on average. In the 1990s, the capital output ratio had fluctuated; it had risen in 1992/93—owing to slower growth and higher expenditures because of the massive floods—and again in 1995/96, and 1996/97, owing to the inflow of foreign investments into the energy sector. The slowdown in certain sectors of the economy had also contributed to the short-run fluctuations in the capital-output ratio. The staff had done some simulations and had come to the conclusion that, despite the fluctuations during the 1990s, the 3.2 ratio prevailing in the 1980s seemed to be consistent with the projected improvement in savings and that it was a plausible ratio on which to base the medium-term scenarios.

The projections with respect to revenues for 1997/98 took into account the special factors that had been present in 1996/97, the staff representative stated. In 1996/97, there had been large rebates under the General Sales Tax (General Sales Tax), when the authorities had shifted to an invoice-based system, and the tax base had been broadened. There had also been a great deal of social resistance to the budget, and the staff at the Central Board of Revenuer had been affected by the change in management, which had hindered tax administration. In addition, the weak financial position of public enterprises had depressed the nontax revenue side of the budget. In making the revenue projections, the staff had carefully examined the adjusted base—adjusted for those exceptional factors—and factored in the measures already taken, such as better enforcement of revenue collection, the introduction of an audit program, improved tax administration, and better coordination of information on the sales tax, income tax, and customs duties. Through those measures, the authorities hoped to better detect tax evaders and compel them to pay taxes. One of the measures taken in the 1997/98 had been the standardization of the unification of the General Sales Tax rate. The standard rate had been lowered from 18 to 12 ½ percent, but there had been other rates—a 5 percent rate and 10 percent—which had been eliminated. The staff had incorporated the impact of the unification in its projections.

The ability of the authorities to collect the projected revenues depended to a large extent on the performance of the manufacturing sector, because a slump in that sector would adversely affect sales tax, the staff representative noted. Also, lower imports would affect customs revenue. In July and August, the staff had had discussions with the authorities and had ascertained that the sales tax and customs duties had not met the program targets. The authorities believed that the main reason was that the manufacturing sector was not recovering as fast as envisaged, which had resulted in lower revenues from the sales tax. At the same time, imports had been lower than projected, which had led to lower customs duties and sales tax from imports. The staff had been very concerned about the revenue situation for September, particularly given the uncertainty regarding direct taxes, and had expressed concern to the authorities at the discussions during the Annual Meetings. The authorities had indicated that they would take corrective measures, if the sales tax and customs duties fell below programmed targets. Those precautionary measures were outlined in the staff report. In the event, the revenues from direct taxes for the month of September and from the oil surcharge were higher than anticipated, as a result of which overall revenues for the first quarter had exceeded the indicative target. While that was a welcome sign, given Pakistan's history of revenue shortfalls, there was no room for relaxing the effort. The staff and the authorities had agreed that, for the months of October and November as well, corrective measures would be taken if revenues were lower than programmed.

Mr. Sivaraman said that he was puzzled by the increase in revenues from direct taxes, given that the tax rates had been reduced by 50 percent across the board. The only possible explanations were that the reduction in the rate had spurred tax compliance, or that there had been a sudden improvement in tax collection. He would be interested in the staff's explanation.

The staff representative from the Middle Eastern Department responded that the reduction in the rates of the sales tax and customs duties in March had led to a decrease in revenues from those sources. However, the impact of the reduction in direct taxes had not yet been felt, as it would come into effect in fiscal year 1998/99. The staff agreed that a reduction in rates would only buoy revenues if there were a concomitant improvement in tax compliance.

Mr. Donecker asked whether the end-September revenue target was realistic, and whether the authorities planned to take contingency measures if the target were not met.

The staff representative from the Middle Eastern Department observed that the outcome in September was unrelated to the latest measures taken by the authorities. For example, there was a lag between the implementation of the change in the tax rate and the realization of returns from it. Thus, the change in the customs duties had not had an impact on the September outcome, but would probably have an impact later. The sales tax and customs duties had performed below expectation, but the shortfall had been compensated for by the higher income tax returns, which had come in at the end of the quarter. He would note, however, that there was a seasonal element to the income tax returns, with returns being higher at the end of the quarter. Thus, the income tax returns for September were higher than the previous two months, bringing total revenues in line with program targets. As to whether the end-September data were accurate, the staff was concerned about the matter and was

monitoring developments and checking the accuracy of the data that was coming in. For example, data on the finances of public enterprises could be verified against data on transfers in the budget. The staff would take very seriously any misreporting. The authorities took pride in the ownership of the program checking, and any misreporting would damage their credibility.

The most important element of the tax reform over the medium term was the extension of the general sales tax at the retail level, the staff representative continued. The staff had had lengthy discussions with the authorities on that; the authorities wished to take a two-step approach, which entailed a transitional phase during which retailers would pay a 3 percent turnover tax, before moving to the full-fledged general sales tax of 12.5 percent. The staff would have preferred a clean once-and-for-all transition to the General Sales Tax, but the authorities, while not questioning the desirability of that, preferred to ease in the transition to the General Sales Tax. They had stressed that the transitional phase would not be longer than two years, which would be synchronized with the planned tariff reforms. On the latter, too, the staff had had lengthy discussions with the authorities regarding the timetable. The authorities felt that they would like to maintain the maximum tariff rate of 45 percent for the time being, to assess the impact on tariffs, imports, and the overall performance of revenues. They stressed that there were administrative costs to implementing the tariff reform and that it was cumbersome to change tariff rates every year. However, in discussing the long-term outlook, the authorities were of the view that, perhaps, it might be better to undertake tariff reform sooner rather than later, and preferably before 1999—provided that the General Sales Tax had come into effect. The staff thought that was a reasonable timetable, in light of the measures that had recently been taken in the area of tariff reform.

The staff supported the authorities' approach to agricultural income tax, and fully shared Mr. Sivaraman's views on the subject, the staff representative stated. It was true that the agricultural sector was dominated by small, subsistence farmers, and it was difficult to gauge the extent of monetization. At the same time, a substantial portion for the GDP originated in that sector, and there were large landlords who evaded income tax. The staff was advised by experts in that area not to rely on the agricultural income tax as a major revenue source, and therefore did not consider it useful to establish quantitative targets for it. The World Bank was assisting in the design of a tax on agricultural income, which entailed introducing a land-based tax and harmonizing and increasing tax rates across the provinces. The performance across the provinces had been uneven. The process of raising revenues at the provincial level would be gradual and would not involve changing the constitutional provisions on revenue sharing between the central government and the provincial governments. The staff welcomed the fact that the authorities had raised the possibility of bringing electricity within the ambit of the General Sales Tax, which might entail a change in the constitution. The ability of the authorities to extend the General Sales Tax to electricity would depend on whether it was considered a "good" or a "service," as the sales tax applied only to goods.

Mr. Sivaraman commented that experience from elsewhere in the region suggested that it would not be prudent to pressure the authorities into increasing agricultural income tax. The revenue outturn would be very low and not worth the effort. It would be better to have a hybrid form of taxation, i.e., an agricultural land-based tax for subsistence farming and income tax for cash crops.

The staff representative from the Middle Eastern Department noted that the medium-term outlook for revenues was consistent with that for other ESAF-supported programs. The recent paper on the review of experience under ESAF-supported programs had shown that the average targeted increase over a three-year period was 1.1 percent of GDP. In the case of Pakistan, the targeted increase was 1.5 percent of GDP, of which 1 percent would be from tax revenue and 0.5 percent would be from nontax revenue. On the expenditure side, a sharp containment was expected for 1997/98, but thereafter, there would be sufficient room for increases in social spending. There would also be room for the payment of interest on the cost of issuing government securities to the banks, which would be required at the time of their privatization in order to bring their net worth to zero. The cost of recapitalizing the banks in order to address the problem of nonperforming loans—which amounted to about PRs 100 billion—had also been incorporated in the projections. Defense expenditures were slated to decline to 4.6 percent of GDP in the first year, and the authorities had indicated that they would try to reduce defense spending even further.

On the core development program, discussions between the World Bank and donor countries and the authorities were continuing, the staff representative noted. While agreement had been reached on the public sector development program, they had yet to reach agreement on the core development program. The intention was to protect the core development program in the face of budget cuts. On the budget itself, the design of the budget reflected the various constraints that the authorities were facing. It should be noted that, although the budget deficit was programmed to decline to 5 percent from 6.2 percent, the underlying adjustment was substantially larger, if one took into account revenues lost because of certain reforms.

The program envisaged an improvement of about 0.3 percent of GDP owing to public enterprise reform, the staff representative continued. It was the first time that the staff had had the opportunity to look closely at the operations of the public sector enterprises, and it had found that the biggest problem area was the energy sector, particularly the Water and Power Development Authority (WAPDA), which had a large deficit. The authorities had requested World Bank assistance to address the problems of WAPDA, and the recommendations for the World Bank mission would be incorporated into a medium-term deficit reduction plan for WAPDA. The reform of WAPDA would have a beneficial impact on the macroeconomic situation.

The authorities had already taken most of the prior actions under the World Bank's Banking Sector Adjustment Loan, the staff representative observed. By mid-September, they had recovered overdue payments amounting to PRs 7 billion of cash, in order to meet the World Bank's requirement that they recover PRs 10 billion by the time of the World Bank Board's consideration of the loan; the Bank staff was confident that the authorities would recover the remaining PRs 3 billion by then. The expectation was that they would recover up to PRs 20 billion by early December. Banking sector reform was critical, and it was possible that the staff had underestimated the extent to which resolving the problems in the banking sector could have a favorable macroeconomic impact. The authorities had also taken prior actions in the area of capital market loans in order to meet the requirements of the Asian Development Bank's loan.

On developments in the external sector, total remittances in July and August had been $301 million, compared with $207 for the same period in 1996, the staff representative reported. Foreign direct investment had also increased in July and August to $153 million,

compared with $90 million for the same period in 1996. Portfolio investment had increased to $131 million in July and August, compared with $78 million in 1996. There had, however, been a decline in nonresident institutional deposits in July and August, which had amounted to $164 million, and there had also been a sizable decline in foreign currency deposits with nonbank finance institutions. Some of those depositors had returned in the first half of October, which was the reason for the increase in reserves during October compared to end-September. The deposits covered by the forward cover schemes amounted to about $10 billion. There was no easy solution to that problem. The staff hoped that, with the improvement in the current account, the need to rely on that type of foreign financing would be reduced, and, consequently, with the strengthening of demand management and the improvement in the returns on rupee assets, residents would switch back to holding rupees and nonresidents would convert funds into rupees instead of transferring them into foreign currency accounts.

Ms. Lissakers asked the staff to clarify how the foreign currency deposits affected the central bank's foreign exchange reserves.

The staff representative from the Middle Eastern Department noted that commercial banks surrendered the foreign exchange deposits to the State Bank of Pakistan in exchange for rupees, for a fee under the forward cover scheme. Thus, the flow of funds had an immediate impact on the central bank's gross reserves. The result was that the foreign currency deposits became a foreign exchange asset of the central bank and a foreign exchange liability for the commercial bank. The stock of foreign exchange deposits would remain large for some time, but the expectation was that holdings of foreign currency deposits by residents would decline. The Fund-supported program aimed at bringing about changes in exchange controls and the foreign exchange market to enable commercial banks to hold more foreign assets themselves instead of surrendering them to the central bank under the forward cover scheme. There were also plans to introduce foreign currency bonds, which would provide for a transparent record of the foreign currency liability in the budget, and to reduce the central bank's provision of forward cover gradually. One possibility was to increase the fee for the forward cover, but that would need to be implemented carefully as it could have a destabilizing impact on the deposits. The staff had considered recommending an upper limit on the stock of deposits covered by the central bank, but decided that it would be better to reverse the central bank's provision of forward cover gradually rather than to try to impose a cap on. The staff agreed that the program was backloaded in terms of the reform of the foreign exchange market and of the foreign currency deposit scheme. However, the staff felt that exchange system reform had to be implemented cautiously, after banking sector reform was under way. The staff would specify concrete measures regarding the relaxation of surrender requirements and other measures in the context of the first review.

The program provided for the restructuring of government ministries by June 1998, the staff representative continued. The staff thought it advisable to wait to see the extent of downsizing achieved under the civil service reform, which included a freeze on hiring and voluntary early retirement, before undertaking the restructuring of the ministries and departments.

Finally, on the problem of child labor, the authorities were working with international organizations, such as the International Labor Organization and UNICEF, the staff representative noted. The authorities agreed that it was important that the children employed in industries be treated well, and that they have adequate access to food and education.

Ms. Lissakers asked whether there was a specific plan for the privatization of the seven large state-owned enterprises. There had been considerable interest by private investors in the telecommunication industry, and privatizing it would strengthen the government's financial position.

The staff representative from the Middle Eastern Department noted that the policy framework paper laid out the specific dates for privatization of most of those enterprises—except WAPDA. The privatization of WAPDA was a sensitive issue; WAPDA would need to undergo substantial restructuring before it was ready to be put up for sale. Some of the public sector enterprises would be privatized after the first year of the program. The staff's approach was to assess the situation with respect to the privatization of the enterprises closer to the dates outlined in the policy framework paper, and at that time to provide greater specificity and structural benchmarks for their privatization. At present, the strategy was to put forward a performance plan for WAPDA by the end of the year and a restructuring plan for the other enterprises by the end of the fiscal year.

Ms. Lissakers asked why a faster track for privatization was not being considered for some of the other enterprises, particularly as the sale of the gas or telephone company could yield substantial windfalls in revenues.

The staff representative from the Middle Eastern Department responded that, by end-June 1998, two of the seven enterprises, notably, the Sui Southern and Sui Northern Gas companies would be put up for sale.

Mr. Mirakhor, responding to the question whether any constitutional action was required to levy agricultural income tax, noted that the tax had been introduced by an ordinance of the caretaker government, and the new government had made it into a law, which was already being implemented by the provinces. Thus, no other legislative action was required to move forward with the levying of the agricultural income tax. On the question whether the end-September revenue outturns represented "window dressing," he would note that the figures reflected the duty on defense imports, which were collected at the end of each quarter. At the same time, revenues from sales tax and customs duties, at about PRs 3 billion, were lower than the previous year, owing to lower sales tax and tariff rates.

The Deputy Director of the Policy Development and Review Department, in response to questions by Directors on the phasing of ESAF resources, noted that the staff had applied the general guidelines, which indicated that uniform disbursements across the program period would be preferable. To be sure, there had been some cases in which ESAF-supported programs had been backloaded, but this was generally done to fit to the profile of the financing requirements of the member, for instance, those relating to official debt-service payments. Such a situation did present itself in the case with Pakistan, where comparable treatment considerations suggested equal ESAF disbursements over successive periods of the arrangement. As Ms. Lissakers and some other Directors had noted, there was the issue of Pakistan's uneven track record, which pointed to the desirability of some backloading of access. This was achieved by backloading the Extended Arrangement, in a way that yielded a combined access under the ESAF and EFF for the successive three years of 40, 50, and 60 percent of quota, respectively. This entailed a substantial backloading, which seemed reasonable in the circumstances. A more pronounced backloading might have been perceived by markets as indicative of a lack of confidence in the program on the part of the Fund; the

staff had not wished to give a basis to such a perception, which might have risked an adverse market reaction.

The staff representative from the World Bank noted that the negotiations with the authorities on the World Bank's Banking Sector Adjustment Loan had gone smoothly. As of October 20, the authorities had already met most the 18 conditions, and the staff was confident that the authorities would meet the remaining conditions by the time of the World Bank Board's consideration of the loan, which was scheduled for December 9. One of the remaining conditions was the divestiture of the government's share in the partially privatized bank, which was scheduled for March 1998. It would have been inadvisable to proceed quickly with that, because it could have produced a negative reaction on the stock market. Also, the authorities wished to obtain advice from a financial advisor before proceeding with the divestiture. The remaining measures would, however, be taken prior to the meeting of the World Bank Board. One of the conditions of Bank support for the banking sector reform was the establishment of 10 additional banking courts the Board date. The authorities had begun working on that. Another condition of the Bank loan was the recovery of PRs 10 billion from loan defaulters—which was almost equivalent to the amount of the Bank's loan of about $250 million—prior to the World Bank Board meeting.

Ms. Lissakers asked how quickly the staff expected the three big banks—which held 45 percent of total bank deposits—to be privatized.

The staff representative from the World Bank responded that the timing of privatization of individual banks was indicated in the matrix of policy actions in the policy framework papers—all the banks were expected to be privatized by December 1999.

Mrs. Sein made the following statement:

> This chair would like to commend the Pakistani authorities for their determined efforts to move ahead with reforms on the macroeconomic and structural fronts which, as reflected by the staff analysis, as well as in Mr. Mirakhor's helpful statement and in Mr. Shaalan's and Mr. Sivaraman's statements, would be extremely challenging, but nevertheless achievable. I shall limit my statement to a few areas for emphasis.
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> As staff have highlighted, a comprehensive set of structural reforms is required to reinvigorate a credible pick-up in economic activity. Improvements in the tax system including efforts at broadening the tax base as well as strengthening the tax administration is one of the key areas in this regard. The authorities' intention to streamline the government machinery, introduce reforms in the civil service, and rationalize public expenditure without affecting "core" expenditure requirements such as health, education and social programs, could lead to increased efficiency and of course, the much-needed savings.
>
> However, these efforts will unrealistically be viable without making commensurate adjustment in the handling of the public enterprises which, for many years, had been a burden to the state. Staff have provided a glimpse of the privatization program for some of these state-run corporations which somehow do not appear to be convincing particularly in the schedule of

implementation. In view of the vital importance of this program, perhaps the staff's views on how it might be possible to hasten the pace of the privatization program would be welcome.

The expected on-going reforms in the financial sector are indeed encouraging. This chair concurs with the main elements incorporated in the current efforts to strengthen the financial system and improve the prudential regulations. The authorities' intention to insulate both the State Bank of Pakistan and the banking system itself from outside interference would provide the basic platform for improving efficiency and financial discipline.

To sum up, on the basis of the Policy Framework Paper prepared by the staff, we understand how critical it is for Pakistan to secure the assurance and trust of the multilateral institutions to continue to provide the assistance needed both in financial as well as in the form of technical expertise. The comprehensive and ambitious nature of the economic program that is being considered by Pakistan, during this difficult time, provide reasons why it deserves our full support, and we wish the Pakistani authorities every success in their efforts.

Mr. Andersen made the following statement:

I note with satisfaction that the proposed adjustment and reform program is heavily concentrated on structural changes which are long overdue, but it is also clear that the program presents significant downside risks associated with Pakistan's limited implementation capacity, and the generally weak macroeconomic situation, to which come the numerous implementation setbacks and reversals in the past. In this context, I share the concerns and uneasiness expressed by Ms. Lissakers and several others regarding the strength of the program and lack of specificity in a number of key areas. After all, the overall access under this program is quite significant, and while there is some backloading of purchases under the EFF, this is not the case for the concessional ESAF resources.

We have in previous program discussions on Pakistan provided significant benefit of doubt to the Pakistani authorities with only meager results in general, and the rather bleak track record of Pakistan strengthens the need for determined and timely policy implementation in the period ahead. Not only do programs which go off track hurt the country's credibility, but they also put this Board in an uncomfortable position when a new program with new promises is on the table after a series of failures, which, if we recall, were backed by commitments not fundamentally different from the present ones, although I acknowledge that the generally satisfactory implementation of the staff monitored program offers some comfort.

The program focuses largely on structural reforms in a number of important areas of the economy, such as the budget, the financial sector, governance and the trade regime. Major progress in all these areas is necessary, which we have repeatedly emphasized in this Board, in order to address the deep-rooted fiscal problems associated with lack of transparency in

budget management, a tax system with a much too weak tax base characterized by many waivers and exemptions, a heavy reliance on taxation of trade from which everybody suffers, and the numerous examples of shortcomings in the area of governance which have significantly hampered macroeconomic performance in the past. Also, I noted with concern that the banking sector is in a crisis situation aggravated by deteriorating governance, lack of credit discipline and overstaffing, with an alarmingly high share of nonperforming loans. As noted by Ms. Lissakers, more the Fund conditionality in this area, which can have very significant macroeconomic consequences, would have seemed appropriate. I hope that the authorities realize that sustainable progress for the Pakistan economy will depend on lasting efforts in all these areas which will also contribute importantly to strengthen and maintain the confidence of the markets and of the international community. While the number of action points for Pakistan to comply with under the program may indeed look tremendous, as pointed out by Mr. Sivaraman in his statement, they largely reflect the lack of sustained efforts in the past which naturally contributes to a continued lengthening of the necessary policy agenda, and I find it much easier to find areas where more ambitious efforts would seem appropriate than the opposite.

Let me add just one point in relation to the exchange rate policy. On last week's devaluation of the rupee, I would like to emphasize the importance of ensuring that the adjustment will be supported by the necessary tight monetary, fiscal, and incomes policy. We should be careful not to send the signal that an exchange rate adjustment is appropriate in itself and that a proactive managing of the exchange rate can be used to gain sustained competitiveness advantages, recalling that this institution was established to avoid competitive devaluations.

In conclusion, the program put forward is subject to considerable risks, but once more, I am willing to give the authorities the benefit of doubt by supporting the proposed decision, although I do it somewhat reluctantly. I base my support on the encouraging performance to date by the present government and the expectation that the authorities will ensure that their commitments will be met with firm and sustained implementation, and that they take additional corrective action to ensure achievement of the program objectives if needed, and seize every opportunity to move forward the implementation schedule where possible, including in the critical areas of broadening the tax base, strengthening the financial sector, promoting governance, and ensure a more liberal and open trade environment. Thus, full and sustained implementation is a must and, like Ms. Lissakers, I look forward to much stronger second and third year programs.

Mr. Lushin made the following statement:

The papers presented for today's meeting provide clear evidence of the great efforts undertaken by the staff in order to analyze the situation and assist the authorities in drafting the reform strategy. I think that this work deserves to be highly praised by the Board.

The Pakistan authorities seem to have launched a serious reform program, which displays strong adjustment efforts both in macroeconomic and structural areas. Given the authorities' radical commitment to implement their "home-grown" adjustment strategies, we can expect this reform endeavor to be more successful than the previous ones. Recent economic developments look encouraging as by the end of September all prior actions for the requested arrangements had been taken. Under these circumstances I consider Fund support to be timely and appropriate and I endorse the proposed decisions. At the same time, it is clear that the macroeconomic situation remains very fragile and I urge the authorities to follow the envisaged path of adjustment, since another setback would be detrimental to the country's credibility.

The staff papers provide a comprehensive analysis as well as proper policy recommendations, so I will limit my comments to just a few points.

Radical fiscal consolidation is a cornerstone of the whole reform program as it provides a basis both for the improvement in the monetary sector and stabilization of the external position of the country. I agree with Mr. Mirakhor that the seemingly modest fiscal adjustment (amounting to approximately 2 percent of GDP between 1996/1997 and 1999/2000) in fact represents a radical attempt at budget consolidation due to the deep cuts in import tariffs and income tax rates. The intention to improve compliance by reducing personal and corporate tax rates is understandable, but in the short-run this puts the budget under strong pressure. Since income taxes represent more than a quarter of total federal revenues, I share the doubts expressed by Mr. Sivaraman on the sustainability of revenue targets given the implemented cuts in tax rates.

In the area of financial sector policies, the most challenging task is to improve the performance of the state-owned banks. The fact that reforms in this sector have already been launched, alongside creation of a necessary legal framework, is encouraging. The success of these reforms will allow an eventual restoration of confidence in the national currency, which is rather low at the moment, judging by the rapid build-up of residents' foreign currency deposits over the last year. The latter phenomenon not only puts the country in a vulnerable position, but also incurs sizable quasi-fiscal losses due to the existing scheme of mandatory forward cover of deposits, denominated in foreign exchange. The program seeks to achieve progress in this area by attaining positive real interest rates for domestic currency instruments and also through a reduction in the need to attract nonresident FCDs. As steps in the right direction, these measures, however, will allow a shift in preferences toward domestic currency only gradually.

Concerning external sector policies, the program puts the right amount of emphasis on the need to develop the interbank foreign exchange market and envisages appropriate measures in this area. However, measures in promoting trade liberalization look insufficient. While the reduction of import tariffs is commendable, there still remains a protectionist orientation in import regulations, including at least 28 nontrade barriers and a list of 68 items forbidden for importation. Clearly the authorities need to strike a more

reasonable balance between protection of domestic industries and the necessity to open the economy. There are also anti-export biases in trade regulations, including numerous quantitative restrictions for nontextile exports. I wonder whether such a strongly regulated trade regime is consistent with the framework of market-oriented reforms. Apart from the losses in allocative efficiency, numerous trade barriers are not conducive for good governance. I hope that in the context of the first review, an agreement would be reached on a timetable for phasing out the remaining quantitative restrictions on imports, as it is noted in paragraph 35 of the staff report. Also I find it useful to extend the same approach to exports.

In conclusion I would like to restate my endorsement of the proposed decisions and wish the Pakistan authorities success in their reform efforts.

Mr. Ismael made the following statement:

We would like to join other speakers in commending the Pakistani authorities for their satisfactory implementation of the Staff Monitored Program which has provided the basis for the launching of the proposed adjustment and reform program. The present program is comprehensive and well integrated and focuses appropriately on a wide range of key structural measures. As noted by many speakers, the program is ambitious, but if it is well implemented, this program can certainly help to reverse the deterioration in financial and macroeconomic balances and help the economy to achieve higher growth rates. The taking of all the prior actions is a positive development which augurs well for the program. However, we would add that this commitment needs to be sustained, and the authorities should avoid at all costs a return to the stop-and-go adjustment efforts of previous years.

Overall, we are in broad agreement with the staff analysis and policy recommendations. However, on fiscal adjustment,, while we agree that a sustained effort is needed to increase government revenue and reduce outlays, we would also add that we share the concerns of Mr. Sivaraman as regards agricultural subsidies and income tax on small farmers. This is a policy that needs to be carefully considered, because it could have unexpected adverse effects, especially if this policy causes the small farmers, either to stop producing the small surpluses for the market or simply close their farms and move into the cities. Perhaps a way could be found to limit the application of this policy to the larger landholders only.

On the reduction of import tariffs, we note the short -term adverse effects on government revenue and the need for caution in projecting revenue. Nevertheless, we support the programmed reduction in tariff, and would note that to be successful the new system needs to be fully transparent and that exemptions must be very limited. Also, strengthening of tax and customs administration must be steadfastly pursued.

As regards financial sector policies, we are encouraged by the determined effort of the authorities to reform the banking system. We welcome the indication in Mr. Mirakhor's statement that the authorities have made

progress in this area, and that an improved legal framework for loan recovery, including a new law, is in place. However, the size of the bad loans in the state banks is a source of concern, and we would urge the authorities to address this problem on an urgent basis. In this regard, we wonder if the staff could indicate if the new law will make it easier for the authorities to recover the loans from the 250 defaulters who account for 70 percent of the total amount in defaults, and also have the authorities started to apply the new law?

Overall, while welcoming this program, we note that it is quite ambitious, and may tax the implementation capacity of the country. We would, therefore, support the provision of appropriate technical assistance to Pakistan.

In conclusion, we welcome the successful first steps in the implementation of the present program, and encourage the authorities to maintain the momentum of adjustment and to build on the present achievements in the macroeconomic and structural areas. We support the proposed decision and wish the authorities well in their efforts.

Mr. Erasmus made the following statement:

Let me at the outset state our support for the authorities' request for arrangements under the ESAF and EFF.

This program contains two notable aspects. First, the commitment that has been demonstrated by the authorities. The government has been in office for only a few months and has been able to reach consensus on a program that can justifiably be labeled as "home grown." Some important actions have already been taken in the areas of trade liberalization, tax administration, budget management, and financial sector reform. The front loading of expenditure reduction is another indication of the government's commitment.

The second point to be noted is the diversity of the reform effort. This represents a strong effort to change the structure of the economy. Such a broad-based strategy is certainly in line with what is needed at this stage to raise the performance of the economy.

This is certainly an ambitious program, with little room for slippages. Given Pakistan's past history, that has been referred to by others, I would, therefore, encourage the authorities to persevere in their efforts order to build confidence of the private sector and the international community, both of which are expected to play a major role in helping the authorities to turn the economy around.

Fiscal consolidation, which is the centerpiece of the stabilization effort, appears to be on track. However, it is important that the authorities maintain vigilance with regard to improving revenue performance. Also the performance of public enterprises should be watched closely.

With these observations, I extend my best wishes to the authorities.

Mr. Issaev made the following statement:

We commend the determined efforts of the new government in halting the deterioration in financial and macroeconomic balances and in reinforcing structural reforms. The implementation of the stabilization and structural measures under the staff-monitored program as well as of all prior actions for the requested ESAF and Extended Arrangements is a further indication of the authorities' resolve in pursuing the adjustment and reform process. We encourage the Pakistani authorities to maintain the momentum of reforms.

The proposed medium-term adjustment and reform program appears comprehensive and ambitious. As I am in broad agreement with the priorities and policies of the program, I will be brief.

The macroeconomic situation is still fragile. Therefore, strict adherence to the program is required in order to avoid pressures that could affect the authorities' goals. Bold implementation of the stabilization measures and the acceleration of structural reforms in the fiscal area, enterprise sector, banking system and foreign exchange market must be a priority of the highest order.

The adjustment needed in public finances remains a difficult challenge for the authorities. The existing deficit will not be sustainable, and forceful efforts are needed to increase revenues and to contain unproductive expenditure. In that regard, we welcome the authorities' firm intention to strengthen tax administration and to reform tax and tariff systems as well as to improve the composition of government expenditure. At the same time, steady work will be required to improve the operations of the public enterprises and financial institutions, to enhance the efficiency of the civil service, and to rationalize federal-provincial fiscal relations.

It is evident from the staff report that Pakistan's external position remains highly vulnerable due to the large exposure on account of foreign currency deposits. Thus, the authorities' plan to embark on a strategy to exit from the provision of forward coverage for foreign currency deposits and to develop an interbank foreign exchange market is welcome. In the meantime, every step should be taken to avoid policy slippages which will change investor sentiment and cause capital outflows.

The staff warns that there are some downside risks associated with the strain that the program will put on the country's limited implementation and administrative capacity. Therefore, careful monitoring and essential technical assistance by the Fund and Bank will be crucial for the success of the program.

With these remarks we support the proposed decisions and wish the Pakistani authorities success in implementing their challenging program.

Mr. Goffinet made the following statement:

In recent years, Pakistan has seesawed between good and disappointing policies. Fortunately, the most recent developments have restored Pakistan's

economic prospects and give reason to hope that the new government has drawn the right lessons from failed past attempts to address economic problems. The authorities' recognition of the need to move forward with a broad adjustment program combining stabilization with a meaningful reform package is encouraging. Pakistan's observance of the targets under the staff-monitored program and the taking of the prior actions required for the requested loan programs are promising.

Since I broadly agree with the staff paper, I can be brief.

A core element of the reform program is adjustment of the fiscal imbalances. Besides revising the structure of expenditures, an additional important element of fiscal consolidation is reformation of the tax system. The planned expansion of the income tax base generally, and the imposition of a meaningful agricultural income tax in particular, will be major challenges. The reform in this area must be pursued with determination.

A second major element and challenge of the reform process will be correcting the major deficiencies of the fragile financial system, which faces serious problems. In fact, poor governance, a frivolous credit policy, and serious overstaffing have eroded the financial sector's profitability and weakened its capital base. Nonperforming loans make up 20 percent of the total outstanding portfolio, which by international standards is an alarming situation. I can only urge the authorities to proceed firmly in accelerating the reformation of the banking sector. I gather from the staff paper that not all of the bad loans are owed by potential insolvent debtors, since an incentive package is being offered to persuade defaulters to voluntarily repay their overdue loans. Could the staff give us some details about this specific group of bank customers at whom this incentive is aimed and tell us how important it is in relation to the global nonperforming loan portfolio?

It is essential for the Pakistani authorities to pursue their reform program with determination, with no slippages and no retreat, if confidence in the economy is to be restored. This being said, I can support the proposed decision and wish the authorities all the success in their endeavors.

Mr. Lucenti made the following statement:

We may say that, in the last few years, the experience of Pakistan, regarding macroeconomic adjustment, has not been a good one. The authorities' unsuccessful attempts to address Pakistan's economic imbalances generated high costs for the country in terms of GDP growth, employment and inflation. However, the new government implemented a home made reform program aimed at improving the macroeconomic stance and decisively carry out the structural reform agenda. In fact, during the last several months macroeconomic conditions have improved and the end-September targets under the staff-monitored program have been observed. In addition, all prior actions for the requested ESAF and Extended Arrangement have been taken. Therefore, we support the Pakistani authorities' request of an EFF and ESAF

arrangements, particularly, given that the new government has proved to have a strong commitment to follow through with the program.

Although the adjustment program could have been more precise in some targets, benchmarks and schedules, it is comprehensive and very ambitious. I will not go over the extended details of the program, since, in this matter, the staff did an excellent job. However, I would like to make some brief comments on three issues of my concern: exchange rate policy, monetary policy and policy implementation.

The foreign exchange market, in its transition period toward a more efficient market, will still be affected by the official forward cover scheme. According to this scheme, as I understand it, the State Bank of Pakistan guarantees the exchange rate to any deposit denominated in foreign currency that the bank receives from the financial system. When this deposit is withdrawn, it is done at the same exchange rate. If the SBP's foreign exchange assets are lower than the amount of foreign exchange deposits covered, as indeed they are, then, each time a decision has to be made on whether to devalue the domestic currency, implicitly there is also a decision of incurring foreign exchange losses for the SBP. This constraint and its consequences over the consolidated fiscal deficit may deter or delay the authorities' decision in taking any measure aimed at keeping the economy's competitiveness which is the main goal of the foreign exchange policy. Therefore, I welcome the authorities' intention to shift to the private sector the forward cover scheme, hoping that this can be done the earliest as possible.

Another cause of concern is the weak transmission mechanism of monetary policy. The fact that the increase in the SBP's repo rate (and in the yield of short-term government bonds) did not affect the deposit rate nor the lending rate which show a very high spread, has forced the authorities to open a temporary special deposit facility at the SBP with a return of 17 percent, affecting consequently, the SBP's quasi fiscal deficit. This situation may reflect the weakness of the banking system and the lack of credibility in the fiscal adjustment which reinforces the need to step up the restructuring and privatization of public banks, as well as to strengthen the fiscal discipline.

Finally, slippages in policy implementation and policy reversals have been the main cause of program failures in the past. Usually, it is not the design of the program that fails but it's implementation. Poor implementation originated a loss of government credibility and consequently a loss of national and international support. The problem here is that policy implementation which is the downside risk of the new program, is interrelated with many other issues like insufficiently prepared civil servants, weak public institutions and governance issues, among others, making it look like a vicious circle. To break this circle it is important to continue and increase the efforts to reform the educational and judicial systems and also a close monitoring, as suggested by the staff, perhaps mixed with technical assistance from multilateral institutions, as well as the hiring of well-prepared people to manage the most important reform projects, may help increase Pakistan's implementation capacity.

I wish the authorities every success in their difficult tasks.

Mr. Donecker said that he supported the authorities' request for arrangements under the ESAF and the EFF, in the expectation that the authorities would do their utmost to meet the targets of the program.

The staff representative from the Middle Eastern Department noted that the amount of nonperforming loans was estimated at PRs 127 billion; as of mid-September, PRs 7 billion had been recovered, of which PRs 1.3 billion was under the voluntary repayment loan scheme offered by the authorities. An additional PRs 10.7 billion would be recovered by December. On this basis, about PRs 62 billion—about half the total amount of nonperforming loans—would be written off.

Mr. Mirakhor thanked Directors for their comments, which he would faithfully and promptly transmit to the Pakistan authorities. The authorities had implemented most of the measures that the Board had asked for on earlier occasions; indeed, he was grateful to Mr. Grilli for having emphasized some of those accomplishments. He wished to thank the staff for its hard work in assisting the authorities with the program.

The Acting Chairman made the following summing up:

> Directors agreed with the thrust of the staff appraisal. They were encouraged by the important steps undertaken by the new government to arrest the deterioration in macroeconomic balances, and to carry forward a wide range of structural reforms aimed at opening up the economy and raising its efficiency. They welcomed the observance of most of the targets under the staff-monitored program.
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> Directors noted that the adjustment and reform steps already implemented are an encouraging sign of ownership of the proposed program. They welcomed the implementation of the new federal/provincial revenue-sharing arrangement and the initial actions that had been taken in the areas of tax and tariff reform, banking reform, and public sector restructuring and downsizing, which demonstrated the government's commitment to reforms. At the same time, Directors emphasized that the macroeconomic situation remains fragile and structural weaknesses are still pervasive. In particular, the budget deficit continues to be too large and the structure of taxation and expenditure is distorted. Also, there had been a deterioration in the finances of major public enterprises and monetary policy remained constrained by weaknesses of the banking system.
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> Moreover, pointing to Pakistan's poor track record under past Fund-supported programs, Directors stressed the critical importance for the authorities of implementing their adjustment and reform program steadfastly and of correcting promptly deviations from the program. They observed that a repeat of the stop-and-go policies entailed a high cost to the Pakistan economy, including negative effects on the confidence of donors and investors. Directors emphasized the need for close monitoring of policy implementation under the program, including reporting to the Board as needed.

Directors thought the authorities' envisaged adjustment and reform strategy is ambitious and comprehensive. However, many Directors considered that there is a lack of specificity as regards the timetable for key structural measures, including in the areas of banking reform, privatization, and trade liberalization. They looked forward to greater specification in these aspects at the time of the next review.

Directors attached critical importance to a reduction in the budget deficit. Indeed, many Directors considered that the envisaged path of fiscal adjustment could have been more ambitious, as the budget deficit is a major source of macroeconomic imbalances in Pakistan. Accordingly, Directors emphasized the need to strengthen tax administration and to improve the structure of taxation. Directors felt that it is crucial to extend the General Sales Tax to the retail sector and to accelerate the transition to full reliance on the invoice-based system in order to promote greater documentation and tax compliance. Directors also attached importance to the planned review of the income tax and to the ongoing efforts to enhance the taxation of agricultural income. Directors welcomed the government's commitment to reinstate the automatic petroleum pricing mechanism by December 1997. Directors urged the authorities to stand ready to respond rapidly to any emerging slippages in revenue collection and to take any additional action that might be necessary to protect the budgetary targets.

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

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

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

Directors stressed the importance of making more progress with tariff reduction, urging the authorities to consider an intermediate tariff reduction step in June 1998. They also underscored the benefits that may be expected from the planned further simplification of the tariff structure and the envisaged phasing out of remaining quantitative restrictions on imports. Directors attached importance to the strategy to exit from the central bank-provided

forward cover and to develop an interbank foreign exchange market. They welcomed the recent exchange rate action and stressed that this must be backed by tight macroeconomic policies and structural reforms to ensure competitiveness and export diversification.

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

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

The view was expressed that the use of bonded child labor adversely affected not only economic efficiency in Pakistan, but also the support of some donor countries. While taking note of the ongoing efforts of the authorities, in collaboration with other international institutions such as the International Labor Organization and UNICEF, to ameliorate the child labor problem, Directors encouraged them to persist in addressing it decisively.

It is expected that the next Article IV consultation with Pakistan will be held on the standard 12-month cycle.

The Executive Board took the following decision:

Extended Arrangement

1. The government of Pakistan has requested an Extended Arrangement in an amount equivalent to SDR 454.92 million for a period of three years.

2. The Fund approves the Extended Arrangement set forth in EBS/97/185, Supplement 2.

Decision No. 11589-(97/104), adopted
October 20, 1997

The Executive Board took the following decision, with Mr. Autheman objecting:

Enhanced Structural Adjustment Arrangement

1. The government of Pakistan has requested a three-year arrangement under the Enhanced Structural Adjustment Facility and the first annual arrangement thereunder.

2. The Fund notes the policy framework paper for Pakistan set forth in EBD/97/110.

3. The Fund approves the arrangements set forth in EBS/97/185, Supplement 3.

Decision No. 11590-(97/104), adopted
October 20, 1997

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/97/103 (10/17/97) and EBM/97/104 (10/20/97).

3. PORTUGAL, AND NAMIBIA—ARTICLE IV CONSULTATIONS—POSTPONEMENT

Notwithstanding the period of three months specified in Procedure II of the document entitled "Surveillance over Exchange Rate Policies" attached to Decision No. 5392-(77/63), adopted April 29, 1977, as amended, the Executive Board decides that the period for completing the next Article IV consultation with Portugal shall be until October 17, 1997 and the period for completing the next Article IV consultation with Namibia shall be until October 22, 1997. (EBD/97/113, 10/14/97)

Decision No. 11591-(97/104), adopted
October 17, 1997

4. ANDORRA—TECHNICAL ASSISTANCE

In response to a request from Andorra for technical assistance, the Executive Board approves the proposal set forth in EBD/97/114 (10/14/97) with one objection.

Adopted October 17, 1997

5. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 97/39, 97/57, and 97/60 are approved.

6. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAM/97/160 (10/14/97) and EBAM/97/161 (10/16/97), by Advisors to Executive Directors as set forth in EBAM/97/161 (10/16/97), and by an Assistant to Executive Director as set forth in EBAM/97/159 (10/14/97) is approved.

APPROVAL: November 29, 1999

SHAILENDRA J. ANJARIA
Secretary