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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 92/140

10:00 a.m., November 25, 1992

M. Camdessus, Chairman
R. D. Erb, Deputy Managing Director

Executive Directors	Alternate Executive Directors
M. Al-Jasser	A. A. Al-Tuwaijri
G. K. Arora	
	Wei B.
T. C. Dawson	M. E. Hansen, Temporary
	J. Prader
	V. Kural, Temporary
E. A. Evans	
R. Filosa	I. Papadakis
	J. A. Solheim
H. Fukui	N. Tabata
	M. Nakagawa, Temporary
	K.-T. Hetrakul
D. Kaeser	
A. Kafka	J. C. Jaramillo
	G. Y. Glazkov, Temporary
J.-P. Landau	P. Bonzom, Temporary
	G. Torres
A. Mirakhor	O. Kabbaj
L. J. Mwananshiku	
D. Peretz	
G. A. Posthumus	
	T.-M. Kudiwu, Temporary
S. Schoenberg	B. Esdar
A. S. Shaalan	Y. Y. Mohammed
D. E. Smee	G. F. Murphy
A. G. Zoccali	

L. Van Houtven, Secretary and Counsellor
K. S. Friedman, Assistant

Also Present

IBRD: R. Bendokat, South Asia Regional Office. Central Asia Department: D. J. Goldsbrough. External Relations Department: S. J. Anjaria, Director; G. P. Newman. IMF Institute: S. Nawaz. Legal Department: J. K. Oh. Middle Eastern Department: P. Chabrier, Acting Director; M. A. El-Erian, Z. Iqbal, S. S. Rizavi, G. Shabsigh, S. M. Tareq, S. K. Wajid. Monetary and Exchange Affairs Department: M. Quintyn, M. R. Vaez-Zadeh. Policy Development and Review Department: J. T. Boorman, Director; T. Leddy, Deputy Director; S. B. Brown, H. M. Flickenschild, A. C. A. R. Furtado, S. Kanesa-Thasan. Research Department: M. Mussa, Economic Counsellor and Director; M. S. Khan. Secretary's Department: A. Jbili, A. Leipold. Treasurer's Department: L. U. Ecevit. Western Hemisphere Department: S. T. Beza, Counsellor and Director. Personal Assistant to the Managing Director: R. Saunders. Advisors to Executive Directors: M. A. Ahmed, M. B. Chatah, R. F. Cippa, S. K. Fayyad, B. R. Fuleihan, N. Mancebo, A. Raza. Assistants to Executive Directors: B. Abdullah, T. Berrihun, G. M. Blome, Chen M., J. A. Costa, S. B. Creane, A. Galicia, C. Gaseltine, J. Jonas, K. J. Langdon, J. Mafararikwa, S. McDougall, T. P. Thomas, R. Thorn, J. W. van der Kaaij, A. Viirg, S. Vori.

1. EXECUTIVE DIRECTOR

The Chairman welcomed Mr. Schoenberg as Executive Director for Germany.

2. UNAUTHORIZED DISCLOSURE OF INFORMATION

The Executive Directors, meeting in restricted session, discussed a recent unauthorized disclosure of information.

3. PAKISTAN - 1992 ARTICLE IV CONSULTATION; AND PURCHASE TRANSACTION - EMERGENCY ASSISTANCE

The Executive Directors considered the staff report for the 1992 Article IV consultation with Pakistan and Pakistan's request for emergency assistance (EBS/92/174, 11/4/92). They also had before them a background paper on recent economic developments in Pakistan (SM/92/198, 11/11/92).

Mr. Mirakhor made the following statement:

> My Pakistan authorities greatly appreciate the excellent work done by the staff in the course of the 1992 Article IV consultation and their prompt response to Pakistan's request for emergency assistance following the large-scale floods that hit Pakistan in early September 1992.
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> The staff report provides a vivid description of the widespread destruction that has been caused by the floods. Suffice it to say that the degree of human hardship and physical destruction wrought has been unprecedented. The authorities' immediate response has been to conduct rescue and relief operations and to launch a comprehensive rehabilitation program without seriously overburdening the budget. In this context, a series of measures are being formulated, aimed at mobilizing additional real resources and rearranging spending priorities, while safeguarding key investments in the social sector.
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> In addition to the immediate financing needs, the floods have clouded the macroeconomic outlook for 1992-93. Growth, inflation, and the external accounts will all be adversely affected. The fiscal outlook has been altered on account of substantial revenue losses and the requirements of relief and rehabilitation expenditures. In order to ensure that the financial requirements do not significantly disrupt the underlying adjustment program, the authorities imposed a temporary import surcharge and mobilized additional contributions, which, along with the use of Zakat and Bait-ul-Mal resources, provide for the full funding of urgent relief operations from domestic resources.

It is estimated that the direct balance of payments impact of the flood--comprising lower export receipts and larger imports--would be of the order of $710 million, implying significant additional pressures on an already weak external position. Taking account of disbursements from existing commitments, and assuming the timely release of flood-related assistance from the World Bank, the Asian Development Bank, and the approval of the emergency assistance purchase, it is expected that there will be a gross reserve drawdown of some $75 million in 1992-93 and a decline in the import cover to below four weeks of imports. It is clear that Fund financial support of emergency assistance will be crucial to meeting a part of Pakistan's immediate financing requirements, the absence of which would place an inordinate burden on the country's own limited foreign exchange reserves. Fund financing would also galvanize resources from other official sources, provide a much-needed cushion for the authorities' ongoing program of structural reform, and through its positive effects on domestic and external confidence, minimize the risk of disruptive capital outflows.

Prior to the floods, significant progress was made in the implementation of economic reforms. Real growth in GDP accelerated to close to 8 percent, while inflation slowed. The strong growth performance emanated from a broad-based expansion of all major sectors. Agriculture output expanded on the strength of a record cotton crop; industrial output grew rapidly with the manufacturing sector displaying particular dynamism. There was a 34 percent rise in real private investment in large-scale manufacturing. In the external sector, despite a marked deterioration in the terms of trade and an adverse world economic situation, the trade balance narrowed, as exports rose by 24 percent in volume terms. The much-improved structural policy environment elicited a more than doubling of foreign direct and portfolio investment inflows; a significant upgrading of the economy's capital and export base took place, as evidenced by a 55 percent increase in machinery imports. The combination of higher private capital inflows and a more efficient utilization of aid from the pipeline enabled a modest, though notable, strengthening of the gross external reserves position.

These developments reflect the favorable supply response of the economy to the bold and comprehensive program of fundamental structural reforms. These include investment and price decontrol; trade and payments liberalization; opening up of areas previously reserved for the public sector; and the successful implementation of the first phase of an ambitious privatization program. As Directors noted during the previous Board discussion on Pakistan, in a number of important respects, the authorities' reform agenda went beyond the commitments specified under the Structural

Adjustment Facility (SAF), and its effective implementation has already yielded considerable benefits for the Pakistan economy.

Although fiscal performance in 1991-92 improved relative to the preceding year, the reduction of the fiscal deficit by some 4 percent of GDP in one year proved to be too ambitious. While some domestic slippages did occur, the economy was also subjected to adverse exogenous shocks. These exogenous developments included adverse movements in the price of petroleum and cotton and the associated large fiscal revenue losses arising therefrom, as well as the sharp decline in the external terms of trade compared with the program assumption of an improvement. Furthermore, the special transitional difficulties associated with reforms in the financial sector adversely impacted on monetary aggregates and made the task of achieving the target even more difficult. Finally, higher development expenditures, arising from, paradoxically, the authorities' considerable success in accelerating the pace of disbursements from the aid pipeline, added to the overall fiscal deficit.

Taken together, these factors posed a formidable challenge to policymaking. As the staff report notes, the authorities did take additional measures during the course of the year to restrain the momentum of aggregate demand. Even if these actions proved insufficient to secure a rapid convergence to the originally programmed path of adjustment, Pakistan's performance in 1991-92 was consistent with the long-term objective of sustained and noninflationary growth supported by strong external viability. Economic growth, investment, exports and private capital inflows responded exceptionally well, reflecting growing domestic and external confidence in the authorities' policies. More specifically, the economy's productive structure was modernized; the exchange rate was managed in a prudent manner; inflationary pressures were contained; the fiscal deficit was reduced; the external position strengthened; and, finally, the authorities' ambitious structural reform agenda was pursued with determination.

There was little indication in 1991-92 that the strength of domestic demand had adversely affected export performance. Indeed, despite a 5.8 percent fall in export unit values, weak external demand, and barriers to market penetration, exports rose by 17 percent overall (24 percent in volume terms) with nontraditional--mainly manufactured--exports expanding by 16 percent. This performance contributed to a narrowing of the trade deficit. Despite the improvement in the trade balance, the current account deficit rose.

While this might appear at first glance to be the ineluctable consequence of accommodative financial policies, a correct interpretation requires consideration of a number of factors that have a direct bearing on the deterioration in the current account. Among these, the most important is, first, the fact that Pakistan suffered a 3.1 percent deterioration in the external terms of trade; at constant relative prices, the increase in the current account deficit would have been much less. Second, the rapid growth in private sector imports was associated with a marked shift in the composition of imports toward machinery and equipment, which will contribute to the modernization of the economy's capital stock, strengthen and expand the productive capacity of the economy, and thus enhance prospects of continued strong output and export growth. Third, the recorded decline in workers' remittances reflected not so much an exogenously induced fall in resource transfers to the economy from abroad as a statistical reclassification of a portion of these inflows following the liberalization of the rules governing holdings by residents of foreign currency accounts. In other words, workers' remittances, which previously reduced the current account, are now recorded in the capital account of the balance of payments as a financing item.

Be that as it may, the authorities recognize that, despite the recent strengthening of the gross official reserves position, Pakistan's reserve level remains tenuous, and there is a clear need to bolster the "reserve cushion" to support the authorities' ongoing structural reform program as well as to guard against contingent risks.

The authorities' policy stance for 1992-93, formulated prior to the floods, focused on deepening progress in the structural area with a tightening of macroeconomic policies. Accordingly, economic growth was expected to be maintained at a high rate against the backdrop of a further easing of inflationary pressures and a strengthened external position. In the structural area, emphasis was placed on further liberalization of the exchange and trade regime, consolidation of financial sector reforms concurrent with a move toward indirect monetary controls, a strengthening of the tax base, and accelerated privatization. A number of important measures were taken in the context of the 1992-93 budget to broaden the tax base--including extending the system of income tax collection, reducing General Sales Tax (GST) exemptions and intensifying GST audit procedures. The authorities also enhanced the developmental impact of budgetary expenditures through the implementation of the Social Action Program. These actions were aimed at achieving a significant reduction in the overall budget deficit and a much tighter monetary policy stance.

Despite the severity of the consequences of the floods, there has been only a brief pause in the intensification of the adjustment program, as the Government moved quickly to deal with the flood damage. Nevertheless, the authorities took interim action to protect the underlying path of adjustment: a temporary import surcharge was levied, voluntary contributions were mobilized from public entities and government employees, strict limits were placed on flood-related budgetary outlays, and, in the monetary area, steps were taken to increase the flexibility of rates of return on government securities.

The Pakistan authorities remain strongly committed to pursuing their reform agenda in the context of a sustainable macroeconomic and financial framework. With respect to financial policies, the authorities are in the process of formulating a set of measures aimed at further enhancement of revenues and curtailment of expenditures as well as strengthened demand-management policies. To consolidate the gains already made under the financial sector reform program and contain inflationary pressures, the authorities intend to restrain liquidity growth through the credit plan currently under preparation that could support the productive sectors without creating additional financial pressures. Accordingly, the authorities have indicated their intention to resume policy discussions with the Fund staff soon after Executive Board consideration of the 1992 Article IV consultation. These discussions will assist in implementing appropriate policies in the context of a revised medium-term framework.

The authorities wish to assure the Executive Board that the adverse consequences of the floods have not diminished their resolve to persevere with their growth-oriented reform and adjustment program. Indeed, it is their hope that the forthcoming discussions with the staff will pave the way for a successor Enhanced Structural Adjustment Facility (ESAF) arrangement.

Mr. Shaalan made the following statement:

As you know, in my former capacity I had the privilege of heading the Article IV consultation missions to Pakistan this past summer. As you also know, until a few weeks ago, Pakistan was represented by this chair. The fact that the authorities and the staff are in agreement on most important issues has made my task today a lot easier.

At the outset, I would like to express (through Mr. Mirakhor) our sympathy with the people and Government of Pakistan for the tragic losses in life and property brought about by the devastating floods last September. The data provided in the staff report on the flood damage, though preliminary, are quite striking. The authorities should be commended for the manner in which they responded to the immediate emergency needs of the affected regions. We also strongly welcome their commitment--notwithstanding the disruptive effects of the floods--to pursue their reform agenda in the context of a sustainable macroeconomic framework, as indicated in Mr. Mirakhor's statement. Undoubtedly, external aid, including Fund emergency assistance, is critical to mitigate the impact of the disaster on the balance of payments. We therefore fully support the requested purchase of 25 percent of quota, which in our view is fully in line with the Fund policy on emergency assistance.

Pakistan's economic performance in recent years has, in many respects, been quite favorable. Real sector developments in 1991-92 were particularly impressive, with output and exports recording healthy rates of growth. The sharp increase in real investment by the private sector (both domestic and foreign) is particularly welcome as an indication of further increases in growth potential in the future. There is no doubt that this performance is due, in good measure, to the wide-ranging structural reforms that have been implemented in recent years, including in particular exchange and trade reform, investment decontrol, and privatization. The fact that this performance has coincided with a rather turbulent period in Pakistan's political life is indicative of a robust private sector. These considerations bode well for sustained and rapid growth in the years ahead. Of course, one should not forget that Pakistan is still a low-income country, with enormous social and developmental needs, and an annual population growth rate of more than 3 percent. Therefore, a relatively high rate of GDP growth should be among the authorities' primary economic objectives. Stable macro policies, as well as continued progress on structural reforms, are important ingredients to achieve this objective.

Let me now make a few specific comments on fiscal, monetary, and external sector policies, in that order.

I think we can all agree that fiscal policy is central to the success of Pakistan's adjustment and reform program. I have no doubt that adverse exogenous factors have contributed to the financial slippage last year. But it is also clear that the authorities will need to strengthen their fiscal effort in the period ahead, particularly if the impact of the recent floods is to be contained.

While on fiscal issues, let me make three brief observations. First, with respect to expenditures, the problem, in my view, is not so much the level of spending. In fact, compared with other countries, spending relative to GDP in Pakistan does not seem to be excessive. But with interest payments currently absorbing a significant part of expenditures, an improvement in the structure of fiscal expenditures will depend, among other things, on the authorities' success in reducing the public sector borrowing requirement.

Second, although revenues in 1991/92 fell short of the target, a positive element of the fiscal performance is that the increase in revenues resulted mostly from structural reforms in the tax system. It is our hope that the authorities will make progress in bringing agriculture under the tax net. This should remain a priority objective, given that an important part of the economy is currently untaxed.

Third, as far as the 1992/93 budget is concerned, I note that, even before the floods, the authorities had intended to adopt additional measures in the course of the current fiscal year. The need for such measures is obviously greater now, and we are confident that a comprehensive fiscal package will be adopted soon.

Turning to monetary developments, one issue that is alluded to on page 9 of the report is the possibility that financial sector reform may have complicated macroeconomic management, at least in the short term. If so, it would not be the first time that the pace of, otherwise desirable, reform in one sector has a negative impact on other sectors or other areas of economic performance. The problem is that it is often difficult to control the pace and sequence of reform in a clear and predetermined manner. While on this issue, experience has demonstrated that in developing countries financial reform is often hampered by the existence of a number of institutional shortcomings. Among these are inadequate intermediation, the rudimentary nature of financial markets, and, more importantly, the limited administrative capacity to implement the reforms effectively.

On the external sector, we welcome the improvement in the trade balance in 1991/92, resulting mainly from the sharp rise in export volumes, which more than offset adverse price developments. We are also pleased to see that the medium-term outlook of the balance of payments continues to be positive, notwithstanding the large short-term impact of the recent floods. Let me make two additional observations on the external sector.

First, on the question of the foreign currency accounts as a source of balance of payments financing, I believe it is difficult to measure in advance the stability or volatility of these assets. The authorities' judgment, as well as the staff's caution on this matter, are both understandable. But what is clear--and on this both sides agree--is that a significant increase in external reserves will be needed over the medium term, particularly as the process of external sector liberalization strengthens further.

My second observation is that the increase in exports has occurred despite impediments to market access for important sectors like textile. I can only agree with the authorities' concern about protectionist policies in major industrial countries, particularly in industries where developing countries are clearly more competitive.

I have not said much about structural policies, mainly because the authorities' reform program is proceeding well and, in some respects, such as privatization, better than originally planned, despite the absence of a developed capital market which is usually critical for successful privatization. While still on this issue, let me also stress the importance of increasing competition--and where necessary strengthening the regulatory framework--to ensure that privatization will indeed produce the expected efficiency gains.

More generally, and as I said earlier, the success and sustainability of structural reform depend critically on macroeconomic stability. This implies more fiscal adjustment. It also implies more financing to support the reserve buildup necessary for financial stability in the interim period. It is our hope that the forthcoming discussions between the authorities and the staff will set the stage for an economic program that can be supported by ESAF resources.

Let me conclude by supporting the proposed decisions and wishing the authorities every success in the challenging tasks ahead.

Mr. Al-Jasser made the following statement:

Since Pakistan embarked on a comprehensive adjustment program supported by the SAF arrangement, impressive and commendable structural reforms have been implemented. These results are all the more significant, given the severe unanticipated shocks that have confronted the economy over the past several years, be it a deterioration in the terms of trade, political uncertainty, reduced foreign aid prospects, heightened regional tension, or the most recent devastating floods. While these shocks have prevented the full realization of the program targets and, at times, have contributed to a slackening in the reform efforts, the authorities persevered with the general thrust of the adjustment strategy.

It is heartening to note that the authorities' extensive economic reforms, including a liberalization of the exchange, trade, and foreign investment regimes, an ambitious privatization program, and the deregulation of domestic economic activity, have fostered a favorable supply-side response. Indeed, per capita income rose steadily, exports expanded markedly, especially nontraditional exports, and domestic investment increased. The significance of these developments is reinforced by the accompanying invigoration of the private sector and the large inflows of foreign direct and portfolio investments. In short, the reform program is beginning to bear fruit.

As indicated in Mr. Mirakhor's helpful statement, the authorities recognize the importance of consolidating these achievements through a deepening and intensification of the reform efforts. However, it is equally important to ensure that the slippages in financial policies do not derail the gains realized on the structural front. Consequently, a tightening of financial policies is crucial. This has been rendered all the more important and difficult by the recent floods.

Like most cases, that fiscal consolidation has been the Achilles' heel of the adjustment program, although progress has been made in the 1991/92 program, compared with the 1990/91 program. Nevertheless, the SAF targets were not attained, owing to a combination of adverse exogenous developments and domestic policy slippages. However, within the context of Pakistan's weak fiscal structure, a fiscal consolidation target of 4 percentage points of GDP may have been somewhat overambitious. This is underscored by the fact that discretionary measures are needed in Pakistan to achieve a standstill in the deficit, thereby rendering the necessary fiscal effort to achieve the program target greater than 4 percentage points of GDP.

In this context, the recent increase in revenues of 2.5 percentage points of GDP is noteworthy, particularly because it included measures to broaden the tax base and increase the yields of existing measures. Nevertheless, more needs to be done, and I share the staff's view that bold actions are needed to improve further the elasticity and structure of the tax system. Turning to expenditures, where much of the slippages occurred, I do not believe that, for a developing country such as Pakistan, total government expenditures of about 26 percent of GDP are excessive, especially given the need to improve social services.

Clearly, the recent floods have greatly complicated the task of fiscal consolidation. Here, I welcome the authorities' prompt introduction of compensatory measures. Despite these commendable measures, the overall budget deficit is projected to reach 8 percent of GDP. Fiscal deficits of this magnitude are unsustainable and call for a realistic and resolute medium-term plan to strengthen public finances. The authorities' intention to implement additional deficit-reducing measures, with a view to strengthening the structure of the budget, is welcome. It is hoped that appropriate and effective mechanisms are also developed to include the agricultural sector in the tax net.

An improvement in public finances will facilitate the authorities' monetary reforms and reduce the pressure on international reserves. Regarding monetary reforms, while I welcome the progress made towards indirect monetary control, I share the staff's concerns about the system of credit-deposit ratios, as it tends to reduce the incentive for deposits mobilization and to increase that for currency substitution. Consequently, it is important to ensure the transitional nature of this system. I am also concerned about the marked increase in foreign currency accounts, given that these inflows could be reversed easily, and that a significant fraction of this foreign exchange has been used by the authorities. Hence, it is important to increase Pakistan's international reserves, which can best be brought about through a tightening of the financial position.

Regarding the external accounts, I am particularly encouraged by the sustained strong performance of exports and the consequent narrowing of the trade deficit. Nevertheless, despite these improvements, the current account deficit increased. While I am troubled by this development, Mr. Mirakhor's persuasive arguments regarding the reasons behind this increase are reassuring. This is particularly true of the shift in the composition of imports toward intermediate goods that can only enhance the economy's export and growth potential. In any event, a tightening of financial policies will help strengthen Pakistan's weak gross official reserves position.

Finally, the staff report and Mr. Mirakhor's statement have forcefully illustrated the devastating impact of the recent floods. The authorities' prompt response to this natural disaster merits our admiration and support. Indeed, the staff report and Mr. Mirakhor's statement have provided a compelling case for Fund emergency assistance. Suffice it to say that I support, fully, the authorities' request.

In conclusion, Pakistan's economy is undergoing a transformation through a reduction in the role of the public sector and a modernization of the economy's capital stock. As a result, the authorities' objective of strong and sustainable growth is within reach. However, it is imperative to ensure that lax financial policies do not reverse these impressive gains. Consequently, the authorities need to introduce measures that would strengthen public finances and restrain liquidity expansion without jeopardizing the momentum of growth. This can best be achieved through continued Fund involvement in the context of an ESAF arrangement.

With these remarks, I support the proposed decisions and wish the authorities continued success in their difficult endeavors.

Mr. Schoenberg made the following statement:

Like Mr. Shaalan, I have been looking forward with particular personal interest to the staff report on the Pakistan economy, as I had the opportunity in 1980 to serve as a member of an economic consultancy team, headed by the former German Minister of Finance, Karl Schiller, which spent six months in Pakistan and then submitted its recommendations to the Pakistan Government.

And, indeed, many of the structural weaknesses of the Pakistan economy outlined by the staff do sound quite familiar to me, for instance: the taxation of imports and exports; the narrow revenue base of public finances, and particularly the fact that the agricultural sector continues to be outside the explicit tax net; and the limited flexibility in the rates of return on financial assets on the one hand, and mandatory credit for commercial banks on the other.

Also, Pakistan's fiscal situation appears to have remained the most important macroeconomic area of weakness through the 1980s and up until now. I can, therefore, fully support the thrust of the analysis and recommendations in the staff report.

Turning to Pakistan's SAF program, I welcome the fact that considerable progress has been achieved in the area of structural reform. Financial policy performance has been weak, however, and major economic indicators--like the ratios fiscal deficit/GDP and current account deficit/GDP--show hardly any sign of improvement, compared with 1988/89, the beginning of the adjustment process. Therefore, I would like to point out that a possible future ESAF program should be considerably more ambitious than the current SAF program, and that the authorities should implement comprehensive "prior actions" before seeking approval for such a program.

Concerning the requested emergency assistance by the Fund, I support the staff's proposal. Like Mr. Al-Jasser, I think this is a compelling case for Fund emergency assistance. However, such emergency assistance should be accompanied by adequate adjustment efforts by the recipient country and visible progress toward balance of payments viability. In this regard, the intended strengthening of the policy stance in 1992/93 might not be sufficient to prevent liquidity pressures in the balance of payments in the coming years, as the staff's external projections demonstrate.

Let me now turn briefly to specific policy areas. I agree with the staff and other speakers that a firm fiscal policy stance is crucial for the success of the future adjustment process. In this context, it is disquieting to note that it has not been possible to implement a comprehensive tax reform in the past four years and that numerous tax exemptions still exist. The continuously rising interest payments, which are budgeted to account for 5.4 percent of GDP in 1992/93, are another cause for concern. The interest payments might even rise further if the Government is forced to pay more realistic interest on its debt after a comprehensive reform of the financial markets. The rising interest payments underline the need for cuts in other current outlays, including economically unproductive expenditures like defense payments.

In view of the fact that domestic liquidity increased by 21 percent in 1991/92 and that the inflation rate is expected to increase about 2 percentage points in 1992/93, one might have expected a more thorough analysis of the question whether the present stance of monetary policy and, particularly, the level of interest rates, are adequate. It appears to me that the large liquid balances resulting from continued strong expansion of the money supply will inevitably reduce the efficiency of monetary policy as an instrument of demand management. Therefore, I would like to encourage the authorities to reduce the growth rate of monetary aggregates to a level below the growth rate of nominal GDP and to introduce strict limits for the budgetary financing by the State Bank of Pakistan. In addition, the authorities should accelerate the reform of the financial sector, with the goal of improving competition, introducing new market-oriented instruments, and liberalizing interest rates.

In this context, I wonder whether the staff could comment on the impact the implementation of "Islamic banking principles" (toward a so-called "interest-free economy") might have on monetary developments, particularly on the efficiency of credit allocation and, in view of the relatively low domestic savings rate, on deposit mobilization. I would also welcome an indication as to what extent the adherence to such "Islamic banking principles" could run into conflict with further movements toward a system of indirect monetary control, which the staff rightly considers as desirable.

With respect to interest rates, the recent increase in the maximum acceptable bid rate at the Government treasury bill auctions is a step in the right direction. However, according to the latest edition of the IFS, actual interest rates still seem to be considerably below the maximum bid rate. In August 1992, for example, the money market rate--according to the IFS--amounted to 1.66 percent and the Government bond rate 7.64 percent. In addition, one has to take into consideration that all new government-guaranteed debt instruments are taxed at source, thereby reducing further the net yield of these instruments. In this connection, I would like to emphasize again the importance of establishing positive real interest rates as soon as possible.

The necessary tightening of monetary policy should be accompanied by a further stabilization of the nominal exchange rate, which could help break inflationary expectations. In contrast to this proposed approach, the present exchange rate policy of the authorities looks like a fairly explicit attempt to target the real exchange rate. This policy is somewhat too gradualistic, in my view, and it might not sufficiently counteract existing inflationary pressures.

Tighter monetary and exchange rate policies should also allow an acceleration of trade reforms. Progress in this field has so far been very slow, and Pakistan's tariff structure remains very much on the protectionist side, with maximum ad valorem tariff rates of up to 90 percent.

Lastly, and as a point of encouragement to the Pakistan authorities, I would like to make the point that many of the remaining imbalances and structural weaknesses in the real sectors of the economy--only some of them are mentioned in the staff paper--which have largely resulted from government intervention can be interpreted as an unused national potential, which can be activated by giving more room to market forces in order to speed up the development process.

With these observations, I can support the proposed decision.

The Chairman commented that, in view of Mr. Schoenberg's experience in Pakistan, it would be interesting to have him comment on areas where improvements in efficiency seemed possible.

Mr. Schoenberg recalled that, at the time of his stay in Pakistan, 50 percent of the students at Karachi University were women, but only a small percentage of women graduates entered into professional activity, which seemed to be an inefficient use of resources.

Mr. Peretz said that he strongly agreed with Mr. Schoenberg's remark on the importance of making better use of women in the economy, and of improving their education as well.

Mr. Peretz then made the following statement:

I would like to start by expressing the sympathy of my authorities to the Pakistani people, as they endeavor to recover from the disastrous flooding in mid-September.

I note that the authorities' preliminary estimate is that Pakistan will suffer a significant reduction in output growth as a result of the floods--perhaps as much as 1.5 percent of GDP. The impact of the floods will inevitably pass through into the fiscal, monetary, and external accounts of the country. Let me say straightaway that I can support the proposed decision, in particular the purchase of 25 percent of quota. In all the circumstances, it seems to me a very clear case for access to this particular element of emergency assistance.

The floods have clearly had a significant impact on the budget; tax revenues will be lower, and reconstruction and rehabilitation costs are substantial. I therefore welcome the authorities' intention to introduce additional revenue-raising measures and to cut back on some low-priority public expenditures. Clearly the original targets for next year under the June budget are no longer feasible. Nonetheless, I hope that the measures taken, and to be taken, will at least be sufficient to bring the fiscal outturn next year in line with the new projection in the paper before us today.

In this context I look forward to a speedy conclusion of the work of the Parliamentary Committee looking at taxation of agriculture. Like Mr. Shaalan, I continue to believe that there needs to be a substantial widening of the revenue base in Pakistan so as to include taxation from the agricultural sector. More generally, the low responsiveness of tax revenue to income growth continues to be a cause for concern.

Moreover, there needs to be a comprehensive restructuring and prioritization of public expenditures away from less productive current expenditure, especially defense spending, and toward more productive development and investment activities. This is essential if the underlying fiscal position is to be improved.

A greatly improved fiscal performance would be expected under any ESAF program, if and when we come to discuss that at the Board. Persistent and substantial fiscal slippage has been a major feature of the four years of Pakistan's SAF arrangement. Following this emergency assistance drawing, I would expect to see significant prior actions, and preferably a period of sustained fiscal adjustment, before any consideration was given to a new program with further access to Fund resources. I am very pleased that a mission will be leaving shortly to help implement the appropriate policies within a revised medium-term framework.

Turning to monetary policy, I very much support the continued movement toward more indirect monetary instruments as a means of controlling domestic liquidity. Unfortunately, and here I share Mr. Schoenberg's concern, the higher maximum treasury bill interest rates, and the rise in the State Bank's discount rate, have been insufficient so far to offset the upward pressures on liquidity. I therefore welcome the intention to increase interest rate flexibility and to expand further open market operations. I would urge that these measures be taken quickly, so as to compensate to some degree for the additional borrowing requirements resulting from the floods. Do we know when the Government plans to remove the existing credit ratios, and thus move to a market-oriented money market?

On exchange rate policy and the development of a more open foreign exchange market, might I suggest that these issues be given a little more attention by the staff and the authorities. A freely convertible currency, if achieved, would greatly assist the policy objectives of the program, such as the use of indirect monetary instruments, and I wonder what the staff sees as a realistic time scale for movement to full convertibility. I also think that the authorities should consider using the exchange rate more as a guide to policy in their attempts to reduce inflation. If the intention is to improve external competitiveness, the only way to do that effectively in the medium term is by controlling domestic costs.

I was going to make some remarks on the liberalization of the trade regime and on the very encouraging supply-side developments in Pakistan, but I find I have very little to add to what has already been said and I agree with what has been said by others.

Unfortunately these developments have not, so far, been supported by sufficiently firm financial policies. As the Government recognizes, the recent natural disaster makes early action all the more important.

Mr. Kural made the following statement:

Today's request for emergency assistance is accompanied by a statement from the authorities indicating their intention to strengthen the policy stance for 1992/93, by, inter alia, reducing the fiscal imbalance, tightening monetary policy, and maintaining a responsive exchange rate policy. The authorities have also asked for a Fund mission following the Executive Board's completion of the Article IV consultation to assist them in implementing tight fiscal and monetary policies to correct last year's slippages, thereby ensuring that the market-based exchange rate maintains the competitiveness of Pakistan's exports, and accelerating the structural reforms begun under the SAF arrangement. Toward the latter goal, they wish to explore the possibility of a Fund-supported program in the context of a possible ESAF arrangement.

We commend the authorities' renewed efforts in late 1990 to restore economic growth and to implement structural adjustment measures for liberalizing, privatizing, and diversifying the economy, and we fully endorse the staff's view that support in the form of an emergency assistance purchase would help them to meet the substantial foreign exchange financing requirements occasioned by the floods without seriously depleting Pakistan's external reserves. Such a purchase would also help catalyze other official assistance and reduce the risk of disruptive private capital flows.

The fiscal deficit remained the weakest aspect of Pakistan's macroeconomic management in 1990/91 and thereafter. There are several areas where the pursuit of other objectives has interfered with fiscal goals. Aside from exogenous shocks, future evaluations of Pakistan's performance will depend crucially on whether the authorities can mobilize sufficient public sector resources to meet the country's external financing requirements. Moreover, the correction of Pakistan's balance of payments vulnerability will have to be undertaken simultaneously with sound investments in social sector outlays. This puts a heavy premium on finding a policy mix for the ongoing financial liberalization that will not affect the public budget adversely. Pakistan's traditional emphasis on public expenditures increases the difficulty in balancing internal and external adjustments in the economy. The lack of room for raising public revenues and reducing current expenditures often creates large public sector savings gaps that absorb both private savings surpluses and external savings.

The centerpiece of the financial program was the removal of the deeper structural weaknesses in the fiscal area. The policy initiatives launched were aimed at i) reforming the tax system; ii) rationalizing public investment by cutting current expenditures and reordering capital expenditure priorities; and iii) protecting investments in the social sectors. Unfortunately, these did not succeed. The staff report and background paper describe in some detail how, in late 1990, Pakistan followed up a period of some slackening with a renewed effort aimed at placing the economy on a sustained high medium-term growth path. These measures were consolidated and extended in successive stages by efforts during FY 1992 and FY 1993, prior to the floods, to intensify the structural reforms and support them with tighter fiscal and monetary policies. These new policies have two broad overall objectives. The first is stabilization combined with better implementation of Pakistan's exchange rate policy. The second is liberalization of the trade system, paving the way for the "supply response of the economy to the bold and comprehensive program of fundamental structural reforms," as Mr. Mirakhor puts it in his statement.

The following sequencing should be used to maintain an appropriate balance between promoting Pakistan's international competitiveness and containing inflation: first, the stage should be set for a further deepening of the structural reform effort; second, there should be substantial decontrol of the financial markets by permitting appropriate flexibility with respect to rates of return; third, a responsive exchange rate policy should be maintained; and fourth, there should be staged liberalization of trade. Macroeconomic consistency requires more than keeping external deficits within the limits set by international competitiveness. Domestic output growth, inflation targets, and international debt management all have implications for the financing of public expenditures. For Pakistan, the central issue is how to create a surplus of private savings over investments sufficient to reconcile external targets and fiscal deficits while avoiding any damage to output growth. Reducing the fiscal deficit to a financable level while observing those macroeconomic targets at least ensures the fiscal policy remains sustainable. If successful, such an adjustment would shield the stated macroeconomic targets from jeopardy from the fiscal deficit, high inflation, or escalating payments. This does not, of course, guarantee that the targets can or will be achieved, but only that the fiscal deficit is not inconsistent with them. The question is whether the 1992/93 sustainability constraint on the fiscal deficit, and the international competitiveness constraint on external borrowing updated to reflect changes in the medium-term domestic economic and financial outlook, will leave enough room for public and private investment and continued output growth. Could the staff comment on this point?

In the end, Pakistan's flood losses need to be compensated in order to protect the momentum of economic growth and stabilization by achieving a balance between the progress of the structural adjustment program and the conduct of macroeconomic policies. The flood losses not only threaten the possibility of meeting the macroeconomic targets, but could also derail the structural adjustment process, which would be very difficult to get back on track. The timely provision of appropriate flood relief will help Pakistan to preserve the momentum it has gained through its energetic efforts of the recent past. I therefore support the proposed decision.

Mrs. Hetrakul made the following statement:

I would like to extend my sincere sympathy to the Pakistan authorities for the extensive damage the recent large-scale floods did to the country and the people. It is unfortunate that the adverse effects of the floods have been a major setback to the country's economic prospects, especially as Pakistan has progressed considerably in its implementation of economic reforms and adjustment programs in recent years.

As a result of the floods, output and export growth will be lower, with more intense inflationary pressures. The budgetary cost of repairs, relief, and rehabilitation will be quite substantial, adding to an already weak fiscal performance. The external accounts will also be adversely affected, with large export shortfalls and more imports required to sustain the emergency need of the people. Even with expected higher aid disbursements from international organizations, reserves will be drawn down rather than the higher than expected accumulation in reserves envisaged prior to the floods.

I am in broad agreement with the thrust of the staff appraisal. I also highly commend the determination of the authorities to strengthen the stabilization policy stance at an early stage, including the implementation of additional revenue and expenditure measures in a timely manner, to reduce the larger fiscal imbalance and the additional tightening of monetary policy, contain the rapid inflation, and improve the more vulnerable external financial position.

I am also encouraged by the authorities' action to further strengthen their structural adjustment measures along with the intention to take early steps in stabilization policies. Structural adjustments and reforms are very crucial for the medium-term growth of the country, as they would help create a more favorable macroeconomic environment and a more resilient economy, one that is prepared to absorb unexpected adverse exogenous developments. In fact, the supply side has responded favorably to the structural reform measures, especially in 1991/92. I welcome all the structural measures outlined by the authorities, including the fiscal and tax regime, financial reform, trade liberalization and simplification of tariff structure, intensification of the privatization program, legal reform, the social action program for education, health, sanitation, and the domestic security system.

However, there are some points I would like to emphasize. First, all the program policies and measures outlined by the authorities must be implemented in a consistent manner and as soon as possible. Second, discipline must be seriously exercised, especially on the fiscal side. In this regard, I hope that the authorities will continue to implement tight fiscal measures, by combining a widening of the tax base, a curtailing of current outlays, especially the nonproductive expenditure such as defense, and a reordering of capital expenditure priorities to avoid any slippages as in the past, thereby not leaving a heavy burden for other financial policies. Third, it is important to note that the performance of both the government and private sectors needs to be as efficient as possible, especially with already limited resources. The privatization program needs to be expedited, and evolution of competitive market structures should be encouraged. At the same time, the efficiency of the public sector development program and its sectoral allocation should be under careful consideration.

The last point I would like to address to all the countries represented at this meeting today. I would like to call your attention to a hypothetical country, sufficiently endowed with factors of production, whose people are leading a life not much above subsistence level, accepting low remuneration for labor, and thus able to produce and sell goods at rather low price. However, the country's well-to-do neighbor, which cannot match the country's cost of production owing to higher wages and domestic tariffs, prefers to produce its own good, rather than import the cheaper good. As a consequence, the neighboring country pays more for the good, while the hypothetical country cannot sell the good. In this case, I go along with the authorities in noting that many developing countries' efforts to accomplish international competitiveness have been useless because major industrial countries have kept up their trade barriers. Actions to open up markets by industrial countries will certainly help the external balances of developing countries.

Finally, I note with satisfaction the willingness of the authorities to cooperate with the Fund, thereby paving the way for increased involvement of the Fund. Meanwhile, Fund emergency assistance would help the country meet immediate needs without serious depletion of Pakistan's international reserves and would facilitate the successful implementation of the ongoing structural adjustment program.

With these comments, I can support the proposed decisions.

Mr. Bonzom made the following statement:

At this stage of the discussion, and as I agree with the thrust of the staff appraisal and with many comments made by previous speakers, I will just elaborate briefly on the undeniable progress that has been made, on the sources of fragility in the current context, and on the need to deepen, in the near future, the stabilization and reform process.

As is correctly stressed, both in the staff paper and in Mr. Mirakhor's helpful statement, Pakistan has made "significant progress," including in 1991/92, in all areas of structural reforms. The budgetary structure has begun to improve, with the broadening of the tax base and the first steps taken toward placing more emphasis on development and social outlays. Reform of the financial sector has included the move toward positive real interest rates, the adoption of a more flexible and transitory method of monetary control, and a needed improvement in supervisory provisions. As important, the privatization process has been continued, together with the promotion of competition, especially in the banking market. Finally, steps have been taken to foster regional cooperation, and liberalization of the trade system has been pursued.

All these positive steps, which have been taken despite sometimes difficult circumstances, have led to very favorable responses in terms of growth--in the context of a slightly reduced inflation--of exports (especially nontraditional ones) and of investment, including private and foreign direct investment. Such trends cannot be overstated in the case of a country like Pakistan; they certainly constitute some of the conditions for the establishment of a sustainable growth path over the medium term.

Sources of fragility remain or have appeared, however. The deterioration of the current account in 1991/92 is partly optical, as it coincided with the reclassification of private transfers. The further deterioration forecast for 1992/93 is also explained largely by the direct effect of the floods. However, the authorities should try to aim at securing a substantial reduction in the degree of vulnerability linked to the excessive dependence on potentially volatile inflows of capital and to the very low and decreasing level of reserves. Similarly, the gains on inflation have been small in 1991/92 and could be reversed if the projected 15 percent growth in liquidity materializes this year. This leads, of course, to the main area of fragility, namely, the budgetary situation. Last December, this chair pointed to the very ambitious character of the target proposed for 1991/92. In fact, the deficit was cut only marginally, and this slight progress is under jeopardy if no additional action is taken soon.

The preservation of the progress achieved so far thus clearly points to the crucial need for a deepening of the stabilization and reform process. Once again, I will only point to a few key areas for further action.

First, budgetary consolidation is now essential. We thus welcome the authorities' intention to take additional measures, especially to further reduce exemptions. More generally, a review of the tax status of agriculture would be appropriate. Other speakers have also tackled these points. On the expenditure side, we concur with the call for prudent management of the necessary transition toward more productive public investments and social outlays, which must be adequately prioritized and targeted to the most urgent needs of the relatively rapidly growing population.

Second, on monetary policy, I have noted the intention to accelerate the movement toward indirect methods of control. I cannot but agree with the validity of the aim thus settled, and, indeed, preparatory steps have already been taken in this area. But I have also noted that, as recognized by the staff itself, indirect methods have delivered correct results as far as the control of credit to the private sector is concerned. I would thus urge caution in moving to the new system, especially in the current circumstances, characterized, inter alia, by remaining pressures on liquidity and on prices. Third, such circumstances would also certainly allow for a larger weight being given to the anti-inflationary role of the exchange rate policy. I fully share Mr. Schoenberg's comments in this regard.

These remarks on financial policies being made, I would not like to underestimate in any way the need to pursue structural reforms, especially as regards the situation of the public sector and the supervision of the financial institutions. A satisfactory outcome to the riba issue will also go a long way toward fostering confidence among domestic, as well as foreign, economic agents.

Let me conclude by stressing that, in view, first, of the results achieved so far, second, of the intention to correct past slippages and to strengthen the policy stance in the framework of forthcoming discussions with the Fund, and, third, of the severe human suffering and economic consequences of the recent floods, my authorities strongly support the proposed decision on emergency assistance for Pakistan.

The staff representative from the Middle Eastern Department said that the question whether there was a contradiction between Islamic banking principles and the authorities' move toward indirect monetary control raised a host of theoretical and practical issues. The authorities had informed the staff that work was ongoing on the consequences of the implementation of an Islamic economic system for new and existing instruments of economic management. That examination was taking place in several fora, including a government-supported committee consisting of representatives of the Government, religious groups, and academic circles. The banking system had been operating on noninterest principles since 1985, with the exception of the issuance of government securities, certain activities of the State Bank, and operation of foreign currency deposit accounts borrowing. In that context, there would appear to have been no problem with greater use of indirect monetary control instruments. The current uncertainty stemmed from the Federal Shariat Court finding that certain existing banking transactions were inconsistent with Islamic law. That finding had been appealed by the Government and by commercial banks. The Supreme Court had yet to reach a finding on that appeal. In its discussions with the authorities, the staff had stressed the importance of clarifying quickly the key elements of the institutional framework, so that the appropriate instruments could evolve. The authorities had indicated their view that the Supreme Court was likely to reach a finding which would provide sufficient time for appropriate financial instruments to evolve.

As to the timetable for the move to indirect monetary control, the authorities shared the staff's concern about the problems inherent in the transitional steps with respect to the credit deposit ratios implemented at the beginning of the current fiscal year, the staff representative commented. Given the monetary situation, the authorities were keen to move expeditiously toward greater use of indirect monetary control instruments. In that connection, they had requested Fund technical assistance in assessing the preconditions, not only from a liquidity point of view but also from an institutional point of view. To that end, a technical assistance mission was due to visit Pakistan in the coming days. That visit would follow one by staff from the Statistics Department assessing the adequacy of monetary aggregates for policy purposes.

The money market rates in Pakistan fluctuated considerably, reflecting the short-term liquidity position of the banking system, the staff representative commented in response to a question on the matter. In mid-1992, those rates had reflected a large increase in deposits by banks in anticipation of the relaxation of the bank-by-bank credit ceilings. The rates on treasury bills and longer-term securities were more representative of the interest rate structure. The treasury bill cutoff rate was 13.1 percent in October, which implied a weighted average rate of 12.7 percent. The three- to five-year rates on the federal investment bonds were 13 to 15 percent. Nevertheless, the staff considered that greater flexibility of rates was warranted in the current circumstances.

Speakers had commented on the composition and flexibility of the budget, the staff representative recalled. As Directors had noted, the expenditure side of the budget was dominated by two items--interest and defense expenditures--which accounted for 45 percent of total outlays. That pattern limited the flexibility of the budget and underscored a critical policy issue: in order to expand public investment, which was viewed as necessary both for social considerations and for increased efficiency by creating the conditions to crowd in the private sector, substantial infrastructure and social outlays were needed, as had also been stressed by the World Bank staff. Two tasks should therefore be accomplished: the distribution of expenditures should be examined, particularly with a view to reducing unproductive outlays; and the issue of the narrow revenue base should be corrected. Indeed, one Director had made the point that, in order for Pakistan merely to stand still in terms of revenue collection, there was a recurrent need for the authorities to take discretionary and politically sensitive decisions.

In the area of investment, it was clear that private investment was responding positively to the authorities' structural reform measures, with financing through repatriation of capital, foreign direct investment, and portfolio investment inflows, the staff representative commented. The issue in the area of investment was the performance of the public sector, which in turn raised the fiscal issues he had mentioned.

The authorities were maintaining a managed float system under which the exchange rate was set against the intervention currency, the U.S. dollar, subject to developments in the trade-weighted basket, the staff representative from the Middle Eastern Department remarked. The staff felt that, given Pakistan's weak external reserve position, the present exchange rate policy had served the country well in maintaining competitiveness and export growth without having an excessive inflationary impact. The staff would support a move toward a more stable exchange rate. A precondition for that move, however, was a sustainable macroeconomic policy stance.

Mr. Peretz said that what he had meant to suggest was that exchange rate policy should be taken into account in monetary policy goals in general, and a specified level of interest rates in particular.

The staff representative from the Middle Eastern Department responded that the foreign currency accounts had become a principal financing item of the balance of payments. One important element was the nonresident bank component, which had responded to interest rate differentials adjusted for exchange rate cover; hence, that was a factor in interest rate policy and was kept under careful review.

Mr. Murphy made the following statement:

I broadly agree with the staff report and can support the proposed decision on emergency assistance.

The Pakistani authorities are to be commended for having made significant headway in structural reforms. As Mr. Mirakhor's statement clearly shows, there have been substantial payoffs from these actions, most notably in the supply response of the economy and the prospects for nontraditional export growth.

However, I join those who emphasize the weaknesses of the authorities' progress in addressing their fiscal imbalances, which threaten to derail the efforts made to date.

The susceptibility of the Pakistani economy to exogenous shocks--changes in the terms of trade and the occurrence of natural disasters--serves only to reinforce the case that the fiscal imbalance should be addressed with resolve, so that the authorities would have more of a cushion (or room for maneuver) when confronted with exogenous shocks.

Although we were pleased to see that, in the initial budget for 1992/1993, defense expenditure as a percentage of GDP was programmed to decline slightly, military expenditure continues to be unacceptably high, at one third of all provincial and federal current expenditure. Our position with respect to unproductive expenditure--that it is not compatible with the goal of sustainable growth--is well known.

Looking ahead to the authorities' request for an ESAF arrangement, it is essential that appropriately strong conditionality be developed for inclusion in any proposal coming to the Board, so as to ensure that Pakistan will be able to achieve and maintain fiscal balance.

In conclusion, I would like to join my colleagues in extending deepest sympathy to those who have suffered from the recent flooding in Pakistan. I support the proposed decisions.

Mr. Torres made the following statement:

Economic developments in Pakistan during the fiscal year 1991/1992 within the framework of the program supported by the third annual SAF arrangement have been mixed, with both improvements concerning the structural reform and discouraging results from fiscal policy, which has remained an important area of weakness. Progress to date on structural reform has been significant as reflected in the staff report, while the demand management stance resulted in larger than programmed domestic and external imbalances.

Concerning the real part of the economy, it is encouraging to see the favorable response of production, exports, and investment to structural reforms, which, in spite of weak cojunctural policies, have not faced long reply lags. We welcome the determination by the Pakistani authorities to pursue structural measures, in particular trade and payment liberalization and the privatization program.

From a historical perspective, we share the staff's opinion that the key policy change in the fiscal area for Pakistan in the near future is the narrow revenue base, a common problem in many developing countries, and the structure of expenditure. When the direction of these two elements simultaneously weaken the fiscal balance, there is a high possibility of facing a vicious circle, so it is recommended that immediate corrective actions be taken. Since monetary developments have been strongly influenced by the fiscal outcome, the basic challenge lies in making progress toward indirect monetary control in the context of an appropriately tightened domestic credit stance.

It is encouraging, though, to know that within the modified framework for 1992/1993, the authorities are committed to mobilize additional resources, curtail current outlays and reorder capital expenditure.

We would like to urge the Pakistani authorities to move with decision toward more ambitious efforts in the pursuit of structural and conjuncture measures, in view of the manifest vulnerability that eventually could undermine the gains already achieved. We still see with concern, weaker than programmed financial policy performance and a highly exposed external sector.

Finally, we sympathize with Pakistan under the difficult situation they are facing, and accordingly commend them for the bold actions already taken to cope with this critical situation.

With these remarks we support the proposed decision.

Mr. Solheim made the following statement:

I am in broad agreement with the staff appraisal and will make only some brief remarks.

The authorities have to be commended for the way in which they have responded to the tragic flood disaster and the steps taken in implementing the economic and financial reforms. This has clearly supported economic activity and has contributed to increased private participation in various sectors of the domestic economy, which previously were dominated by the government sector.

However, despite the positive developments in a number of areas, the policy performance has remained weak with regard to some important quantitative program benchmarks and targets. The rate of inflation is higher than targeted, and the need for a marked tightening of financial policies remains urgent. The elimination of trade restrictions is proceeding quite slowly, and it is my impression that Pakistan's trade regime remains among the most restrictive in Asia. Although some progress has been made in improving the revenue structure of the budget, a broadening of the tax base and a strengthening of the tax administration remains imperative.

In spite of a relatively strong economic growth performance, the future progress in improving the welfare of the population is made difficult by the high population growth. As a result, Pakistan's social indicators may also, in the years ahead, lag behind those of other low-income countries. In light of Pakistan's weak performance in social and environmental policies, it is regrettable that such a high share of government expenditure is allocated for defense purposes.

In the Board discussion in December 1991, some Directors raised the question whether the time was not ripe to use the exchange rate as a nominal anchor to foster price stability. In this staff report, the staff touches only briefly on this issue, but states that the authorities' policy in this regard has struck an appropriate balance between promoting competitiveness and containing inflation. Has the staff any further comments on this issue?

With these remarks, I support the proposed decisions.

Mr. Arora said that he sympathized with the people and Government of Pakistan on the enormous loss of life and the widespread destruction caused by the floods. He fully supported Pakistan's request for emergency assistance and the proposed decision, and he wished to make a few points for emphasis.

Given the long tradition in Pakistan of commitment to managed and planned development, it was remarkable that Pakistan had made a number of significant changes, Mr. Arora continued. The Pakistani authorities were to be commended for their determination to liberalize the economy. Indeed, their performance was a lesson for many other developing countries that were trying to improve their economic performance. During his visit to Pakistan in 1991, the Managing Director had witnessed the remarkable and rapid changes that the authorities were making. The authorities had seen their efforts reflected in the improved performance of GDP growth and exports. Despite the concerns that had been expressed about the fiscal measures, it was important to recognize that there had been a substantial decline in subsidies in Pakistan; as a proportion of the budget, they had fallen from 7.2 percent to 3.1 percent--an important achievement. In addition, the share of development expenditure had increased from 0.5 percent to 26.8 percent, another important achievement.

The authorities should certainly examine the main causes of the continued fiscal imbalance, and particularly the decades-long political and social stalemate in Pakistan among all major social groups in Pakistan--the agricultural community, industrial workers, industrialists, and the public sector in general--which had precluded an agreement on a viable strategy for reducing the fiscal deficit, Mr. Arora commented. The Government must give the highest priority to trying to resolve the stalemate by building a consensus, which would take some time, a fact that should be borne in mind by Directors who had suggested that Pakistan should implement comprehensive prior actions before an arrangement under the ESAF could begin; forcing a predetermined pace of adjustment might well create serious problems.

While Pakistan's export performance had been remarkably good, it remained dependent on a single commodity--cotton--and the structural reform strategy should be aimed at diversifying the economy, Mr. Arora considered. While the policy changes introduced thus far would move the economy in that direction, and the recent trends in imports should be helpful in that connection, further state intervention would probably be required to diversify the manufacturing base.

As Mr. Solheim had remarked, the authorities should pay adequate attention to social indicators, Mr. Arora said. In that connection, the authorities' current emphasis was welcome, but further guidance from the Board was needed.

Mr. Posthumus made the following statement:

In September, Pakistan was hit by heavy floods, which obviously have had a severe impact on Pakistan's financial and external balances. This external shock added to macroeconomic disturbances in fiscal year 1991/1992 (which ended before the floods hit the country). Output and exports responded strongly to the structural reform measures taken, but financial imbalances continued to exist. The targets for inflation, money supply growth, the fiscal deficit, and the balance of payments were all missed by a considerable margin.

For 1992/1993, the staff urges a further strengthening of financial policies, especially with regard to fiscal policy. Overruns in this area cause problems in the monetary field and increase the country's external vulnerability. I fully agree with the staff recommendations. I liked the statement on page 22 in particular: "Indeed, fiscal adjustment is at the center of the policy challenge, with a firm fiscal stance providing the foundation for other macroeconomic policies." This piece of advice would fit nicely into almost every European member's Article IV consultation for 1992.

I also agree with the analysis that sustained structural reform--and Pakistan has been quite successful in this respect--presupposes macroeconomic stability, and macroeconomic stability is a self-reinforcing phenomenon. Developments with regard to the foreign currency accounts can illustrate this. The liberalization of rules governing domestic holdings of these accounts with commercial banks has resulted in an increase of more than $1 billion since 1990/1991. The use of proceeds of these foreign currency accounts increases the vulnerability of the external accounts to changes in private sector sentiment. The only way to convince holders to exchange foreign currency into own currency deposits, without reversing the liberalization measures, is to increase confidence in the own currency by implementing sound macroeconomic policies.

Regarding exchange rate policy, I read that Pakistan "has struck an appropriate balance between maintaining the competitiveness of the tradable sector and containing inflation." As I have emphasized on earlier occasions, this approach is not without risks. The only way to strengthen competitiveness of the export sector through macroeconomic policies, without jeopardizing inflation targets, is the implementation of stable financial policies, which fits the staff recommendations I mentioned and supported.

On monetary policy, I note that the main challenge lies in making progress toward indirect monetary controls. A technical assistance mission is scheduled to visit Pakistan in December for this purpose. The introduction of more market-related monetary instruments has to take place in the context of the implementation of Islamic banking principles. My question to the staff is to what extent these objectives are compatible. Until now, the implementation of monetary policy was hindered by the "relatively limited flexibility in rates of return," as the staff appraisal teaches us.

Pakistan has asked for emergency assistance of 25 percent of its new quota (SDR 189.5 million). I support this request. However, I would recall that, last December, Pakistan drew SDR 109 million under its third-year SAF arrangement. Pakistan missed by substantial margins most of its quantitative benchmarks and targets for the period ended June 1992, and a similar outcome is expected for the end-September benchmarks and targets. In December 1991, it also drew SDR 122 million under the CCFF. Together with the emergency assistance to be approved today, Pakistan will have drawn around SDR 420 million in a period in which it did not implement appropriate financial policies. While I continue to support some low-conditioned access under the CCFF, the total of all operations raises a question about the Fund's conditionality. I therefore urge the staff and the authorities to conclude a program as soon as possible. This program should take into account the emergency purchase of today, with regard to both the access under the new arrangement and the conditionality attached to it. In this way, we can safeguard the application of adequate conditionality, as requested by the Board during its 1982 discussion on emergency assistance, without jeopardizing a quick and flexible response during emergency situations.

Mr. Wei made the following statement:

At the outset, we wish to express our deep sympathy to the people of Pakistan for the terrible loss of human life and economic damage caused by the recent devastating floods. We fully support the authorities' request for Fund emergency assistance.

Pakistan's economy has benefited greatly from the Fund-supported program, and under the SAF arrangement, in particular, significant progress has been made in structural reform, characterized by the favorable response from the supply side of the economy. The strong growth of GDP contributed to the good performance by the external sector, with a sharp increase in exports and a great strengthening of the foreign exchange position.

Although Pakistan has achieved considerable success in the structural area, its financial policy measures lag behind the pace of structural progress. This was evidenced by the widened fiscal deficit and increased pressure on monetary and credit policies. To ensure that the structural progress achieved so far is not jeopardized, additional strong corrective measures are clearly needed to reinforce fiscal and monetary policies, particularly in the face of the extreme difficulties caused by the floods.

Since I am in broad agreement with the staff appraisal, I wish to emphasize only a few points. Fiscal consolidation is the key to a successful economic reform program. Therefore, the further deepening of progress in structural reform depends crucially on the fiscal policy stance. We welcome the authorities' intensified efforts to improve the budget structure and reduce the deficit. Various tax measures, aimed at stimulating revenue, as well as measures to contain expenditures, are encouraging. As regards monetary policy, the authorities should maintain a tight policy stance and speed up financial sector reform as a means of implementing indirect monetary control.

Apparently, the recent devastating floods have made the above tasks extremely difficult, which has made tightening of financial policy even more important. In this context, I would like to join the staff in stressing the need to pursue and sustain, with determination, fiscal deficit reduction, and to facilitate implementation of monetary and exchange rate policies, as well as those policies that deepen structural reform.

While it is true that, as recognized by the authorities, restoring medium-term viability relies mainly on domestic policy efforts, the current situation in Pakistan obviously requires urgent external assistance to enable the authorities to overcome temporary adverse developments and sustain the pace of economic adjustment. In this respect, I fully agree with the staff about stressing the importance at this particular juncture of timely financial support from the Fund, as well as from the international community.

With the above remarks in mind, we support the proposed decision and wish the authorities success in their difficult efforts to implement the comprehensive reform program.

Mrs. Hansen made the following statement:

We support Pakistan's request for emergency assistance in view of the additional budgetary and balance of payments strains caused by the devastating floods of August.

We recognize that the large, unexpected relief efforts required in the aftermath of the flood will result in a weakening of economic performance and further compromise the attainment of Pakistan's objectives under its third-year SAF arrangement. However, we note with regret that these strains come on top of pre-existing macroeconomic and structural weaknesses, which, in our view, were not being addressed nearly vigorously enough prior to this natural disaster.

We are very disappointed to see, for example, that virtually every quantitative benchmark and indicative target under the program from December 1991 to June 1992, aside from international reserves and limits on external debt, was missed. We recognize that the structural benchmarks in the program may not capture all of the progress that has been made on structural reform. But be that as it may, only four out of ten measures identified as structural benchmarks appear to have been fully implemented.

More disturbing is the fact that little in the way of macroeconomic stabilization appears to have been accomplished over the four years of the three-year SAF program. The 1992/93 fiscal balance is projected to be less than 1 percent of GDP lower than it was at the outset of the SAF program in 1988/89; the current account deficit held steady in the initial years, but it now appears to be on an upward trend, and domestic prices, as measured by the GDP deflator, also appear to be rising over the SAF period. It is encouraging that growth has been strong, but we would have hoped that the authorities would have taken better advantage of this period of strong growth to make greater progress on macroeconomic stabilization.

We welcome the progress that has occurred in some areas of structural reform, including in particular privatization, some improvements in the tax system, and some further trade liberalization. However, we regret that more action has not been taken to address the country's fiscal problems, which in turn have led to problems in controlling domestic credit. Further action is particularly needed on broadening the tax base, including, among other steps, extending the tax system to the agricultural sector and reducing reliance on international trade taxes. Like Mr. Schoenberg, we believe that a comprehensive tax reform should figure prominently in any successor arrangement. At the same time, expenditures need to be reordered away from nonproductive uses and toward capital spending and associated recurrent expenditure needed for further growth. These reforms should be complemented on the monetary side by further reliance on indirect means of monetary control, including greater flexibility on rates of return on financial instruments and the deregulation of credit allocation.

I would also like to express our concern about the perpetuation of the 6 percent import license fee, which reflects Pakistan's inadequate tax base and constitutes an exchange restriction under Article VIII. We regret that this restriction has not been eliminated, as was urged during Pakistan's previous Article IV consultation. In the wake of the floods, we reluctantly accept approval of this restriction, but we expect the authorities to adhere to their intention to remove it in the next budget.

In closing, I would like to associate myself with the remarks of Mr. Peretz, to the effect that there should be substantial prior actions, and quite possibly a period for improved performance, before Pakistan moves on to an ESAF arrangement.

Mr. Evans made the following statement:

I fully support the authorities' request for emergency assistance. I would like to compliment the staff on the speed with which they addressed that request and the way in which they approached it.

It is some time now since we last approved emergency assistance, and it is good to have some more experience as guidance. I do note that, within the past few years, there have been occasions on which we have not proceeded with a request for emergency assistance. I recall two cases in particular in which emergency assistance would have been readily awarded if we had followed the approach followed in this particular case.

I would like to make one particular point in that regard, because in one of those cases the argument was put by the staff that the assistance required could be readily met by the World Bank and other development institutions, a view with which I agree, in the abstract. But in the light of that, it is a little galling to see here, in the staff report and in the opening statement by Mr. Mirakhor, the view that the emergency assistance would help in catalyzing assistance from official sources. I do not think that emergency assistance is a case for which we can use the catalytic argument, because it is unconditional assistance; the Fund need not act as a catalyst in providing such assistance, and this need not be an argument in providing assistance. If we were to make use of the provisions in the guidelines on emergency assistance for countries with programs, there may even have been a doubt as to whether emergency assistance would be warranted in this case, given Pakistan's performance under the program.

I would like to comment a little more on that matter, in terms of looking at a future ESAF arrangement for Pakistan, and I would like to caution against going too quickly down that route. I heard Mr. Peretz suggest that we might have prior actions on fiscal policy, and I heard Mr. Arora, who obviously also has experience in the nature of the problems facing Pakistan, caution against prior actions. I think that, indeed, this situation might warrant a further Board meeting before we take a decision on a future program, because in this case we have a major issue at stake in terms of the future development of this country. We have had, as Mrs. Hansen referred to it, four years' experience of a three-year SAF, and when outsiders hear about this and the progress made--the structural reforms have been commendable--they may feel that the World Bank and the Asian Development Bank have done very well, but when they look at Pakistan's financial situation, and the complete lack of progress in that area, they may say that the Fund has failed.

It is clear, including from Mr. Shaalan's opening comments, that addressing the fiscal problem is central to the future of programs implemented by Pakistan. I thought the staff put that point particularly well on page 8, where the valid point is made that failure to address financial imbalances would not simply be a problem in its own right, but would undermine the structural reform policies. Therefore, we have to look very carefully at the possibilities. This is a case in which the authorities' ability to undertake development policies is heavily constrained by their debt situation, and there are real question marks about the political ability to address the resultant budgetary problems. That situation should be considered by the Board further, before deciding the shape of a program.

Mr. Nakagawa made the following statement:

I wish to express my authorities' strong sympathy to the people of Pakistan for the damage caused by the floods, and my authorities' support for the emergency assistance. We believe that this is a typical case for emergency assistance, and we support it.

As to the policy content of the paper, I find myself basically in agreement with the comments by Mr. Schoenberg and Mr. Peretz. I would like to associate myself strongly with those speakers who expressed their concern about fiscal policy. In particular, I would stress one point that cannot be over-emphasized, namely, that the authorities certainly need to look for a way to convert unproductive expenditure--especially defense expenditure--into more productive expenditure. In this connection, I would like to stress that the charter under which Japan provides aid to countries stipulates that the development of defense expenditures in aid recipients' national accounts is one of the factors to be taken in account in the provision of assistance.

We welcome the negotiations on a possible ESAF arrangement, which would maintain the authorities' momentum of structural reform. However, I would like to associate myself with Mr. Schoenberg and others who stressed that such an arrangement would require a more ambitious program than the SAF program. The fiscal component of the program in particular should be much stronger. In this connection, as Mrs. Hansen remarked, a comprehensive tax reform should be one of the components of the program. In addition, prior actions should be set before the start of the program.

The only point on which I have a major disagreement with the previous speakers is exchange rate policy. I agree with the staff that the authorities' policy has been useful in maintaining international competitiveness without causing inappropriate inflationary pressure.

In addition, I do not agree with Mr. Evans's point on the catalytic role of the Fund with regard to this emergency assistance. My authorities are favorably inclined to Pakistan's request for an emergency commodity import loan.

Mr. Glazkov commented that Pakistan was in a critical phase of its economic transformation, and the economy was very sensitive to external factors. Natural disasters that affected an entire country typically required authorities to introduce emergency direct controls of the economy and could affect efforts to achieve the desired structural reforms.

Therefore, the proposed emergency assistance for Pakistan was clearly necessary, and it was the Fund's duty to provide it. However, he agreed with previous speakers' comments on the economic performance of Pakistan in general, and on certain expenditures in particular, including military ones, which created some doubt about the prospects for economic policy in Pakistan. However, given the staff's recommendations and the authorities' letter of intent, the authorities could be relied upon to maintain appropriate economic policies in the coming period, and the emergency assistance should be provided. The proposed decisions were acceptable.

Mr. Posthumus stated that he sympathized with Mr. Evans, who had commented on the noncatalytic role of emergency assistance by the Fund.

The staff representative form the Policy Development and Review Department said that the reference in the staff report to the catalytic role of the proposed emergency assistance was made in the narrow context of mobilizing relief for the emergency situation, not in the broad sense that was customarily meant. The guidelines on emergency assistance did anticipate a potential Fund role in mobilizing assistance in emergency situations; in that connection, the relevant portion of the guidelines stated that, in "emergency situations, timing is crucial. Quick assistance from the Fund can provide relief and encourage financing from other sources."

Mr. Evans commented that his point concerning the role of emergency assistance had to do with the consistency of the application of the relevant guidelines. The staff should apply the guidelines consistently from one case to the next.

Mr. Mirakhor commented that, over the past four years, the staff had been examining theoretical issues concerning Islamic banking and had produced some dozen papers on the subject. Before Islamic banking principles could be applied in a country, the financial system would have to be completely free to ensure the achievement of the main objective, namely, that the rates of return from the real sector were transmitted to the financial sector, rather than the reverse, as happened under traditional banking. To that end, substantial organizational and institutional arrangements, together with certain financial instruments--which required considerable time to introduce--would have to be in place. There was no limit on the number of financial instruments that could be developed to handle the requirements of Islamic banking.

He was particularly pleased that a number of speakers from countries that had historically had an interest and influence in the region were concerned about the question of military expenditure in the region, Mr. Mirakhor commented. All the authorities in the region would certainly agree that it would be preferable to have expenditure by the military sector allocated to other sectors, to solve pressing social problems. Anyone familiar with the region recognized that there was a political will among all the authorities to improve the living standards of the people throughout the region. Unfortunately, the end of the Cold War had not brought with it a peace dividend in terms of a reduction of tensions in many regions; indeed, in some regions, tensions had increased. It was the duty of major countries that wished to see other countries reduce their so-called military expenditure, to take a more active role in reducing regional tensions. As long as regional tensions existed and intensified, it was unrealistic to expect that countries would unilaterally reduce the level of military expenditure. The only working model for a reduction of tension and mutual de-escalation of military expenditure in the world was the model suggested by the ending of the Cold War; according to that model, heavy military expenditure in support of a strong defense posture played a key role in reducing or eliminating tensions among countries. Perhaps countries in various regions also currently were trying to follow the same model--creating a strong defensive posture that would lead to a reduction of tension and an eventual peace.

Pakistan's Prime Minister was already on record as favoring a mutual de-escalation of defense expenditure in all countries in the region through discussions on a mutually supportive and cooperative defense agreement, Mr. Mirakhor continued. His authorities hoped that that proposal would be taken seriously by all countries in the region and would be supported by all the major industrial countries. That effort might lead to a reduction of tension and, perhaps, to decline in military expenditure.

In his opening statement, Mr. Mirakhor recalled, he had been careful not to suggest that the proposed emergency assistance was going to play a catalytic role. He had mentioned his hope that the Fund's assistance would "galvanize" assistance from other sources. He had used that particular term intentionally, not because the Fund's resources were not needed by the authorities, but because he agreed with Mr. Evans that consistent application of the relevant guidelines on emergency assistance in all cases was needed. In saying that the Fund's emergency assistance would galvanize assistance from other resources in the particular case of Pakistan, he was not suggesting that the Fund's emergency assistance was going to play the traditional catalytic role.

Several speakers' comments to the effect that, in their view, Pakistan's fiscal performance had not been sufficiently strong, raised a fundamental question about Fund-supported programs, Mr. Mirakhor said. Directors naturally would have to look at each staff report and make judgments for themselves.

Pakistan's program had two policy instruments--fiscal policy and monetary policy--and three target variables, namely, the current account position, the inflation rate, and the stock of reserves, Mr. Mirakhor noted. The quantitative targets in Pakistan's program were set on the basis of certain assumptions made by the staff, as was usual in country programs. However, there was an important problem with the program for Pakistan, and with Fund-supported programs in general: there was no automatic feedback mechanism built into such programs. In the case of Pakistan, for example, a 2.4 percent improvement in the terms of trade had been assumed, but the terms of trade had actually declined by 3.1 percent--a 5.5 percent shock to the Pakistan economy. There was no mechanism by which, as soon as it became evident that an assumption underlying a program was proven inaccurate, a feedback process would begin, so that the quantitative targets under the program could be reset. The targets for Pakistan had not been reset despite the unexpected developments affecting the economy; the authorities were still expected to achieve a 4 percentage point reduction in the fiscal deficit--a goal that several Directors had suggested might have been too ambitious even before the exogenous shocks. The authorities and the staff have suspected that that target might be ambitious, but it clearly would have been attainable if the assumptions underlying the program had proven correct. Revenues from taxes on income and profits had doubled between 1989 and 1992; that fact was one response to the suggestion by some speakers that the fiscal performance had not been sufficiently strong. In addition, in just one year, direct taxes had increased from 14.6 percent of total revenues to almost 17 percent. The revenue effort had led to a 39 percent increase in total revenue in 1991. In the absence of the external shocks, there would have been only a 6 percent shortfall from the revenue target. Accordingly, in cases in which performance was knocked off course by external shocks, beyond the control of the authorities, it would be useful to have an automatic feedback process that would result in a resetting of the targets. It was true that Fund-supported programs were closely monitored, but when unexpected developments occurred and performance was less favorable than anticipated, the monitoring led merely to recommendations that the authorities should intensify their adjustment efforts; usually no effort was made to reset the quantitative targets. In addition, there was a sequencing problem in Pakistan, as the liberalization of the financial sector was coming into conflict with the public debt management. A recent staff paper noted that that situation was not unique to Pakistan; many countries attempting to liberalize the financial sector had faced a conflict between monetary management and debt management issues.

In sum, Mr. Mirakhor concluded, he hoped that the Board would not impose constraints on the authorities in Pakistan by requesting prior conditions that would undermine the continuation of the genuinely credible results under Pakistan's SAF arrangement.

Mr. Al-Jasser remarked that Mr. Mirakhor's final point was well taken. Other speakers seemed to have suggested excessive conditions for Pakistan's use of the ESAF. An ESAF arrangement should further the adjustment process in Pakistan. The Board should not build the seeds of failure into a possible ESAF arrangement for Pakistan by setting excessive, unrealistic expectations, beyond the country's implementation capacity. That was not to say that a weakening of the adjustment effort in Pakistan was to be advocated; indeed, in the present case, the Board was requiring more of the authorities than it had seemed to require in other cases.

The Chairman said that he had been impressed by Directors' remarks on the ESAF, and the staff would have those remarks in mind in negotiating a program with the authorities. It was difficult to find the right balance between prior actions and the requirements of an arrangement itself. Prior actions were indeed necessary, but they should be realistic and feasible; Pakistan should be encouraged to develop a whole range of actions that could ensure that an ESAF arrangement would have a genuinely decisive and positive impact on the country.

Mr. Peretz stated that he agreed with the comments by the Chairman and Mr. Al-Jasser on a possible ESAF arrangement.

The Chairman commented that he, too, had noted the authorities' commitment to progressively and prudently reduce military expenditures. He had discussed that matter with two Prime Ministers of Pakistan as well as with authorities in India, all of whom had expressed the wish to limit defense expenditures. Of course, their task would be made easier if there were a regional security arrangement, which was clearly lacking in a number of areas. The authorities he had met were working on arrangements for mutual de-escalation of the military buildup. Those efforts were promising and must be encouraged. The fact that the authorities knew that, to an increasing extent, the international community wished to see countries move in that direction, was important to those authorities, who had no objection to the attention that others paid to the matter of their military expenditure.

The Chairman then made the following summing up:

Executive Directors agreed with the broad thrust of the staff appraisal. They welcomed the progress achieved by Pakistan in implementing structural reforms, as reflected in measures to liberalize, diversify, and privatize the economy. They noted that these measures had contributed in 1991/92 to strong GDP and export growth, increased domestic investment activity, higher inflows of foreign direct and portfolio investments, and increased vitality of the private sector. At the same time, Directors expressed concern at persistent weaknesses in Pakistan's financial balances. These weaknesses were evidenced by the large deviations relative to the programmed fiscal and monetary benchmarks and targets and had resulted in a slower than programmed reduction in inflation and a weak external position.

Directors emphasized that an effective and permanent reduction in the fiscal deficit is the key to a sustainable adjustment and reform process in Pakistan. In this regard, they welcomed the steps taken by the authorities in the context of the 1992/93 budget to widen the tax base and simplify the structure of certain taxes. They also commended the authorities on the deepening of the privatization program and the further reduction in quantitative trade restrictions.

In view of Pakistan's domestic and external financial imbalances, including its considerable exposure on account of foreign currency deposits, Directors stressed the importance of additional fiscal adjustment measures. In this regard, they urged the authorities to take bold steps to expand the coverage of direct taxes to all sectors of the economy, further reduce exemptions from indirect taxes, and improve public sector pricing policies. Directors noted, in this context, that a broadened coverage of the domestic tax base would also facilitate the deepening of the trade liberalization program. In addition, a number of Directors underscored the need to contain current expenditures, particularly those for unproductive purposes, including defense outlays mentioned by many speakers, while raising public investment outlays in areas such as infrastructure, education and social sectors.

Directors observed that sustained fiscal adjustment efforts would alleviate the excessive burden that has been placed on monetary policy, as well as provide a strong basis for an early effective move to indirect monetary management. Such efforts would also facilitate the intensification of structural reforms, which should continue to emphasize the trade and privatization areas. Several speakers stressed that the authorities should give more emphasis to the anti-inflationary role of exchange rate policy, which, in the process, should become increasingly a guide to monetary and interest rate policy.

Directors noted the considerable damage caused by the recent floods and expressed deep sympathy for the resulting human suffering and physical devastation. They commended the authorities on their adoption of emergency relief efforts and on their commitment to implement flood rehabilitation measures while continuing the underlying adjustment and reform program.

Directors emphasized that Pakistan's adjustment and reform measures required and deserved the continued and timely availability of external financing on appropriate terms. Several Directors also stressed the importance of a reduction in trade protectionist measures facing Pakistan's exports.

Finally, several Directors expressed the hope that Pakistan would formulate and implement a strong and comprehensive adjustment program with significant and realistic prior actions, particularly in the areas of financial policies and structural reforms, that could be supported by the use of ESAF resources.

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

The Executive Board approved the following decisions:

Pakistan - Decision Concluding Article XIV Consultation

1. The Fund takes this decision relating to Pakistan's exchange measures subject to Article VIII, Sections 2 and 3, and in concluding the 1992 Article XIV consultation with Pakistan, in the light of the 1992 Article IV consultation with Pakistan conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. As described in EBS/92/174, Pakistan maintains a number of restrictions on the making of payments and transfers for current international transactions in accordance with the transitional arrangements under Article XIV, Section 2, except that the restriction evidenced by the payment of an import license fee required at the time of opening letters of credit or of making payments for imports, which also gives rise to a multiple currency practice, is subject to Fund approval under Article VIII, Sections 2 and 3. The Fund welcomes the recent action taken by the authorities to eliminate certain restrictions, and notes Pakistan's intention to eliminate the above requirement for an import license fee. The Fund urges the authorities to phase out all remaining restrictions as soon as possible. In the meantime, the Fund grants approval for the retention of the exchange restriction and multiple currency practice arising from the imposition of the import license fee until July 1, 1993 or the date of completion of the 1993 Article IV consultation with Pakistan, whichever is earlier.

Decision No. 10197-(92/140), adopted
November 25, 1992

Pakistan - Purchase Transaction - Emergency Assistance

1. The Government of Pakistan has requested a purchase equivalent to 25 percent of quota (SDR 189.55 million).

2. The Fund notes the intentions of the Government of Pakistan as stated in its letter dated November 1, 1992, and approves the purchase in accordance with the request.

Decision No. 10198-(92/140), adopted
November 25, 1992

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/92/139 (11/20/92) and EBM/92/140 (11/25/92).

4. UKRAINE - REPRESENTATIVE RATE FOR UKRAINIAN KARBOVANETS

The Fund finds, after consultation with the authorities of Ukraine, that the representative exchange rate for the Ukrainian karbovanets under Rule O-2(b)(i), is the rate for the U.S. dollar in the exchange market as determined by the National Bank of Ukraine on the basis of competitive bidding among representatives of participating commercial banks. (EBD/92/277, 11/18/92)

Decision No. 10199-(92/140), adopted
November 20, 1992

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

The Executive Board approves the recommendation by the Committee on Liaison with the CONTRACTING PARTIES to the GATT with regard to the guidance statement for the Fund representative attending the GATT consultation with the Philippines, as set forth in EBD/92/280 (11/20/92).

Decision No. 10200-(92/140), adopted
November 20, 1992

6. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAM/92/124 (11/20/92) and by Advisors to Executive Directors as set forth in EBAM/92/123 (11/19/92) is approved.

APPROVED: June 15, 1993

JOSEPH W. LANG
Acting Secretary