NOT FOR PUBLIC USE

0404

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 93/133

10:00 a.m., September 16, 1993

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
M. Al-Jasser	A. A. Al-Tuwaijri
	M. Sirat
	J. Prader
	V. Kural, Temporary
I. Fridriksson	J. A. Solheim
	A. Törnqvist, Temporary
H. Fukui	N. Tabata
K. P. Geethakrishnan	
J. E. Ismael	
	K. Link
	W. Ch. Keller, Temporary
A. Kafka	
	A. V. Mozhin
	E. V. Kotova, Temporary
	J. Papadakis
	A. Galicia, Temporary
A. Mirakhor	O. Kabbaj
L. J. Mwananshiku	J. A. K. Munthali, Temporary
D. Peretz	D. A. Barr, Temporary
	O. Havrylyshyn
	A. R. Ismael, Temporary
S. Schoenberg	
A. S. Shaalan	
D. E. Smee	
	J. M. Abbott, Temporary
E. Waterman	
	Wei B.
	Wu H., Temporary
	S. del C. Olgiati, Temporary

J. W. Lang, Acting Secretary
M. J. Miller, Assistant
C. P. Clarke, Assistant

Also Present

S. Certan, Minister of Economy, Moldova. IBRD: R. Regina Bendokat, J. Walters, Europe and Central Asia Regional Office. European I Department: C. M. Watson. European II Department: J. Odling-Smee, Director; E. Brau, Deputy Director; J. A. Haley, M. A. Horton, G. Justice, A. Ouanes, G. Shabsigh. External Relations Department: S. J. Anjaria, Director. Fiscal Affairs Department: N. Mates, R. McMorran, P. J. Schiff. Legal Department: R. B. Leckow, J. K. Oh. Middle Eastern Department: P. Chabrier, Director; M. A. El-Erian, A. C. A. R. Furtado, S. H. Hitti, Z. Iqbal, E. B. Maciewjewski, A. Salehizadeh, S. M. Tareq, J.-P. Zhou. Monetary and Exchange Affairs Department: T. J. T. Baliño, G. R. Iden. Policy Development and Review Department: J. T. Boorman, Director; M. Allen, N. Calika, U. W. Corsepius, N. Kirmani, R. Moalla-Fetini, A. Singh, S. K. Wajid. Research Department: M. S. Khan, Deputy Director; N. Haque. Secretary's Department: A. Jbili. Treasurer's Department: H. Flinch, K. Kenney. Advisors to Executive Directors: M. A. Ahmed, L. E. Breuer, T. K. Gaspard, J. Jamnik, M. F. Melhem. Assistants to Executive Directors: B. Abdullah, S. E. Al-Huseini, R. N. A. Ally, G. M. Blome, J. H. Brits, J. M. Burdiel, A. Cathcart, M. Dzervite, J. C. Estrella, S. S. Farid, L. Fontaine, H. Golriz, M. A. Hammoudi, K. J. Langdon, G. J. Matthews, S. C. McDougall, T. Oya, N. Prasad, S. K. Regmi, S. Rouai, M. Ryan, L. Tase, A. Viirg.

1. PAKISTAN - STAND-BY ARRANGEMENT, AND EXCHANGE SYSTEM

The Executive Directors considered a staff paper on Pakistan's request for a 12-month stand-by arrangement in an amount equivalent to SDR 265.4 million (EBS/93/140, 8/20/93; Sup. 1, 8/25/93; and Sup. 2, 9/13/93). They also had before them a policy framework paper for 1993/94-1995/96 (EBD/93/141, 8/30/93).

Mr. Mirakhor made the following statement:

The staff has produced a concise and well-written paper on recent economic developments and prospects in Pakistan. Especially noteworthy is the fact that the report was provided expeditiously to the Executive Board for consideration of Pakistan's request for a stand-by arrangement at the earliest feasible date. The authorities wish to thank the management and staff for their cooperation and valuable assistance.

Directors will recall that the 1992 Article IV consultation with Pakistan was brought to the Board in conjunction with a request for emergency assistance following the widespread destruction caused by floods in September 1992. On that occasion, while Directors commended the implementation of the impressive array of structural reform measures to liberalize, diversify, and privatize the economy, they expressed concern regarding the persistence of Pakistan's weak financial balances. Accordingly, they emphasized that an effective and lasting reduction in the fiscal deficit was the key to sustainable adjustment, and essential for reaping the full benefits of supply-side reforms.

Following the adoption of immediate measures to deal with the flood damage, action was taken to tighten the stance of fiscal and monetary policies and improve competitiveness through adjustment of the exchange rate. Revenue collection efforts were intensified, expenditures were contained, and efforts were made to limit the growth of monetary aggregates. As a consequence of these corrective measures, aggregate demand pressures were reduced and financial performance improved in the second half of 1992/93. The importance of these measures was heightened by the need to offset the impact of a series of exceptional exogenous shocks that further weakened the economy. The outbreak of a plant virus in certain cotton growing areas exacerbated the flood damage. As a result of these adverse developments, agricultural output fell by more than 4 percent.

The external position also came under severe pressure. After a relatively good performance in the first half of the year, there was a dramatic falloff in export growth, as the flood and viral damage to production and export supply was felt, and as Pakistan witnessed a deterioration in its terms of trade. As a consequence, the trade balance worsened at a time when the external payments position was already under strain owing to capital outflows stemming from domestic political tensions. The combination of these factors made the gross reserves position extremely vulnerable. All in all, 1992/93 was a very difficult year for Pakistan, and, while the authorities recognize that economic performance was not entirely satisfactory, the severity of domestic and external shocks, at a time of political crisis, would have produced a much worse outcome but for the measures adopted.

In response to these adverse developments, the authorities, building on the foundation already established, implemented a set of measures to immediately address the weak reserves position and minimize capital outflows and, next, to broaden and deepen the foundation for sustained economic growth. Accordingly, the macroeconomic policy stance for 1993/94 aimed at a sharp reduction in the fiscal deficit, based on significant revenue mobilization and expenditure containment efforts, a further tightening of monetary policy, and additional structural reforms. By introducing these measures, the authorities avoided having to resort to widespread restrictions and administrative controls that, while politically convenient, would have eroded much of the favorable impact of domestic adjustment policies already implemented. The staff paper provides the details of the quantitative and structural aspects of the measures that were taken, and they need not be repeated here. It should suffice to highlight two aspects. First, new revenue-generating measures equivalent to 1.4 percent of GDP were accompanied at the outset of the fiscal year by a strengthening of the budgetary structure. The latter was accomplished by broadening the base and expanding the scope of direct and indirect taxation, while making adjustments in petroleum prices more responsive to developments in landed costs. Second, on the expenditure side, the authorities took a bold decision to cut military outlays by close to 1 percent of GDP.

The implementation of the strong corrective policy measures contained in the 1993/94 budget, however, was placed at risk by the continuation of a difficult political situation--bordering on a constitutional impasse--and resulting in mounting pressures on the balance of payments. Thus, when the present interim Government under the leadership of Mr. Moeen Qureshi took power, it inherited a difficult economic situation. It moved swiftly to calm markets and restore confidence. A significant, discrete adjustment of the exchange rate was undertaken to reverse the erosion in external competitiveness, check capital outflows, and assist in stabilizing the balance of payments. This action was followed by the termination of the concessional urban transport credit scheme, which had contributed to the large increase in private sector credit and external pressures. On August 16, the authorities moved again to tighten monetary policy sharply and to enhance financial intermediation, including, inter alia, through a marked reduction in the scope of concessional credits and higher rates of return on the range of available financial instruments. On August 19, the Government announced a comprehensive package of supplemental revenue-raising measures and other reforms.

The supplement to the staff paper provides a full description of the actions that the authorities have taken against the background of a well-articulated medium-term adjustment strategy aimed at promoting economic growth in an environment of financial stability. These include measures to raise additional gross revenues of PRs 10.5 billion in the remainder of the present fiscal year, and thereby to firmly secure the targeted reduction in the fiscal deficit for 1993/94. In addition to the steep upward adjustments in key administered prices aimed at bolstering budgetary revenues and provincial finances, the authorities have implemented, for the first time in Pakistan's history, the politically controversial agricultural wealth tax, which has a larger valuation base, and have supplemented this action with a provincial income tax. Action has also been taken in the external sector to liberalize the trade system and remove a number of Article XIV restrictions, as a first step toward Pakistan's early acceptance of the obligations of Article VIII.

Progress in implementing the program in the first two months has in general been excellent, and there are strong indications that all end-September performance criteria can be met. The large bank borrowing that occurred in July is being reversed; trade performance has been encouraging, and there are signs of a reversal of capital outflows; and foreign exchange reserves have risen, although they still remain at low levels. Based on these favorable developments and indications, the authorities are confident that, given the strength of the prior actions, the economy can return to a path of stable and noninflationary growth.

In looking at the program, two elements should be emphasized. First, in terms of the strength and the heavy front-loading of actions, the authorities have gone beyond the commitments outlined in their letter of intent. For example, the authorities had planned to take additional measures equivalent to PRs 6 billion to safeguard the fiscal target for 1993/94. As the staff supplement shows, the measures actually taken are expected to yield over PRs 10 billion, resulting in net incremental budgetary receipts of PRs 7.5 billion. This brings the cumulative gross revenue effort in 1993/94 to over PRs 32 billion--more than 2 percent of GDP--an effort that is without parallel in Pakistan's economic history. Second, the structural content of the program is substantial, particularly with respect to the taxation of agricultural wealth, a reduction in defense expenditures, and other reform measures in the fiscal, financial, exchange, and trade and payments areas. It is clear that the design and implementation of policies go well beyond what is normally associated with a stand-by arrangement. From the outset, the authorities' objective has been a comprehensive medium-term program to be supported by a multiyear Fund arrangement. Nevertheless, they have agreed with the present two-stage approach--with the request for a stand-by arrangement being followed by an enhanced structural adjustment facility (ESAF) and/or extended Fund facility (EFF) arrangement--to allow for the endorsement of the program by the Government that assumes power following the October elections.

Regardless of which of the leading political parties forms a government, it is important to emphasize that there are strong reasons to believe that the political commitment to the adjustment program will be sustained, and that the policy measures implemented thus far will prove to be durable. Most of the politically difficult decisions that were needed to create the proper conditions for financial stability and sustained noninflationary growth have already been taken. This fact alone should make it easier for the incoming Government to continue to maintain the momentum of adjustment. The interim Government has kept the major political parties informed of the policies being implemented; in fact, previous governments had each negotiated various components of the program. Although there has been widespread criticism of the measures that have had a significant and immediate impact on prices, a broad consensus appears to have developed on the need for and direction of economic reforms, particularly with regard to tight demand management and the maintenance of economic liberalization. Given the consensus on the direction of economic policies and the strong prior actions implemented, there is little risk that the commitment to the program will change. Thus, although the authorities have opted for the two-stage approach, they see it nonetheless as a continuum--with the stand-by arrangement laying the basis for a smooth progression to an ESAF/EFF arrangement immediately following the October 1993 elections.

The authorities are confident that the success of the strong prior actions will ensure that the targeted path of adjustment will be adhered to over the medium term. The present program is meant to mark a watershed in Pakistan's economic history. It will help create an environment in which the country can realize the full efficiency gains of massive and unprecedented reform efforts. In view of the fact that the program has already received strong endorsement by the multilateral agencies, timely external financial assistance to Pakistan will lead to a further strengthening of confidence-building measures undertaken by the authorities and will thus reinforce substantially the irreversibility of the adjustment process.

Mr. Al-Jasser made the following statement:

In the past few years, Pakistan has implemented a broad set of impressive and commendable structural reforms. It is encouraging to note that these reforms have fostered a favorable supply-side response. GDP expanded at a robust pace, exports rose markedly, and domestic and foreign investment increased. These results are all the more significant given the severe unanticipated shocks that have confronted the economy over the past several years.

These achievements notwithstanding, demand management performance fell short of the authorities' targets, owing mainly to fiscal slippages. As a result, Pakistan's internal and external imbalances remained substantial. Therefore, the authorities' request for a stand-by arrangement, to be followed at an early stage by a program supported by an arrangement under the ESAF or the EFF, is indeed welcome. This will provide the appropriate framework to consolidate progress already achieved in the structural reform, while stabilization efforts are strengthened.

I would like to commend both the authorities and the staff for their efforts in formulating the program for 1993/94 under the stand-by arrangement. The program is comprehensive, and, if fully implemented, will place the economy on a path of high economic growth. However, the actions required under the stand-by arrangement have for the most part already been fully implemented. This is a loud and clear signal of the authorities' seriousness and resolve in adopting and implementing the needed adjustment policies, and I have no hesitation in supporting the proposed decisions. In this regard, I fully agree with Mr. Mirakhor that the design and implementation of policies go well beyond what is normally associated with a stand-by arrangement. This should bring about a smooth transition to an arrangement under the ESAF or EFF immediately following the October 1993 elections.

I fully agree with the authorities' priorities and planned policies. The fiscal adjustment targeted for 1993/94 is both impressive and ambitious. In this regard, the prior actions taken by the authorities, especially the broadening of the tax net to the agricultural sector, the reform of the tariff system, and the increase in utility prices, are commendable. Moreover, the introduction of revenue measures that go beyond those envisaged in the program confirms the seriousness of the authorities in tackling the fiscal deficit. Despite these impressive measures, it remains to be seen whether the ambitious projections for tax revenues would be achieved. Therefore, I urge the authorities to monitor the revenue situation closely.

On the expenditure side, the importance of continuing efforts to improve the structure of spending is reinforced by the need to contain overall expenditures while meeting higher debt-service costs. Indeed, domestic debt-service costs may well increase further in the short run, as yields are fully freed in the treasury bill auction markets. Moreover, pressures to raise wages are likely to intensify. In this regard, it is most important for the authorities to fully implement their plan to rationalize expenditures and prioritize investments while containing overall spending.

Fiscal restraint will also hold the key to the success of the authorities' monetary and credit policies. The reduction in the budget deficit will allow for a larger allocation of credit to the growing private sector, while anchoring the economy on the firm path of declining inflation. Fiscal consolidation will also facilitate the efforts of the authorities to free the rates of return in the financial markets without placing strong upward pressure on interest rates, which could prove unduly disruptive to the private sector. Moreover, the elimination of the concessional urban transport credit scheme and the increase in interest rates on other concessional lending will improve the allocative efficiency of credit. These measures, coupled with the planned structural reform of the financial sector, should further improve the functioning of the capital markets and consolidate the move toward a market-based system of indirect monetary control.

Concerning the external sector, I fully support the authorities' efforts at further exchange and trade system liberalization. Tariff reform, as well as a reduction in the negative list of imports, is a step in the right direction. Moreover, the authorities' removal of a number of exchange rate restrictions is also commendable. While further liberalization of the exchange and trade system is needed, I am confident that the authorities will take the necessary steps to do so as soon as it is practical.

The current exchange rate policy of the authorities has served the country well. I therefore agree with the staff that the timely and sustained implementation of fiscal and monetary measures is critical to the continued effectiveness of this policy.

Pakistan has already undertaken substantial structural reform. In particular, I welcome the emphasis in the current program on intensifying and consolidating these reforms, especially strengthening the deregulation and privatization program and improving the social indicators. Of course, substantial additional measures are embodied in the policy framework paper.

It is encouraging to note that implementation of the above-mentioned policies has already started to pay dividends. Gross official reserves of Pakistan have registered substantial gains since mid-July, increasing by more than two-and-a-half times, to $507 million by end-August. This should raise confidence in Pakistan's reform process, as well as send a message to all countries about the benefits of implementing appropriate adjustment policies.

Pakistan is clearly implementing an outward-looking, growth-oriented macroeconomic adjustment program, which is expected to result in an expansion of private and foreign investment, an increase in reserves, and a reduction in fiscal imbalances. The international community should be urged to support these efforts through the elimination of trade restrictions. To this end, I urge that all restrictions on developing countries' exports be removed as quickly as possible.

The program is both impressive and ambitious. The authorities deserve much credit for the strengthened vigor they have introduced into Pakistan's adjustment effort. We in the Bretton Woods institutions can take pride that among the present architects of this program are two distinguished former staff members of the World Bank and the Fund. I wish Mr. Moeen Qureshi and Mr. Muhammad Yaqub and their colleagues every success in helping Pakistan overcome the agonies of underdevelopment.

Mr. Peretz made the following statement:

I almost feel as if I should start by declaring a personal interest in this request for Fund support. I became a strong personal admirer of the present caretaker Prime Minister of Pakistan when I got to know him as a Senior Vice President of the World Bank. My admiration is deepened as I have seen the speed and political and economic skill with which he has put together a program of economic measures in Pakistan, and as he has gained the internal and external support needed to see them through. This is a tribute to both Moeen Qureshi and the Bretton Woods institutions as a training ground. Perhaps we should encourage more Fund and Bank staff to follow the footsteps of Messrs. Qureshi and Yaqub.

The speed with which a high-quality reform program has been put in place in Pakistan is also an example to the rest of the world, and in particular, to the many countries that face similar economic difficulties, but which say that rapid economic policy action is difficult or impossible.

There are uncertainties ahead, including the October election and Pakistan's own poor past record of policy implementation. However, I am sure that in this case, prompt Fund financial support is well justified, first by the wide-ranging and ambitious set of prior actions already taken--which in some respects go beyond the performance criteria agreed at the end of August--and second, by the indications that have been given by the main political parties that whoever wins the elections will follow through on an economic program along the lines of the one being put in place.

Given Pakistan's past poor record of implementation, I would want to emphasize the importance of Pakistan continuing fully to implement the measures that are now being supported by the stand-by arrangement. The importance of following through, as quickly as possible after the elections, with a medium-term program of measures that could be supported by an extended arrangement or--preferably--an ESAF arrangement should also be stressed.

I note that tax revenue, which is already low as a proportion of GDP, must rise sharply in order to meet the projected fiscal deficit target. The steps that have been taken to broaden the tax base, develop a sales tax, and rationalize trade taxation will need to be supported by improved implementation and collection. I welcome in particular the introduction of a wealth tax on agriculture. Although agriculture employs more than half of the labor force, the ownership of land is very concentrated, so the new tax is progressive in nature. I hope that its introduction is smooth, and I look forward to its eventually generating substantial contributions to revenue after it has been expanded, in line with the performance criterion set out for end-June 1994.

On the expenditure side of the budget, the authorities have indicated that they intend to reduce military spending by a little less than 1 percent of GDP. This is very much welcome, but military spending remains high, at about one third of total Government current expenditure. I would urge Pakistan to explore the possibility of securing further reductions in military spending, as part of a multilateral reduction in military spending across the whole region.

Regarding monetary policy, after the summer's balance of payments difficulties and exchange rate devaluation, the need for a tight but credible monetary policy is self-evident. Official rates of return have been increased by about 2 percentage points, and partly as a consequence, foreign exchange reserves have begun to rebuild. This is yet another demonstration of the benefit of having positive real interest rates and real rates of return that are sufficiently positive to stabilize inflation expectations. I urge the authorities to continue their policy in this respect.

With respect to trade liberalization and tariff reform, I am pleased to see the planned reduction in the maximum tariff from its previously very high level of 90 percent to a point that has yet to be established, but will likely be in the range of 35 percent to 50 percent by 1994/95. Even this level remains high, however, and I would urge the authorities and the Fund to aim to agree on a figure at least at the bottom of the range when reaching agreement on a program to be supported by an extended arrangement. In addition, I note that the elimination of export taxes will be a particular help in establishing the recovery of exports.

The privatization process has been fairly impressive so far, with the majority of industrial companies being sold off, but it seems to have slowed considerably since the time of the Article IV consultation discussion in November 1992. It will be important for an extended program to include benchmarks for progress in this area, and I note that the policy framework paper envisages extensive measures aimed at privatizing or reforming publicly owned companies. It will also be essential to have adequate regulation of the major utilities in place. Again, I welcome the fact that the policy framework paper recognizes the need for strengthening the regulatory bodies.

The interim Pakistan Government has made a very impressive start on an ambitious program of reform. I would have expected no less from the interim Prime Minister. The program must continue to be implemented and developed after the October elections. Assistance from the Fund will be essential to the success of the program. I support the short-term stand-by arrangement, and I also look forward to Pakistan embarking on an extended arrangement supported by an ESAF arrangement in due course.

Mr. Shaalan made the following statement:

I very much welcome the opportunity to discuss developments in the Pakistan economy in the context of the authorities' request for Fund financial assistance in support of their adjustment and reform program.

The Pakistan economy faced a series of adverse exogenous shocks in 1992/93 and early 1993/94. This compounded the impact of weak fiscal policies and resulted in a precarious foreign exchange position by mid-July. The interim Government is to be commended for its prompt adoption of comprehensive adjustment and reform measures that build on the policies of previous administrations. In addition to strong front-loaded fiscal, monetary, and exchange rate actions to strengthen the external position, the program incorporates structural measures that provide the basis for sustained high economic growth. Indeed, and as envisaged in its design, the program's content and coverage warrant multiyear Fund support under the ESAF and/or the EFF that would replace the proposed stand-by arrangement at an early stage. The impact of the program has already been reflected in a recovery of gross international reserves from the very vulnerable levels of mid-July 1993. This should be a clear signal to countries facing similar problems in the design of their programs.

The program for 1993/94 targets appropriately a strengthening of the gross international reserve position and a reduction in inflation in the context of a rebound in economic growth from its flood-impacted level, and a containment of internal and external indebtedness. Consistent with these macroeconomic targets, financial policies are being directed toward reducing the public sector borrowing requirement by 2.6 percent of GDP and lowering the current account deficit to 2 percent of GDP. I would like to focus on a few underlying policy issues.

As indicated in the authorities' comprehensive memorandum on economic policies and the policy framework paper, the sustainability of the wide-ranging structural reform policies implemented in recent years was being undermined by the inadequate financial policy stance--particularly in the fiscal area. Thus, despite a series of measures, Pakistan was unable to record an effective increase in its budgetary collection. This contributed not only to domestic and external financial imbalances, but also to constrained spending on the social sectors. In this context, we strongly welcome the fiscal adjustment component of the authorities' program for 1993/94. The reduction in the budget deficit of 2.3 percent of GDP is being achieved through significant revenue mobilization and the curtailment of unproductive outlays. Moreover, these measures are being accompanied by bold structural reforms to improve the revenue structure. I would point in particular to the expansion of the direct tax net to the agricultural sector--a measure that clearly signals the commitment of the authorities to addressing long-standing structural weaknesses. That was a measure that I personally would not have expected, given the social and political situation in Pakistan. Also noteworthy is the expansion of the general sales tax toward a broad-based modern value-added tax and the rationalization of taxation on international trade. I hope that before the value-added tax is introduced, the necessary infrastructure will be put in place, in order to secure effective tax implementation and collection. The policy framework paper appropriately contains a clear road map for further progress in these areas over the next few years.

The fiscal adjustment is being accompanied by measures to restrain liquidity growth and improve financial intermediation. Given the difficult external position, we welcome the authorities' measures to support the exchange rate adjustment through a comprehensive increase in the rates of return structure and a determined move toward market determination of such rates. Indeed, the experience of Egypt clearly points to the success that coordinated financial polices can have in bolstering the reserve level and in lowering external account vulnerability on account of foreign currency accounts. The effectiveness of monetary policy will be enhanced by the reduction in fiscal imbalances and the curtailment of concessional credit facilities.

In the context of the experience of Egypt, I have referred to the critical importance of well-coordinated financial policies to achieving overall program targets. With the benefit of hindsight, however, that particular experience suggests that monetary policy was tighter than was needed to achieve the program targets--certainly the inflation target. Looking at the case of Pakistan today, I wonder whether the same could not be said about the programmed monetary policy stance, especially with regard to the inflation target and providing sufficient credit for the private sector. What leads me to this question is the staff's apparently conservative assumption on the behavior of demand for money in 1993/94, as implied by the targeted containment of liquidity expansion to below the projected growth of nominal GDP. A staff comment on this issue would be highly appreciated.

The deepening of structural reforms in the external trade and payments and domestic deregulation areas should also be emphasized. Pakistan has achieved much in these areas, and we are encouraged by the authorities' determination to consolidate and extend the gains. Lower tariffs are being accompanied by a reduction in non-tariff barriers through action on the restricted and negative lists. The authorities have also specified a timetable for the elimination of all payments restrictions subject to Fund jurisdiction under Articles VIII and XIV during the fiscal year. These important steps leading to full current account convertibility of the Pakistan rupee, like direct taxation of the agricultural sector, were considered unlikely only a short time ago. The external trade and payments reforms are to be accompanied by an intensification of the privatization program, including its extension to major utilities.

The staff paper points clearly to the challenges and risks facing the program. In view of the uncertainties and experience under recent programs, I very much share the staff's emphasis on the importance of sustained policy implementation and readiness to adopt additional measures if the need arises. The implementation of the program's comprehensive prior actions--in some cases going beyond those specified in the memorandum on economic policies--is an encouraging signal in this regard. I am also encouraged by indications of the broad consensus on economic policy challenges among the major political parties. This bodes well for the sustained implementation of the program after the October elections.

Having emphasized the importance of determined domestic policies, I would also stress the role of a conducive international environment--both in terms of a reduction in protectionist barriers in major export markets, and in terms of the timely availability of external assistance. These two areas have often hampered reform efforts in Pakistan.

The Fund's willingness to move quickly and provide financial assistance in support of the authorities' program provides important demonstration effects, as does the World Bank's approval of the Public Sector Adjustment Loan a few days ago. Given the structural emphasis of the program and its medium-term orientation, I would support continued Fund involvement, including early Board consideration of assistance under the ESAF and/or the EFF.

Regarding the matter of social safety nets, I welcome the increasing emphasis being placed on investments and current outlays in the social sectors. The staff indicates in the paper that "measures would need to be coordinated with other safety net programs seeking to protect the most vulnerable segments of the population...". I am not sure whether social safety nets, as defined in the Acting Chairman's summing up of the Board discussion on the subject, have been, or are being, put in place in conjunction with the program before us today. It may be recalled here that the definition I am referring to is "temporary arrangements and an adaptation of more permanent social protection measures which are aimed at mitigating possible adverse effects of reform measures on the poor and vulnerable groups." I would appreciate some staff elaboration on what has been, or is being, done toward this objective--outside of the payment of 100 rupees to individuals below a certain income threshold. In any event, I would stress the importance of ensuring adequate protection under well-designed safety nets in the period ahead and over the medium term, in particular in view of the planned intensification of the reform efforts in the areas of deregulation and privatization.

I support the proposed decisions.

Mr. Geethakrishnan made the following statement:

I would like to compliment the authorities on the speed with which they have formulated the package of measures that will help to accelerate the reform process. This has also enabled the expeditious processing and consideration of their request for a stand-by arrangement.

The measures that constitute the prior actions and structural reform criteria, as listed in Table 9 of the staff paper, are indeed impressive and commendable. Some of these, in particular that to extend taxation to the agricultural sector, are indeed quite courageous steps. The implementation of these measures will give the much-needed momentum to the reform process, and will also put the reform process itself on an irreversible onward track. This chair would like to compliment the authorities on the bold initiatives that they have taken. We support the proposed decision on the stand-by arrangement.

Mr. Tabata made the following statement:

I appreciate the fact that the Pakistani economy attained an average of approximately 6 percent real GDP growth, an increase in productivity in the manufacturing sector, and an expansion of exports, through the implementation of various kinds of reforms under the previous program under the structural adjustment facility. However, the fiscal deficit is still large, the inflation rate has not yet subsided, and the external position has been fragile. In addition, a parliamentary election is scheduled to be held next month. Taking these factors into account, as the staff pointed out in the paper, the existence of a certain amount of risk cannot be denied.

Accordingly, the authorities are required to make every effort to implement economic reforms, and, at the same time, to observe the performance criteria under the coming program.

In any event, it is welcome that almost all the prior actions, except the liberalization of imports of some commodities relating to national security, are satisfied, some policy measures beyond the program targets are already implemented, and the Government's borrowing from the banking sector has begun to decrease through the contraction of expenditures, as well as through the inflow of foreign money.

On the fiscal front, it is a matter of great regret that the fiscal deficit vis-à-vis GDP largely surpassed the program target in 1991/92, and deteriorated further in 1992/93. The 1993/94 target of reducing the ratio to 6.7 percent, however, is still extremely high. Further efforts are required on both the revenue and expenditure sides.

On the revenue side, it is welcome that some enhancement measures have already been taken in recent weeks; however, the reduction of tax exemptions and concessions, the simplification of the tax rate structure, the reform of the general sales tax, and the rationalization of trade taxation should be executed without delay.

On the expenditure side, military outlays are planned to be reduced from 6.5 percent of GDP in 1992/93 to 5.6 percent in 1993/94. However, the level is still extremely high. Taking the inflexible budgetary situation into account, it is all the more important to cut military expenditures further, by thoroughly investigating every item.

In order to reduce inflation and inflationary expectations, the cautious implementation of monetary policy is imperative. Under the first year of the program, the rate of increase in credit to the government sector is planned to decrease substantially, from 11 percent in 1992/93 to 3 percent this year. In order to realize this significant reduction, as the staff pointed out, it is urgent to improve the government bond market. In this connection, I would like to ask the staff when an expansion of the open market and an increase in instruments using market operations will be implemented. At the same time, I would like to ask the staff whether the market has credible brokers, healthy participants, and a reliable payments system. Market infrastructure is extremely important for the smooth functioning of the open market. I would like to have staff's assessment of this.

I highly appreciate the raising of interest rates last month, the termination of the transport scheme, and the Government's firm commitment to reform the financial sector.

The staff strongly denied the existence of non-market-based lending or policy-guided financing to certain sectors. However, these kinds of non-market-based financing are sometimes useful to provide loans for small- and medium-sized enterprises and for housing construction, given the low saving rate in the economy and the insufficient intermediary role played by the banks.

With regard to the external sector, I expect that the recent depreciation of the exchange rate will have favorable effects on the external balance. At the same time, the introduction of some measures, such as tax incentives, in order to promote the inflow of direct investment, is worth considering.

The Japanese authorities appreciate the fact that the Pakistani Government has implemented various reforms under the leadership of Prime Minister Qureshi in cooperation with the Fund and the World Bank. This, in turn, enables the new cabinet to continue executing the reform policies. I strongly hope that the new cabinet will make every effort to implement various reforms under the coming program, and will put the economy back on a sustainable growth path. I support the proposed decisions.

Mr. Schoenberg made the following statement:

Like previous speakers, I am concerned about the substantial deterioration in the economic situation in Pakistan over the recent past, which has eroded a large proportion of the hard-won gains achieved in earlier years. At the same time, however, I welcome the fact that the new interim Government, which includes acknowledged economic experts, has come forward quickly with a comprehensive adjustment program designed to overcome the current problems. We also welcome the fact that the Government intends to implement this program in close cooperation with the Fund and the international community. Nevertheless, today's request for a stand-by arrangement is bound to provoke some critical remarks in view of the country's unsatisfactory macroeconomic performance under previous Fund-supported programs. I cannot help but observe in this context, as the staff also does, that on several occasions in the past, Pakistan launched comprehensive adjustment efforts that achieved initial success, but which tended to falter afterwards. Thus, it remains to be seen whether the Government that will take office after the elections in October will be willing and able to sustain the announced fundamental reorientation of financial policies.

It is also to be noted, as the staff makes clear, that the risks to the program in this case are considerable. These relate, for example, to the outcome of the October parliamentary elections. Speakers who have referred to the strong commitment of the Government or of the authorities to the program should bear in mind that, in any parliamentary democracy, such a commitment is guaranteed only until the next election--in this case, next month.

I would also like to point in particular to the external position, which will remain very vulnerable during the following months, creating the impression that even limited policy slippages or minor adverse external developments--which cannot be ruled out, given the many risks to the program and the past experience--might derail the whole adjustment process.

This raises the more fundamental question as to whether or not the Fund's financial support can be justified at this stage. In my view, it would have been desirable to wait until the new

Government that will be elected in October has established an adequate track record over a certain period of time before presenting this request for a stand-by arrangement to the Board. In any case, such a track record should be a prerequisite for an arrangement under the ESAF or EFF, which the incoming Government might seek to arrange immediately after its inauguration. That would mean that, before the Fund could consider entering into an extended arrangement, the performance criteria under the new stand-by arrangement would have been observed for some time.

A back-loading of disbursements under the envisaged stand-by arrangement would have been more appropriate than the proposed front-loading. However, I realize the urgent need at present to bolster Pakistan's gross official reserves through exceptional financing, in which the Fund's financial assistance should play an important role. In addition, nearly all the announced prior actions have already been implemented, and the available indicators suggest that Pakistan will be in a position to observe the performance criteria and indicative targets for end-September 1993. Under these circumstances, I can support the requested arrangement. However, I should emphasize that the full and timely implementation of the 1993/94 program will be indispensable, and that the Government to be elected in October must make a clean break with the policies of the past.

With regard to fiscal policy, I welcome the relatively ambitious deficit reduction target for 1993/94--an improvement of the primary budget balance by 3 percent of GDP. A casual observer might criticize the fact that the bulk of the fiscal adjustment is scheduled to be made on the revenue side. I tend to agree, however, that the thrust of the structural adjustment, which is aimed at addressing a long-standing problem of public finance--the narrow tax base and the relatively inelastic tax system--is the right one. The measures envisaged will still only lead to a slight increase in the ratio of tax to GDP in 1993/94--from 13.4 percent to 14.1 percent, according to the staff paper. That could point to the need to further broaden the tax base, including more comprehensive taxation of the agricultural sector. The recent extension of the direct tax net to agriculture can be seen as an appropriate step in this direction, although tax exemptions in this area are still prevalent, and the yield of the new tax measures is thus expected to remain modest, at least in the first year.

The elasticity and flexibility of the tax system could also be improved by further reforms in the area of administered prices. Here, I would encourage the authorities to replace at an early date the petroleum and natural gas surcharge with value-added excise and sales tax, which would allow consumer prices to adjust automatically to changes in international prices and exchange rate movements.

With respect to monetary policy, I welcome the objective to limit domestic liquidity expansion to 14.5 percent in this financial year, which is somewhat below the 16.5 percent expansion in nominal GDP. I note, however, that the growth of monetary aggregates has exceeded considerably the growth of nominal GDP in the past two years by probably more than 14 percent, which might have led to a certain liquidity overhang in the economy. The monetary policy envisaged under the program will reduce this excess liquidity only slightly, and therefore might not be tight enough to break inflationary expectations. I would welcome some staff comments on that issue. The authorities should thus stand ready to tighten monetary policy further if inflationary pressures do not subside in the course of the year.

I would underline the staff's view that a responsive rate of return policy is crucial for the attainment of the program targets. The recent increase in central bank and treasury bill rates is to be welcomed in this regard. I note, however, that the new lending rate on concessional credits--11 percent--is only slightly higher than the current inflation rate, while a number of deposit rates still seem to be negative in real terms. Obviously, a number of legal uncertainties prevail in this area, including those surrounding the status of the Shariat Court ruling on interest, which may have a negative impact on deposit mobilization.

The authorities should, therefore, accelerate the reform of the financial sector, with the goal of establishing adequate market-determined rates of return in all areas. In addition, the Government should formulate a timetable for the elimination of the concessional credit schemes, and should aim at an early privatization of the United and Habib banks. I also agree with those speakers who see a need to develop further the government securities market.

With regard to external and structural policies, I would encourage the authorities to build on the structural improvements achieved in the past, and to liberalize further foreign trade, which could contribute to improving the external competitiveness of Pakistan's economy. Although the maximum tariff rate has been reduced recently from 90 percent to 80 percent, the tariff structure remains somewhat on the protectionist side. This holds true in particular for the rates on automobiles, which are still in the range of 70 percent to 250 percent.

With these observations, I can support the proposed decisions.

Mr. Sirat made the following statement:

This chair is pleased to welcome this proposal for a stand-by arrangement for Pakistan, first, because of the impressive speed with which the authorities have committed themselves, with internal support, to a comprehensive and much-needed package of structural reforms, some of which have been implemented through very courageous measures, and second, because of the corresponding speed and professionalism with which the Fund and the World Bank have responded to the Pakistan authorities.

The conclusion of a stand-by arrangement just a few weeks before general elections might seem questionable. However, I can support the proposed decision, given the major structural reforms already implemented, notably, the broadening of the tax base and the general consensus in Pakistan regarding the reform process, as described by Mr. Mirakhor.

Of course, the newly elected authorities would have to continue to pursue a sustained adjustment policy and strengthen the structural reform process, in particular with regard to the tariff structure, for which most reforms are to take place only at the end of the proposed stand-by arrangement. From this point of view, I hope that Pakistan will soon be in a position to shift to a multiyear agreement with the Fund.

This being said, I wonder if the program might not be considered as based upon rather optimistic assumptions regarding both the rate of growth and--above all--the sharp reduction of the current account deficit. Under the program, real growth is to expand by 7.5 percent in 1993/94, while the public sector borrowing requirement would be reduced by nearly 2.5 percent of GDP. Since the growth of private sector investment would be somewhat constrained by the ceilings on the growth of net domestic assets, this assumption relies heavily on the contribution to growth of the external sector.

Exports are seen to rise by 22 percent, and by more than 15 percent in volume terms, while imports would decrease by 4.2 percent, and by 4.7 percent in volume. Altogether, the current account deficit, at 2 percent of GDP, would be reduced to its lowest level since 1988. This target might be difficult to achieve, because the major and welcome liberalization of trade policy will make the containment of import volume more difficult, on the one hand, and the exchange rate depreciation will imply an increase in import prices, on the other hand.

I do not wish to suggest that the program's hypotheses are not achievable, but I would like to stress the caution and care with which the authorities will have to monitor program implementation. I would appreciate comments from the staff on these assumptions, in particular with regard to the sensitivity of the budget deficit target to any decline in the rate of growth, and any possible contingency plan--especially concerning the level of imports--in case export growth does not reach the levels currently expected.

Regarding some policy issues under the program, Pakistan seems to be at a stage at which financial policies should fully match the structural reforms that have already been implemented. I broadly share the staff's comments on fiscal policy. On the revenue side, I welcome in particular the extension of taxation to the agricultural sector. On the expenditure side, I welcome the efforts made to rationalize budget management, and the commitment to increase expenditures in the social sectors--which had probably been sacrificed in the recent past. Indeed, the reduction in the growth of public expenditures should not prevent the authorities from seeking a shift away from unproductive expenditures.

Like previous speakers, I believe that developing the market for government bonds should facilitate the financing of the public deficit, and therefore reduce its inflationary impact somewhat.

Monetary policy will probably be rather difficult to monitor during the program period, as it should allow simultaneously for a reduction in inflation and for adequate financing of the rapid growth of private sector activity. Monetary policy should not be overburdened, and the authorities should keep in mind that the reduction in the budget deficit itself is a key element in the reduction of inflationary pressures, as mentioned by previous speakers. Any slippages in the budget targets would imply a crowding out of the private sector, assuming that the monetary authorities did not accommodate those slippages. The strengthening of the financial markets is certainly welcome, as it should foster domestic savings, thus helping the authorities to follow their objective of keeping investment at roughly 20 percent of GDP.

Reducing the importance of concessional loans is in itself a welcome move, as it would clarify the real financing costs for concurrent projects. Such a measure could imply a reduction of the total volume of investment, with a negative impact on growth, unless the authorities subsidize such investments in other ways. I would appreciate the staff's views on this issue.

With respect to exchange rate policy, the authorities should keep in mind the possible inflationary impact of any prolonged depreciation of the currency. This should reinforce the authorities in their resolve to implement strong internal adjustment measures.

I consider this program to be both impressive and ambitious. In view of the impressive corrective measures taken by the authorities in recent months, I can support the proposed decisions.

The staff representative from the Middle Eastern Department noted in response to Directors' comments, that one speaker had asked whether the monetary program was too tight, in that it would overachieve the inflation target while not providing sufficient scope for meeting the genuine credit needs of the private sector. Another speaker, in contrast, had asked whether the monetary program was too loose, given the inflation target. In formulating the monetary program, the staff and the authorities had tried to take account of a range of issues. The program incorporated a rate of domestic liquidity expansion that was lower than the projected rate of growth of nominal GDP, based on what the staff and the authorities expected to happen with income velocity of money, and taking into account the objective of mopping up excess liquidity in the economy consistent with the growth, inflation, and balance of payments objectives. Bank financing of the budget had been reduced quite sharply, as Mr. Al-Jasser had observed. Specifically, credit to Government, as a percentage of the beginning money stock, would be reduced from 11 percent to 3 percent, and as a percentage of GDP, from 4.4 percent to 1.3 percent, as Mr. Tabata had pointed out. An important change in the composition of private sector credit had also been programmed. With the reduction in directed credits--mostly to the transport scheme--credit availability to the private sector for genuine productive activity was expected to increase from about 1.9 percent of GDP to 2.7 percent of GDP. Therefore, the monetary program provided for greater scope to the private sector, while maintaining the objective of reducing inflationary pressures.

Regarding the adequacy of the institutional structure for government securities, the staff representative continued, the program incorporated a broadening of the markets for both treasury bills and longer-term bonds--three-year, five-year, and ten-year Federal Investment Bonds (FIBs). To make those instruments more attractive, the Government had undertaken to conduct a more flexible rates of return policy, and had taken steps to improve administrative aspects of the securities market--in particular, with respect to managing the maturity structure of government securities and the timing and operation of auctions. In addition, strict limits were being placed on government borrowing from the banking system, which would be reinforced by intended steps to increase the autonomy of the State Bank. A range of primary brokers, both from domestic and foreign banks, existed to deal with the placement of the securities. The Fund had provided technical assistance in the setting up of the primary dealer network, expanding the secondary market, and identifying--with a view to their elimination--discriminatory tax measures that would inhibit the development of the markets. The World Bank had also been providing technical assistance, including in the context of its financial sector adjustment loan.

There had been a significant increase in certain Government directed credits in 1992/93, in large part owing to the urban transport scheme, the staff representative commented. The increase in directed credits had had a direct impact on the financial intermediation process by constraining the ability of banks to provide resources to other private sector activities. There had also been a strong linkage between directed credits and weaker balance of payments developments. The authorities had moved to eliminate the urban transport scheme and to increase concessional rates on all other Government-sponsored schemes. The authorities had also committed themselves to not introducing any new schemes, with a view to eliminating all the concessional schemes eventually.

The spread between deposit rates and lending rates in Pakistan was very large, reflecting banking system inefficiencies, significant non-performing loans, and the fact that banks had been constrained from pursuing profitable lending opportunities in the face of quantitative restraints on them to extend credit in certain ways, the staff representative explained. It was to be hoped that, with the reduction in the number of schemes with concessional rates, banks would be able to offer higher deposit rates, thus increasing the mobilization of savings, while improving their loan-loss provisioning and observance of other prudential requirements.

Regarding the growth assumption and the related issues of exports and the current account, GDP was projected to grow by 7.5 percent in 1993/94, the staff representative continued. That compared with a growth rate of GDP of 3 percent in 1992/93 and 7.7 percent in 1991/92, and with an average rate of GDP growth of 6 percent during the 1980s. The rebound in GDP growth reflected the recovery of the agricultural sector from the widespread negative effect of the floods, which had had a direct impact in reducing cotton, sugarcane, and other crops, as well as an indirect impact on the textile and other industrial sectors that depended on the agricultural sector for inputs. The output levels of the major crops that were being assumed for 1993/94 were consistent with historical levels. At the same time, however, there was some uncertainty about the impact of the locust infestation--an issue which would become clearer in the period immediately ahead.

The rebound in agricultural output and in related industrial activities--in particular, textiles--was also behind the export and current account projections, the staff representative pointed out. Exports were expected to recover their flood-impacted level of 1992-93. The current account would also be affected by reduced flows of flood-related imports--such as wheat and for infrastructure rehabilitation--and the impact of the exchange rate policy and ongoing structural reforms. On the basis of the world economic outlook assumptions, the staff was also projecting an improvement in the terms of trade. All those elements together would be reflected in an improvement in the performance of the current account.

Given the low level of social indicators in Pakistan, short-term social safety net issues were closely related to longer-term social sector policy issues, the staff representative concluded. In collaboration with the World Bank and major donors, the Government had launched in 1992 the Social Action Program. That program sought to improve the coverage and quality of services in the health, nutrition, sanitation, and education sectors. A number of other less comprehensive programs were also in place, such as the Zakat Fund and the Bait-ul-Mal Fund, that were directed at assisting the most vulnerable segments of the population. The recent budgetary package, which had included price increases, also included relief measures, such as the increase in the minimum wage, in lower-level civil service wages, and in food stamp allocations. An explicit allowance had been made in the privatization program for retraining workers. To make further progress in the social sector, and as recognized by the Pakistan authorities, the Social Action Program would need to continue to expand, the degree of coordination between the various elements of social sector programs would need to be examined with the aim of improving their impact and cost effectiveness, and the health and pension elements of social programs would need to be improved.

Mr. Peretz stated that he very much welcomed the phasing out of directed and subsidized credits in Pakistan.

Mr. Tabata recalled that the staff representative had said that the State Bank of Pakistan would be accorded a greater degree of autonomy. He wondered whether the State Bank would be prohibited from purchasing treasury bills that remained unsold at auction.

The staff representative from the Middle Eastern Department replied that the ordinance regarding the State Bank's autonomy had not been issued yet, but the intention was that the State Bank would set a ceiling on the amount of credit that it provided to the Government through its various facilities. That ceiling would be consistent with the monetary program, which itself would be consistent with the macroeconomic objectives. The State Bank would have the power to refuse to extend any further credits above that ceiling.

Responding to a question from Mr. Al-Jasser about the impact of the locust invasion on agricultural output, and subsequently on the growth rate assumption, the staff representative said that the locusts had migrated from Africa and the Middle East to the southern areas of Pakistan and into India in the preceding two weeks. In an effort coordinated by the United Nations and involving Pakistan's donors--and in consultation with India--spraying operations had been intensified. The locust swarms were expected to mature in the succeeding week or so, at which stage the staff would have a better idea of the extent of the damage. The impact on the agricultural crop--mainly in Sind--would depend on the direction and strength of the winds at the time the swarms matured, the amount of rain in the desert areas, and the success of the spraying in killing the locusts. It was too early to tell at the present stage what the outcome of those factors would be. The staff and the Pakistani authorities were monitoring the situation closely.

Mr. Smee made the following statement:

In the real estate business, there is a saying that the three most important considerations in buying property are location, location, and location. In Pakistan, the three most important considerations for the authorities are surely fiscal policy, fiscal policy, and fiscal policy. From the economic perspective, if Pakistan did not exist, it would have had to be invented, so as to prove the importance of fiscal consolidation and why the Fund continues to fight for it.

For all countries--from developing countries, to economies in transition, to industrial countries--when the fiscal side goes well, good things can happen. Fiscal policy is a necessary, but not sufficient, condition for economic reform and a successful program of adjustment. However, when the fiscal side goes bad, everything else falls apart.

In Pakistan, previous valiant efforts have been made to sow the seeds of structural and other types of economic reform, which have fallen on barren ground because the Government gave up the fiscal fight either too soon or because it was politically difficult to continue. Consequently, any gains from other aspects of the economic reform program--that might be welcome in themselves--were dissipated in the absence of fiscal stabilization efforts.

As the staff appraisal notes, the authorities' program for 1993/94 restores the basis for sustained high economic growth in the context of financial stability. Success in this program will then allow not only for a sustained, secular rise in living standards and growth, but also for room to maneuver on the fiscal side, both for the Government and for the economy as a whole, to deal with natural disasters. That room for maneuver is necessary so that, in the short term, the economy is not wrenched sideways in an effort to deal with natural disasters, putting the entire economic development program off track, and making it more difficult to restore the momentum once the crisis is past. Of course, such things as the terms of trade--which any country has little ability to influence--must be taken account of and adjusted to as well.

The staff paper mentions the many risks to the program. I view the uncertainty regarding the outcome of the October parliamentary elections as the most worrisome, notwithstanding the many assurances provided by Mr. Mirakhor and the staff paper itself. Past failures were caused by a lack of political will in the face of daunting fiscal and adjustment policy tasks. I would like to join others in commending the current interim Government for the boldness of the measures that have been taken recently, but it is essential that these policies be carried out completely if the program is to move beyond the short term, and evolve into a successful medium-term program--as we all hope will happen.

I commend the Pakistani authorities for providing for a reduction in military outlays of 0.9 percent of GDP on the expenditure side of the fiscal program. That is difficult to do, but it is required; and it will undoubtedly leave room for other, more necessary expenditures for social and economic development that would have had to have been cut otherwise.

Given Pakistan's dire external reserves position and the commendable steps taken so far by the interim Government to ensure that the situation is corrected, we approve the request for a 12-month stand-by arrangement in an amount equivalent to 35 percent of quota.

Mr. Al-Jasser commented that the uncertainty surrounding the elections to take place in October 1993 exacerbated the program risks. However, it needed to be borne in mind that almost all the political parties had been involved in at least some part of the program negotiations. The interim Government had kept the other major political parties informed of developments. The Fund's experience with successive governments in Pakistan had been good, as programs to which one Government had committed itself had generally been followed by the successor Government after the elections, even when the successor Government had complained about some aspects of the program before it came into office. Taking those factors into account, he was reassured that the incoming Government would not abrogate the Fund-supported program.

Mr. Wei made the following statement:

I join previous speakers in welcoming Pakistan's request for a stand-by arrangement. It is worth recognizing that the previous program of comprehensive adjustment and reform already made substantial progress toward achieving sustained growth, domestic stability, and external viability, through a number of steps to diversify, liberalize, and privatize Pakistan's economy. Although policy slippages cannot be denied, severe natural conditions and adverse external shocks have certainly greatly disrupted the authorities' efforts to continue with the program.

In addressing the immediate issues facing the country, such as the deteriorating fiscal position and the weak external account, the authorities have lost no time in adopting an adjustment program for 1993/94 that demonstrates clearly their consistent and determined commitment to address the country's economic and financial problems in the medium-term context. We strongly endorse the authorities' medium-term objectives and their approach to adjustment, as well as the thrust of the policies outlined in the policy framework paper.

In view of the past experience in implementing the program, and the urgent issues facing the authorities in the period immediately ahead, the following factors are important considerations in securing the success of the proposed program, and they deserve special mention.

I am encouraged that the authorities are standing ready to carry out the proposed ambitious program, and we are pleased to note that they have taken a number of prior actions. As we have learned from other cases, even a well-designed program might not succeed if the authorities are not strongly committed to it and determined to implement it, in particular in the face of political pressures. Therefore, it is most important for the authorities to press ahead with the program for 1993/94, which will lay the foundation for further financial support from the Fund and other creditors.

The authorities recognize that the primary impetus for achieving sustained economic growth and financial stability must come from domestic policy efforts. The authorities' realistic attitude in this regard is indeed commendable. At the same time, the importance of favorable and supportive external conditions, and the continued and timely availability of external financial assistance, cannot be overemphasized.

We fully share the view expressed by Mr. Mirakhor that the program has two eminent features--heavy front-loading of policies and a strong emphasis on structural reforms. These two features further demonstrate the authorities' determination to ensure the program's success.

On the fiscal front, it is well understood that an unsustainable fiscal deficit has been the primary cause of internal and external imbalances. Thus, a key challenge facing the authorities is to improve the fiscal position substantially and to address with persistence the fiscal weaknesses that result mainly from low revenue elasticity and an inflexible expenditure structure. On the revenue side, early efforts have to be made to improve the existing tax base, which is narrow and fragmented, as this has undermined fiscal performance. On the spending side, the program is correctly targeted to contain other federal and provincial outlays. In this connection, I am not sure whether development spending should be reduced. In our view, in order to mitigate the negative impact on production of a tight macroeconomic policy implementation, it is better to avoid cuts in development spending, or to keep them to a minimum. Therefore, when proceeding with their tax reform, the authorities are urged to make every effort to allocate sufficient resources to the sectors that are important in maintaining an appropriate economic growth rate.

A tight monetary policy stance will be essential in helping to improve the fiscal weakness while achieving the inflation target under the program. To a large extent, keeping monetary policy tight means--initially--relying on a substantial reduction in the fiscal deficit financing requirement. We also encourage the authorities to implement fully indirect monetary control instruments, to speed up reform of the financial system, and to strengthen prudential regulations and supervision.

The exchange rate under the managed float regime has helped substantially in expanding the tradables sector, contributing to a certain extent to domestic stabilization. Given the reserve position, we would encourage the authorities to be cautious in implementing continuously a responsive and prudent exchange rate policy, which is directed toward maintaining Pakistan's external competitiveness, containing inflation, and facilitating the liberalization process. It is also essential that the exchange rate be supported by appropriate monetary and fiscal policies.

I join Mr. Al-Jasser's call to remove all trade restrictions imposed on the developing countries, in order to support their adjustment efforts.

Notwithstanding the significant progress made to date in structural reform--progress that has yielded remarkable economic gains--structural reform is still only at the halfway stage. The authorities' continued commitment to further broadening and intensifying reforms, focusing on the deregulation of economic activities and the promotion of the private sector, is impressive. The authorities are strongly encouraged to continue pushing ahead in this direction, as structural reforms are important for macroeconomic management and for restoring domestic and external financial equilibrium, as well as for achieving sustained growth.

I support the proposed decisions, and I look forward to the discussion of a follow-up program--preferably under the ESAF--with the authorities at the earliest possible date.

Ms. Kotova made the following statement:

Today we are discussing one of the difficult cases of adjustment and structural reform. The program to be supported by the stand-by arrangement is a follow-up of several programs, beginning with one set up in 1988/89. All these programs were supported by the Fund under different arrangements. Today's program is aimed at meeting the same objectives that were outlined in previous programs, but which were missed. The issues that once comprised the cornerstones of the program under the SAF, and which were taken up again at the time of the request for emergency assistance, remain on the agenda. The new interim Government intends to move quickly and resolutely to make up for lost time--an intention that deserves support, but which raises additional concerns about the feasibility of the program and the likelihood of its successful implementation.

This chair shares Mr. Mirakhor's view that the design and implementation of policies go well beyond what is normally associated with a stand-by arrangement. However, what is more important than the obviously ambitious scope of the program is whether or not it remains realistic, especially given the legacy of past failures and slippages.

I fully agree with the emphasis placed on the fiscal aspects of the program, as put forward by Mr. Smee. Fiscal consolidation remains the key prerequisite for any other sound financial policies. In the fiscal area, efforts are required on both the revenue and the expenditure sides.

On the expenditure side, public borrowing is growing at an alarming pace, and even if its growth decelerates in relative terms--as envisaged under the program--the public sector borrowing requirement will remain the key factor in the growth of net domestic assets during the program period. Compressing expenditure will be indispensable regardless of the revenue performance; however, it is not clear where the cuts should or might be made, since the details provided on the composition of public expenditures are not adequately disaggregated. Perhaps the staff could elaborate on that point, and explain the reasons for such a nontraditional disaggregation of the composition of expenditures. Perhaps the staff could also share with us its ideas about the ways in which they could be compressed?

On the revenue side, improvements in and consolidation of the tax base remain one of the most vulnerable points of domestic finance, as has been mentioned by many of the previous speakers. On more than one previous occasion, the authorities were urged to straighten out the tax system and to broaden the base of direct taxation through a reduction in exemptions and concessions and a move away from discretionary measures. We would like to wish the authorities every success in enforcing the agricultural wealth tax and the provincial income tax, which will not be an easy task.

The program's key stabilization objective is to reduce inflation to 8 percent a year in the context of a rebound in economic growth. The reduction of the budget deficit by 2.3 percentage points of GDP is envisaged, but at the same time, the current account deficit will not show a downward trend either in absolute terms or as a percentage of GDP, although GDP is growing and will continue to grow. This might mean that latent financing of the budget deficit would continue, but with greater reliance on external sources, bringing a certain amount of fiscal relief, but also making the external position even more fragile.

With regard to monetary policy, the program envisages shifting the focus of resource mobilization and allocation to market-based mechanisms. This is only appropriate, and measures such as a quick phasing out of concessional direct lending and direct support to certain specific investment programs--for example, the transportation scheme--could and should be implemented promptly. This would contribute immediately to the improvement of the monetary aggregates. However, in a package containing these steps, the program envisages widening and deepening the market for government securities and other capital markets, and greater reliance on open market operations in the context of a strengthening of the State Bank's institutional mechanism for liquidity programming. There can be no question about whether or not to develop these mechanisms; nevertheless, their immediate contribution to the rehabilitation of domestic finances is questionable. They cannot be developed quickly, nor can they be used immediately, given the current level of domestic debt--amounting to 40 percent of GDP. These instruments might be more appropriate for use in the medium term and, inter alia, as a future means of refinancing the debt. When two packages that are relevant to different stages of development of the financial sector are equally positioned in a program, and are to be mastered within a period of one year, there is the impression of the misprioritization of objectives. This is just one of the examples of a program aiming to achieve everything in one shot, which might cause serious program implementation problems.

With respect to external sector policies, I understand and accept the rationale in the staff paper for retaining until end-June 1994 the capital account restrictions and multiple currency practices. Given the front-loaded nature of the program, this seems to be reasonable. However, Pakistan's trade and exchange regime remains quite restrictive. Also, maintaining multiple currency practices deprives the country of one of the important tools of balance of payments management--exchange rate policies. However, in light of the amount of work to be done, one must try not to add the straw that breaks the camel's back.

Regarding Pakistan's capacity to repay the Fund, the current, very difficult, phase of Pakistan's development definitely requires sizable financial support from external sources. However, notwithstanding Pakistan's excellent record of payments to the Fund, the risks associated with servicing the country's debt are growing. The external debt-service ratio remains stuck at a level that exceeds 20 percent of export revenues. This figure must not be assessed in isolation, but against the background of the country's debt structure. Large borrowings from multilateral organizations in the past and at present imply a large proportion of unrestructurable debt in the amount outstanding. This is an additional concern, showing how necessary it is to implement the current program successfully, and to reduce--at least--the amount of new financing required by the continuation of reform.

These concerns indicate that the economy of Pakistan stands at a crossroads. Visible successes on the structural front can either be consolidated by urgent and comprehensive stabilization efforts, or wasted, if there are further slippages on the fiscal and monetary fronts. In supporting the proposed decisions, we wish the authorities success in implementing the program completely.

Mr. Havrylyshyn made the following statement:

I join previous speakers in expressing my full support for the program, a program that compares more than favorably with the past record. However, as noted by the staff and other speakers, Pakistan's performance in the recent past has been mixed, at best. On the one hand, decisive steps had been taken in many areas of structural reform, although the process was by no means completed. On the other hand, macroeconomic stabilization policies were not successful, mainly owing to the inability to achieve a substantial fiscal consolidation.

The present program strikes the right balance by setting ambitious goals for the budget deficit and the current account, while maintaining the momentum in structural policies. Clearly, there are risks in the short- and medium-term projections. The planned reduction in public expenditures in fiscal year 1993/94 of about 2 percentage points of GDP may be hard to achieve, knowing that interest expenses will go up, and social programs need to be protected or perhaps even expanded. Similarly, an improvement of 3.5 percentage points in the trade balance in one year looks somewhat optimistic. Sensitivity analyses made by the staff illustrate that full implementation of the program is necessary to achieve the desired results in terms of growth and stabilization. The resolute actions of the present interim Government certainly add to the program's credibility.

Mr. Mirakhor emphasizes that there is a broad consensus among the main political parties on the country's economic policies. This gives some confidence that the adjustment policies will be continued after the elections, and provides justification for front-loading despite the implementation risks suggested by the past record. Indeed, the front-loading may permit sufficient quick action to put the program on an irreversible track--in the fine words of Mr. Geethakrishnan--and thereby reinforce the post-election commitment of the authorities.

The strength of the immediate policy actions, including the impressive list of prior actions, already provides some validation for such a view of front-loading. Nevertheless, I join Messrs. Peretz, Schoenberg, Smee and others in urging the present and future authorities to implement fully the program, and thus fully validate the front-loading.

However, the risks must not be overlooked either. With the front-loaded SDR 88 million to be disbursed upon approval of this program, Pakistan will have drawn from the Fund more than SDR 0.5 billion since December 1991--a SAF purchase of SDR 109 million, a purchase under the compensatory and contingency financing facility (CCFF) of SDR 122 million, and emergency assistance of SDR 189 million--without having to meet the conditionality of performance criteria normally attached to Fund-supported programs. In this connection, Mr. Schoenberg has made an excellent suggestion that reconciles the need for front-loading and the risks of implementation. While recognizing Pakistan's need for a medium-term oriented Fund-supported program and a possible early request under the ESAF and/or EFF, I would like to see Pakistan meet the criteria for completion of the first review of this program before an ESAF request is considered by the Board. It should be possible to do this independently of the question of whether we will again extend the cutoff date for the current ESAF.

Mr. Smee is correct in referring to the rule of three to ensure the success of Fund-supported programs: fiscal policy, fiscal policy, and fiscal policy. This is for the policy side; I suggest that we maintain a rule of triple three, adding with reference to implementation: risk, risk, risk, and to allay concerns of such risks: conditionality, conditionality, conditionality. I support the proposed decisions.

Mr. Mirakhor commented that it was not possible to draw from the Fund without meeting Fund conditionality. Whatever sums Pakistan had drawn, it had done so while observing the Fund's rules and prescriptions.

Mr. Havrylyshyn replied that Pakistan had drawn a large amount without having to meet the kind of conditionality that was usually embedded in the performance criteria attached to Fund-supported programs. For that reason, he considered it important that the Board review the performance criteria under the present stand-by arrangement before discussing a possible ESAF arrangement.

Mr. Mirakhor said that stand-by arrangements had certain prior actions and conditional requirements, which had been more than satisfied in the case of Pakistan. The authorities were not requesting an ESAF arrangement at the present juncture. A stand-by arrangement did not require the support of the incoming Government that was yet to be elected. Once the performance criteria for the end of September--and again later--were met, a review of the stand-by arrangement would serve no purpose.

Mr. Havrylyshyn observed that the resources under the SAF, CCFF, and emergency facility had come without the performance criteria that were usually attached to stand-by arrangements. Together with the front-loaded drawing that was being requested--of SDR 88 million--Pakistan would have drawn a total of about SDR 0.5 billion--a large sum. Taking that into account, it was his view that the Board should have the opportunity to review performance under the stand-by arrangement before considering any request for an ESAF arrangement.

Mr. A. R. Ismael made the following statement:

> We are in broad agreement with the objectives of the program and the policy measures envisaged. We also broadly share the thrust of the staff appraisal, as well as many of the views expressed by previous speakers, especially regarding the need to intensify the adjustment and reform efforts. The objectives set under the program are ambitious, but the determination with which the prior actions have been implemented, and which in some cases have gone beyond those specified in the program, is encouraging, and augurs well for the success of the program.
>
> While we recognize that Pakistan has been beset with a series of shocks since 1992 that has led to the growing imbalances, it appears that inadequate fiscal adjustment has also contributed to this deterioration. We are therefore pleased to note the emphasis that is being placed on fiscal consolidation. In this respect, we welcome the measures envisaged in the program that are aimed at revenue mobilization, expenditure containment, and a deepening of structural reform. From the supplement to the staff paper and Mr. Mirakhor's statement, it appears that, in reaction to the measures introduced, there is already a noticeable improvement in the position of the fiscal and external sectors. The additional details provided by the staff in its answers to lead speakers' questions also confirm this positive reaction, which should encourage the authorities to pursue the reform with more vigor, as there is still room for improvement, especially in the fiscal sector.
>
> On the revenue side, a broadening of the tax base, as well as the reform of the indirect taxation system, would appear to be necessary. Similarly, on the expenditure side, while we welcome the program of civil service reform that is being undertaken, we

would encourage the authorities to undertake a firm review of outlays and to introduce strong monitoring and control measures. However, the efforts to reduce the fiscal deficit and bring down inflation can only succeed if they are supported by a tightening of monetary policies. In this context, the several measures envisaged in the program aimed at tightening credit are appropriate. Nevertheless, here too, a more comprehensive program of financial reform aimed at improving financial intermediation and lessening reliance on direct monetary control instruments would certainly help. As noted in the staff paper, further progress in strengthening prudential regulation and supervision of commercial banks would be necessary.

We commend the Pakistan authorities for broadening their adjustment efforts. We share the staff's views that the measures being implemented will help to achieve the objectives set and pave the way for a more comprehensive multiyear program that could receive Fund support. We support the proposed decisions.

Mr. Mwananshiku made the following statement:

We welcome Pakistan's request for a stand-by arrangement with the Fund, which would be a precursor to a medium-term program under the ESAF. The new program will build on the experience and gains of past adjustment efforts initiated by the Pakistani authorities since 1988.

The progress made over the past five years, which has been most notable in the structural reform area, has yielded substantial benefits in terms of robust output and export growth, strong domestic and foreign investment performance, as well as improved diversification of the production base. However, financial policies, in particular on the fiscal front, have remained weak, as the public sector's involvement in the economy continued to be excessive. Compounded by adverse exogenous developments, including the floods and the terms of trade losses, Pakistan's domestic and external financial imbalances widened. Indeed, as fiscal deterioration persisted and the exogenous problems intensified in 1992/93, output growth weakened, and domestic prices and the external sector position came under pressure.

We are encouraged that, under the current program, the authorities have strengthened measures initiated in fiscal year 1992/93 to address those problems, with emphasis on macroeconomic stabilization and structural reform.

We agree with the staff that the primary challenge facing the authorities is fiscal consolidation, in view of its influence on the effectiveness of monetary and exchange rate policies. In this regard, we welcome the authorities' tax reform and expenditure retrenchment measures, including expenditure switching from nonproductive to productive activities and to the social sectors. We encourage the authorities to take any additional measures that may be needed to meet the program targets. In this regard, the additional prior action taken in August in the fiscal, monetary, and external policy areas, as outlined in the supplement to the staff paper and by Mr. Mirakhor, is reassuring.

A restrained monetary policy that allows adequate credit to the private sector should be maintained. Satisfactory progress in fiscal consolidation and financial sector reform should facilitate efforts leading to enhanced efficiency in resource mobilization and allocation. In addition, an active interest rate policy, geared toward full liberalization of interest rates, should be pursued to achieve financial deepening and the broadening of the securities market, which is necessary for the adoption of a market-based mechanism for monetary control. Given that the establishment of the necessary conditions for the adoption of open market operations will, of necessity, take time, perhaps the staff could explain whether or not there is a time frame within which the transition from the use of direct to indirect instruments of monetary policy should be accomplished.

We commend the authorities for the considerable progress they have made in the area of structural reform, and we urge them to build on those gains by maintaining the momentum of economic liberalization, including of the trade and exchange systems, and accelerating the pace of privatization and public enterprise reform. This should help to enhance the role of the private sector in the economy, encourage foreign investment inflows, and facilitate the process of reducing the fiscal deficit and containing the public sector borrowing requirements.

An optimistic medium-term outlook for the external sector has been projected by the staff. This is predicated not only on a successful and sustained adjustment effort by Pakistan, but also on a supportive external environment. Given the uncertainties relating to the recovery of Pakistan's export markets, as well as the unpredictable weather conditions, the vulnerability of the external sector position is likely to remain high, in particular in the short term. In this regard, Pakistan's adjustment effort will continue to require timely and concessional financial assistance from the international community, which the current arrangement with the Fund should help to catalyze. What is more important, increased market access for Pakistan's textile manufactures in the industrial countries would further strengthen the export performance. As private transfers represent an important element in the country's balance of payments accounts, perhaps the staff could say a few words about the prospects for this major source of foreign exchange earnings.

I support the proposed decisions.

Mr. J. E. Ismael made the following statement:

I support Pakistan's request for a stand-by arrangement, for the following reasons.

First, the difficulty faced by Pakistan's economy is such that Pakistan is now in dire need of financial support to correct its widening internal and external imbalances. It is indeed unfortunate that, after years of robust economic growth, the economy has had to accommodate lower growth, a higher inflation rate, and wider external imbalances, owing to widespread floods, cotton plant diseases, and political uncertainty. The Fund's support is therefore of special significance to the Government to continue instituting its adjustment for growth efforts, which will provide a solid foundation for a subsequent request by the Pakistani authorities for Fund support under the ESAF and/or EFF.

Second, the Government of Pakistan has shown its determination to resolve the severe financial problems, as reflected by its courageous prior actions, which were supported by a strong medium-term program, as outlined in the policy framework paper. In this regard, I am encouraged by the early results of the implementation of prior actions, which point to the improvement of international reserves and the progress in fiscal and monetary management.

Third, given its proven track record in servicing its debts, I am confident that Pakistan will be able to fulfil its obligations.

Let me now comment on the program, which is a choice between various combinations of growth and inflation. I agree that further efforts to recover and maintain high economic growth and to reduce the budgetary deficit, while at the same time avoiding inflationary pressures and strengthening the net external reserves, should be emphasized in the program for 1993-95. The growth target for 1993/94 of 7.5 percent is ambitious, but the inflation target of 8 percent is not ambitious enough. Considering the adverse direct and indirect impact of inflation on the economy and on other social problems, which could aggravate competitiveness, distort the allocation of resources, exacerbate the distribution of income, raise the cost of production, and hamper savings mobilization, I would opt for a lower inflation target.

On the growth side, I am somewhat pessimistic about whether or not Pakistan could mobilize the capital and the expertise needed, owing to constraints in financial and technical resources, domestic as well as external. The amount of investment required to achieve such a high growth target should be large, and should also be complemented by a high level of investment efficiency. The recent efforts to improve revenue performances by, inter alia, an increase in petroleum prices, tariffs and duties, would probably shift resources from the private sector to the public domain, crowd out the private sector's activities, and, hence, run counter to the original intention to encourage the private sector. Besides, the recent bold measures to increase interest rates could also dampen the investment climate, lower investment rates, and, consequently, lower growth. Therefore, in the face of such constraints, it would be more realistic if the authorities could aim their program at a lower inflation target, with the hope that it will still achieve a satisfactory growth rate.

With these remarks, I can endorse the proposed decisions.

Mr. Solheim made the following statement:

I feel tempted to refer to the Board meeting nearly two years ago, when Pakistan's request for the third annual arrangement under the SAF and its request for a purchase under the CCFF were discussed. The country's economic situation now is strikingly similar to its situation then. At both times, the authorities implemented the prior actions, and the staff noted that the chances for bringing the adjustment program back on track were good. This did not materialize last time, however, and now, the authorities are facing almost the same risks and challenges as two years ago.

I am encouraged by the many very positive comments of speakers, and I sincerely hope they will prove realistic. In fact, it appears that the authorities' recent policy actions have contributed to a tightening of fiscal and monetary policies and to a recovery of gross official reserves. There has been progress in structural reform measures and in private sector activity. While the authorities are to be commended for their recent actions, they should take further steps to remove the remaining exchange restrictions, as proposed by the staff, and proceed with import liberalization and tariff reforms.

I concur with the staff that the proposed policy approach will be absolutely essential to restore macroeconomic stability and to place the economy on a higher growth path. However, considerable risks remain for the program, not least because of the vulnerability of the external accounts and the remaining political tensions. While fiscal adjustment, from both the quantitative and qualitative perspectives, constitutes a key feature of the authorities' program, the track record of Pakistan in this area has been undermined before by insufficient adjustment measures. It is therefore essential that the authorities realize that the primary impetus for restoring financial viability must come from domestic policy efforts, and that a considerable fiscal consolidation is needed. Furthermore, a strong commitment to fiscal adjustment will enhance the credibility of measures aimed at restricting monetary growth and improving financial intermediation.

A further broadening of the tax base and a strengthening of tax administration remain imperative. On the expenditure side, in light of Pakistan's lagging social indicators, more emphasis should be placed on productive outlays. Although I welcome the planned reduction in military spending, I agree with Mr. Tabata that further reductions would be desirable.

Although I can sympathize with Mr. Schoenberg's comments on the timing of the Fund-supported program, I concur with the staff appraisal and the proposed decisions. It is evident that Pakistan has an urgent need to bolster gross official reserves, and it is to be hoped that the Fund-supported program and its financial assistance will prove to be catalytic, and thus, to be followed up with capital inflows from public and private sources. Like Mr. Mwananshiku, I should appreciate it if the staff could elaborate on the availability of external financing from such sources.

Mr. Papadakis made the following statement:

Since embarking on a Fund-supported program of macroeconomic adjustment and reform in 1988/89, Pakistan has achieved notable progress in many structural areas. Sustaining those gains has not always been easy, mainly because performance in the area of demand management often fell short of the program targets. Weak financial policies persisted in 1992/93, despite the commendable attempts of the authorities to improve demand management in the second half of the fiscal year. The effects of the slippages were magnified by a number of adverse exogenous factors. The resulting critical external financial position only added to the already substantial economic difficulties.

Pakistan is not the only country in which more durable fiscal improvement would have facilitated a faster emergence of much-needed positive supply-side effects, while containing inflation and the external imbalances from the demand side. In the case of Pakistan, the central problem with the economic strategy pursued in recent years has not been any lack of willingness to proceed with policies that would be conducive to sustained growth and that could be supported by the international community; rather, the core of the problem seemed to be a relative abundance of factors that prevented the fiscal improvement from being durable and continuous. Such durability would have been beneficial in many respects. It would have created greater room for addressing some undesirable side effects of the structural changes; and it would have relieved much of the excessive burden that was placed upon monetary policy, which often seemed to have been left alone in aiming sometimes at too many targets at once.

In the present critical circumstances, it is most reassuring to note from Mr. Mirakhor that there is now a somewhat broader consensus in Pakistan on what remains to be done. The primary impetus for restoring financial viability in the context of sustained growth would need to come, first and foremost, from domestic policy efforts. With this in mind, the authorities have formulated their program for 1993/94 in a medium-term framework. In a clear break with last year's developments, this program reflects a determined effort to address in a more lasting way the country's economic and financial problems. What I found less clear in Supplement 1 of the staff papers was the precise set and timing of the policies that were envisaged for the remaining three-year period, for which the staff projects a substantial correction of domestic and external imbalances. However, the authorities have been cautious enough to offset this deficiency by developing a range of actions to ensure that a possible transition to an ESAF arrangement would have a genuinely decisive and positive impact on the country.

Supplement 1 of the staff papers also noted that considerable risks surround the 1993/94 program. To a certain extent, this is understandable. What is of concern, however, is the staff's caution that these risks are only partially offset by the program design and the existing consensus about the priorities. Whenever I encounter similar remarks in a staff report, I cannot help but wonder whether more could have been done, either on the part of the Fund or the member, to contain these risks, but was not done. In this case, judging from the debt-servicing record and the relatively modest share of obligations to the Fund, the member's capacity to repay is reasonably assured. It would be a different story, however, if either the design or the implementation of the program did not provide a minimum degree of assurance that the risks would be controlled, or that they would be allowed to jeopardize the program's overall objectives. Happily, this is not the case here.

Mr. Mirakhor's statement, as well as Supplement 2 to the staff paper, are both reassuring and clear. The authorities should be commended for not hesitating to go beyond the commitments outlined in their letter of intent, when they believed that this was needed in order to adhere to the targeted medium-term adjustment path. This has set the stage for continuing with a comprehensive three-year program of adjustment and wide-ranging structural reforms that could lead to the permanent restoration of macroeconomic stability and growth. I support the proposed decisions.

Mr. Kural made the following statement:

A number of factors make it difficult to tell how far structural adjustment has actually progressed in Pakistan. The most urgent task now is to reform the structural features that inhibit efficient policy implementation. Unfortunately, a major obstacle to efficient policy formulation, especially in the fiscal area, has been the contamination of the decision-making process with short-term political objectives. On this point, Mr. Mirakhor has reassured us that the program is meant to mark a watershed in Pakistan's economic history. To remove the deeper structural weaknesses in the fiscal area--the main objective of the requested stand-by arrangement--policy initiatives will need to focus on the following areas.

Determined fiscal consolidation will be one of the necessary conditions for tightening monetary policy and sustaining gains in financial sector reforms. A major problem with the financial market has been the long delay in developing and introducing indirect instruments of monetary control, which has forced monetary control to rely heavily on the application of credit schemes. This kind of quantitative intervention in the money market overrides money market equilibrium mechanisms, but is needed when mechanisms for regulating the market do not exist.

The authorities also recognize the need for well-developed and open primary and secondary capital markets that can provide liquidity and ensure the marketability of assets. Without such markets, the money market will not be able to move from short-term, trade-oriented operations to operations providing financial integration with the rest of the world. The measures in the policy framework paper aimed at achieving market-based mobilization and allocation of loanable funds are needed to restore confidence and provide working capital and other resources to get private investment off the ground. We support the proposed decisions.

Mr. Abbott made the following statement:

This is a good program, and we fully support it. We particularly like the fact that the program is designed to introduce much-needed stabilization measures, while simultaneously building a launching pad for a medium-term program of structural reform. Assuming that all goes as hoped, we look forward to being able to support a follow-on program under the EFF in the near future.

The staff appraisal sets the right tone. Some very good work on structural reforms in the late 1980s was overwhelmed by inadequate attention to correcting fiscal weaknesses. The fiscal weakness in Pakistan left the economy highly vulnerable when it was required to confront multiple shocks from the weather, from the terms of trade, and from political developments. Consequently, we are pleased to see that this program looks for major reforms to strengthen public sector revenues through tax rationalizations and base broadening, with these revenue actions to be accompanied by sustained expenditure discipline. The cutback in military expenditure is particularly welcome. The pattern that seems to be developing in Pakistan--and in neighboring countries--is highly encouraging. We hope that it will be extended. The accompanying money and credit measures are also welcome. Moving away from directed credit and excessive reliance on bank financing of an overlarge government borrowing requirement is essential. Getting rid of the transport scheme is an excellent, visible step. Elsewhere, however, the authorities' intentions to switch to greater reliance on market allocation of credit seem a bit more hedged, and the staff's endorsement is more guarded. In contrast to Mr. Tabata's endorsement of paternalistic, dirigiste directed credit policies, I would urge the authorities to address remaining credit allocation policies with the same decisiveness that they have shown in dealing with the transport scheme. The staff representative from the Middle Eastern Department explained clearly why these programs generally degenerate into bad policy, whatever their good intentions.

In general, the economic projections look a bit rosy, given the seriousness of the adjustment problem Pakistan faces, and the sweep of the reform proposals contemplated. The reforms will undoubtedly liberate a good deal of supply-side potential that is now stifled by policy distortions. Trend growth of 6.5 percent to 7.0 percent is certainly achievable, but the structural transformations planned, with simultaneous external stabilization, are going to involve transitional dislocations. A wide confidence interval needs to be attached to these growth projections. The authorities should be careful not to treat these projections as targets. The experience of the recent past clearly demonstrates that the greatest risk to Pakistan's sustainable growth and development has come from inadequate financial disciplines, not from temporary shortfalls from growth expectations. Even with the ambitious program the authorities are undertaking, the economy will remain vulnerable for some time to come. A cautious approach to policymaking will be required.

Mr. Tabata remarked that he welcomed the abolishment of policy-guided lending in the case of the Pakistani transport scheme. However, generally speaking, when banks were not playing effectively their intermediary role, policy-guided lending could be useful. It could be especially useful to encourage the growth of small and medium-sized enterprises and housing construction.

Mr. Keller made the following statement:

We commend the Pakistani authorities for taking advantage of the particular political circumstances to undertake such courageous and ambitious reforms, which certainly merit Fund financial support. However, we sincerely hope that the reform drive will be maintained beyond the very limited term of office of the present interim Government, and that the reforms can be extended and deepened afterward under whatever Government is then in charge.

The proposed two-stage approach is very appropriate, in order to allow time to monitor performance. Considering problems in implementing previous reform programs in Pakistan, the authorities should be cautioned about rushing into an EFF or ESAF arrangement as soon as the new Government has taken office. Several previous speakers have already made these comments forcefully.

We very much appreciate the wide-ranging efforts to broaden substantially the fiscal base and increase taxation in order to make it more efficient and to yield more revenues. These measures also contain an element of social rebalancing of the tax burden, which is very welcome. We trust that the Government is also committed to strengthening tax administration so that it will be in a position to enforce tax assessments and collect what is due.

Expenditure must also be affected by fiscal restructuring. The scarce fiscal means should be redirected to more social investment. While acknowledging the political constraints under which the fiscal reforms are being introduced, the fact that fiscal restraint cannot be sustained unless military expenditure is also gradually curtailed further should also be stressed. The international community will follow developments in this area with great interest.

Mr. Waterman made the following statement:

We all have great sympathy for the difficult period that Pakistan has been through recently, and also for the sizable shocks that the Pakistanis have to deal with from time to time. It must also be recognized that a poorer country has much greater difficulty in adjusting to such shocks than some of the wealthier economies, although that is not always reflected in the conduct of the policy of the latter group.

As other speakers have noted, the policy measures that have been taken or foreshadowed are very impressive, both in terms of their comprehensiveness and the speed with which many of them have been implemented. The prior actions have for the most part either met or exceeded expectations as well. At the same time, however, the problems that Pakistan faces are clearly significant, and a number of speakers have commented on Pakistan's poor past record of implementation. The risks therefore remain considerable, both for Pakistan and the Fund. Mr. Schoenberg and other speakers have commented on the front-loading rather than back-loading that is involved in the program. In that sense, the Fund is providing very strong support to Pakistan, which is a vote of confidence in the authorities' ongoing commitment to the program. I hope it is not, like they say about the second marriage, the triumph of hope over experience; it is one thing to make commitments, but another to keep them, in particular as the political heat intensifies. In that sense, Mr. Smee's comments about the need to keep a central focus on fiscal policy is very apposite, but I am surprised that Mr. Mirakhor has not pointed out to him that real estate agents are not to be trusted.

I place a great deal of weight on Mr. Mirakhor's judgment that the political commitment to the program will be maintained after the October election. I support the proposed decisions.

Mr. Havrylyshyn commented that while he was concerned about the risks in the program, and he would like to ensure that there was an early performance review, he would agree that the front-loading was a good idea in the case of Pakistan. He hoped that the front-loading would secure the commitment of the incoming Government to the program. The Fund's usual level of conditionality was extremely important and useful, and the Fund should return to it in the case of Pakistan as soon as possible.

Mr. Peretz said that he believed that front-loading of the program purchases was not only necessary, given the economic crisis that Pakistan was facing, but also justified, for all the reasons that others had given.

The staff representative from the Middle Eastern Department, responding to Executive Directors' questions, stated that the program targeted a 1.7 percent reduction in expenditure relative to GDP, notwithstanding the increase in interest payments. On current expenditures, a reduction of 0.9 percent of GDP would come from defense outlays, which would affect both domestic and external payment components. A further 0.6 percent of GDP reduction would come from provincial expenditures, which was consistent with the measures that had been taken to increase revenue generation by the provinces themselves. Finally, a 0.2 percent of GDP reduction would come from subsidies--which were already quite low--and improvements in general revenue administration. Since the program negotiations, further progress had been made on civil service reforms, which should provide scope for further expenditure reductions. In particular, the federal ministries and foreign missions that could be closed had been identified. A reduction of 0.6 percent of GDP in development expenditure had been programmed, but the composition of development expenditure would be improved with assistance from the World Bank, consistent with the review of the public sector development program and the public sector adjustment loan that had been approved by the Bank Board on September 14, 1993.

The time frame for moving to indirect monetary control and the specific measures implied therein were set out in the matrix to the policy framework paper for the three-year period, the staff representative noted.

The consumer price inflation target--8 percent--included very large administrative price adjustments for petroleum gas, edible oil, and electricity, the staff representative explained. In that sense, the inflation target could be seen as fairly ambitious.

Regarding the balance of payments, the staff and the authorities had been very cautious about the projections for private capital flows, the staff representative concluded. Thus, projections of private transfers and inflows of foreign direct and portfolio investment were lower than the level that had been achieved in 1992/93. That caution reflected uncertainty about the impact of the political situation early in the fiscal year. It needed to be borne in mind that there had been large increases in both private transfers and foreign direct and portfolio investment in 1991/92, which showed the potential response of the domestic and external private sectors to appropriate structural policies, the reduction of financial imbalances, and the buildup of a sufficient reserve cushion.

Mr. Mirakhor stated that Messrs. Peretz and Schoenberg, while commending the authorities for their action to reduce the maximum tariff rates, had suggested that they should perhaps lower them even more. He was certain that Mr. Peretz was aware of the free trade philosophy of the caretaker Prime Minister. The Prime Minister had espoused free trade very clearly during his career with the Fund and the Bank, and he had no intention of making an exception for Pakistan at the current juncture. The Prime Minister had pressed very hard for tariff reforms. However, the major question in Pakistan was the fiscal position, as Messrs. Havrylyshyn and Smee had pointed out. Unfortunately, so far, the tariff reforms in Pakistan had not been revenue neutral; there was a large revenue impact in moving tariff rates down by 15 percent. Of course, if some tariff exemptions were removed, there was a possibility of re-establishing revenue neutrality. The Prime Minister had instructed the Minister of Commerce to look into that issue. In its negotiations with the authorities, the staff had wisely left the door open for future flexibility on tariff rates.

While no ironclad guarantees could be given in the case of parliamentary democracies, as Mr. Schoenberg had suggested, it was his view that

Pakistan had made a very major shift in policymaking that represented the dawn of a new age, Mr. Mirakhor concluded. He hoped that the shift would be even more evident at the time of the Board's consideration of an ESAF arrangement for Pakistan. He thanked his colleagues for their remarks and insights, which he would convey to the Pakistani authorities.

The Executive Directors adopted the following decisions:

PAKISTAN - STAND-BY ARRANGEMENT

1. The Government of Pakistan has requested a stand-by arrangement for a period of 12 months from September 16, 1993 in an amount equivalent to SDR 265.4 million.

2. The Fund approves the stand-by arrangement set forth in EBS/93/140, Supplement 3.

Decision No. 10468-(93/133), adopted
September 16, 1993

PAKISTAN - EXCHANGE SYSTEM

As described in EBS/93/140, Supplement 1, 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. In addition, Pakistan also maintains exchange restrictions and multiple currency practices, evidenced by the payment of an import license fee required at the time of opening letters of credit or making payments for imports, the forward exchange cover operation by the State Bank of Pakistan, and the advanced income tax taking the form of a 5 percent charge on the purchase of foreign exchange for travel, that are subject to Fund approval under Article VIII, Sections 2 and 3. The Fund welcomes recent actions by the authorities to eliminate certain restrictions, and notes Pakistan's intention to eliminate the remaining restrictions and multiple currency practices noted above by end-June 1994. In the meantime the Fund grants approval for the retention of these restrictions and multiple currency practices until June 30, 1994.

Decision No. 10469-(93/133), adopted
September 16, 1993

2. REPUBLIC OF MOLDOVA - USE OF FUND RESOURCES - SYSTEMIC TRANSFORMATION FACILITY

The Executive Directors considered a staff paper on Moldova's request for an initial purchase under the systemic transformation facility (STF) in an amount equivalent to SDR 22.5 million (EBS/93/149, 9/1/93; and Sup. 1, 9/14/93).

Mr. Sergiu Certan, Minister of Economy of Moldova, was also present.

The staff representative from the European II Department said that there had been a number of developments since the issuance of the staff paper. First, he could confirm that the Moldovan authorities had implemented all prior actions. In some cases, they had taken measures beyond what had been envisaged under the STF program. In particular, starting on September 1, 1993, bread prices had been freed for all but 11 types of popular breads, accounting for no more than 65 percent of all consumption. For the subsidized breads, prices had been increased seven to eight times on average so as to limit the subsidy to no more than 40 percent of cost. Second, as Directors were aware, there was still a large financing gap of about $140 million, most of which fell in the second part of the program. In preparation for the Consultative Group meeting on Moldova scheduled for October 26, 1993, the staffs of the Fund and the Bank intended to meet with creditors in Washington on September 27, in conjunction with a similar meeting on Belarus.

The third recent development, the staff representative continued, was that the cash shortage mentioned in the staff paper had been alleviated with the delivery on September 8 of about 23 billion coupons. As a result, arrears on wages and salaries had begun to be eliminated. Fourth, on privatization, an auction of unfinished buildings had been held on September 7. In addition, a presidential decree had cleared the way for the distribution of vouchers and for holding the first pilot auction for small-scale privatization. The staff understood that, beginning on September 15, the authorities had in fact begun the distribution of vouchers to the population.

Mr. Havrylyshyn made the following statement:

> Since the last Board discussion on Moldova in February 1993, the economic situation has continued to be difficult, but a major step forward has been taken in the political consensus for accelerating economic reform. During this year, Moldova did not record better results in economic performance than the majority of transition economies, and it could not have done so. The inherited disequilibria, the adverse trade environment--in particular energy supply problems--the payments system disorder, and continued use of the ruble, combined with all the nation-building difficulties of an emerging democracy and the limited capacity for the implementation of macroeconomic reform, resulted

in a further deterioration of economic conditions. The fragile measures adopted in the first part of the year, while in the right direction, were not strong enough to overcome the difficulties faced.

Under these circumstances, the authorities became increasingly aware of the unsustainability of the economic imbalances and, albeit with difficulty, they reached a political consensus on the imperative of accelerating the reform, which is needed to ensure an economic recovery. Their determination, supported by the dedication and competent advice of the Fund staff, which my authorities highly value, resulted in a comprehensive program of action, which constitutes, as the staff paper puts it, "a break with the past." This may be seen as one of the major achievements of the Government, laying the foundation for future developments. The program itself aims at reducing the rate of inflation to a monthly rate of 5 percent at the end of 1993 and even lower in 1994, strengthening the level of international reserves, and accelerating the pace of structural reforms. All of this will ensure solid support for the new national currency, the leu, and the sooner progress on this program can be made the less will be the risk that developments elsewhere in the ruble area may affect the outcome.

The principles and objectives of the program are well illustrated in the Government's Statement of Economic Policies and in the policy matrix for the STF, so I will not repeat them. I am confident that Directors will agree that the program is much tougher than STF access might dictate and goes a long way to prepare for an upper credit tranche program, which my authorities intend to work toward with the Fund. I would, however, like to draw the attention of Directors to the measures already taken in the list of prior actions noted in Appendix II of the staff paper. All of these prior actions have been implemented, but I believe it is useful to emphasize some of the key measures in the list.

The monetary program for 1993 was approved by presidential decree of August 27, and important implementation steps have already been taken. The financing rate of the National Bank of Moldova was aligned with that of the Central Bank of Russia--the only country in the ruble area to do so--as a prime measure in the movement toward positive real interest rates. The extension of preferential credit was limited after July 1993, based on an agreement between the National Bank of Moldova and the Government. The authorities are aware that the observance of this decision will not be easy. Pressures will unavoidably occur, but the Government is determined to hold the line and to move toward an auction-based system of credit allocation.

On fiscal consolidation, 1993 has been a year of substantial progress. Already in the first half of the year, the deficit had been reduced to an estimated 13.7 percent of GDP from the 1992 level of 21 percent of GDP. But even this was not considered adequate, and the necessary political consensus has been achieved to adopt a second half 1993 budget variant giving a deficit of 3.7 percent of GDP, achieving a full-year result of below 6 percent, compared with the envisaged level of 11 percent. This will be achieved partly by some revenue-enhancing measures, but most importantly by substantial reduction of consumer price subsidies for bread and milk as of September 1, 1993. In parallel, the authorities are closely cooperating with a Fund technical mission now in Chisinau to build a well-targeted and affordable social safety net to protect the most needy groups, including children, the handicapped, and pensioners.

Good progress was also made on the structural front with price liberalization, the removal of export quotas, and the beginning of the 1993-94 Privatization Program adopted by Parliament. Technical preparations for privatization are finished, thanks to close cooperation with the World Bank, and, by presidential decree, the first auction for privatizing small-scale enterprises will be held on October 9, 1993.

All these actions together are, of course, the cornerstone for the stability of a new currency, and in parallel with them technical preparation for the introduction of the leu is nearly completed.

Notwithstanding all these actions, the balance of payments prospects, as estimated by the staff, still remain very difficult, with a financing gap of $35 million in 1993 and much more in 1994--$140 million, owing mainly to the need to pay for higher energy imports from Russia.

The Moldovan Government has made an impressive first step in stabilization and reform, and it intends to continue and intensify this effort under the STF, moving quickly to a stand-by arrangement. But progress is very dependent on adequate external finance, which, as the staff argues, would be very helpful for Moldova in this period of transition and should involve some degree of concessionality. In this connection, the first meeting of the Consultative Group for Moldova will be organized on October 26, 1993. A positive reaction of the international community to the country's outstanding efforts would be a great encouragement for the authorities to continue the program.

Mrs. Kotova made the following statement:

It is commendable that, after a long period of debate, the authorities are now firm in their intention to move quickly and that a consensus has been achieved that there are no reasonable alternatives to the transition to a market economy. This momentum certainly deserves international support. The country is fully eligible for the STF, owing to the fact that it has suffered from the worst fall in terms of trade of any of the states of the former Soviet Union. Therefore, I have no difficulty in supporting the proposed decision.

Moldova has joined other formerly centrally planned economies in their transition to a market economy with a substantial time lag, and it might enjoy many advantages owing to its late start. In particular, the detrimental consequences of the absence of financial discipline in the economy are now fully recognized, and the program envisages tightening the stance of fiscal, monetary, and credit policies. Moldova probably has fewer problems in deciding to move to a national currency, as the inconveniences associated with the absence of independent monetary instruments have already been vividly displayed and national coupons have already been widely used. We welcome the authorities' commitment to finalize preparations for the introduction of the leu by the end of the year.

Moldova has one more distinct advantage in comparison with its neighbors: it has less of a need for adjustment in the sectoral composition of output and exports than many other states of the former Soviet Union, as agriculture and agroprocessing industries will continue to be the leading sector in accordance with the country's comparative advantage. The recovery strategy can be built around the development of these industries.

Against this background, it is regrettable that instead of capitalizing on some of these advantages, the country tends to repeat many errors that are typical of the initial stages of the transformation process.

The program is oriented toward achievement of two main objectives, which are equally positioned in the program: lowering inflation and containing the decline output. One can observe this dualism of objectives in some similar programs, and this prompts me to discuss this issue in a little more detail. Such a dualism of objectives is understandable; it is caused by political realities and the difficulty of acknowledging the fact that a recently almost-flourishing and definitely not impoverished country suddenly finds itself in a crisis situation, characterized by an enormous budget deficit, galloping inflation, lack of basic consumer goods, and the virtual collapse of the social safety net.

At the same time, such a dualism in stabilization priorities, largely appropriate in a developing market economy experiencing macroeconomic imbalances, is misleading guidance for a country in the initial stage of transition to a market economy. This is not merely a conceptual consideration but a policy issue to be taken into account in analyzing programs of systemic transformation.

Inflation in Moldova is fueled by several key factors, including a huge budget deficit, lax monetary policies, the virtual absence of credit discipline vis-à-vis enterprises, and open-ended consumer subsidies. Within this context, it makes little sense to look more specifically at such drawbacks as, for instance, the provision of rub 38 billion, equivalent to 15 percent of GDP, for indexation of the working capital of enterprises, or of rub 5.3 billion to the Sberbank for partial recapitalization. These are regrettable, but not surprising, slippages, resulting from the traditional adherence of the authorities to means and instruments widely used in a command economy. It is this very feature of the philosophy of the program of actions that, more than any other uncertainty, threatens the program's implementation.

Of all of the authorities' strong commitments, the most promising one could be the explicit readiness to subordinate the output objective to that of building a stable and manageable macroeconomic environment conducive to spontaneous economic recovery in the event of the inevitable trade-off between the two. Suffice it to say that rapidly declining production has not to any extent been accompanied by an increase in unemployment. Sustaining full employment at the cost of lax financial policies and attempts to support output at the same cost mean only that the authorities are not yet fully prepared to pay the price for the transition to a market economy.

Fiscal policy remains the macroeconomic instrument over which the Government has the most leverage to date. The Government tries to consolidate the budget, but the budget is repeatedly overwhelmed by demands to sustain output. The official fiscal accounts, although recording a substantial deficit, do not reflect the sharp rise in expenditure financed through the accumulation of domestic arrears and subsidies provided through extrabudgetary sources. The adherence to the output indicators drives the authorities to the provision of preferential credits to enterprises, the clearance of their arrears, or the provision of tax exemptions. It is hard to consolidate the budget by these means.

What has not yet been fully recognized is that not only is direct financial support to the real sector very costly and ineffective at this stage of the development, it also could undermine the entire financial system. It is commendable that the

National Bank of Moldova is gradually raising the refinance rate and is starting to turn to an auction-based system for the allocation of credit resources. At the same time, the National Bank still has very little autonomy, and its monetary policies could easily be sacrificed to the aim of supporting the real sector and public expenditure. Indirect interest subsidies resulting from the extension of concessional refinancing rates to the banks by the National Bank need to be eliminated, while the growth of arrears and claims on the central bank to finance the budget deficit must be reduced.

As for systemic policies, Moldova lags behind other transition countries in making real progress in price liberalization and, consequently, trade liberalization. Privatization is just about to begin in Moldova. These systemic efforts should clearly be at the forefront of economic policies. Let me stress that sizable technical assistance is indispensable for success in these interlinked areas. Governmental institutions obviously lack the implementation capacity to manage sizable, balanced, and synchronized actions in these areas. For instance, it is regrettable that, although the privatization program is generally quite ambitious, its simplest part--small-scale privatization--is still in the pilot stage. There are almost no excuses for delays in small and "doable" measures, because the main techniques are extremely simple, widely understood from the experience of other countries of the former Soviet Union, and can be immediately applied with some catalytic technical assistance from the international institutions.

The program does not explicitly emphasize the crucial role of a healthy financial sector, although in many respects it might be the main lever for the other systemic policies. Eliminating preferential credits is indispensable not only for fiscal reasons, but also to make all economic activities face the same cost of capital and price incentives. So far, there is no strategy for dealing with enterprise arrears. Bad loans are mounting up, and it is a common practice to turn to credit rollovers and interest capitalization. Portfolio risks for the majority of financial institutions will only rise in the course of privatization, as the number of companies not prepared to service bank loans increases. The authorities are planning to harden budget constraints on state-owned enterprises. However, to this end, they are trying to build a system to monitor public enterprises, aimed at assessing the viability of each company and its ability to meet obligations to the banks. I am afraid this is a daunting exercise and another misallocation of administrative resources--and another attempt to avoid painful episodes of bankruptcy and layoffs at the cost of further depressing the financial sector. I would appreciate the staff's comments on the rationale for this exercise, which seems to me to be a substitute for accelerating privatization. Another question concerns the reasons for the slow pace of privatization, which at the same time is considered by the staff to be the cornerstone of the program.

These are the main serious concerns as regards the domestic aspects. I fully share the staff's opinion that another area of concern is associated with the uncertainty of the timely provision of external financial assistance to Moldova at this turning point in its development. The Consultative Group process moves forward rather slowly, while clear commitments by donors could accelerate the design of a stand-by arrangement in the event of successful implementation of the STF program. To date, Moldova needs sizable financial support. It quickly exhausted its technical credits from Russia, which were equivalent to about $17 million, and accumulated the equivalent of $36 million in arrears to Russia on account of energy imports. Once these arrears were converted into government debt obligations, Russia promptly provided another loan equivalent to $50 million for the remainder of 1993. My authorities intend to continue to support Moldova's trade and transformation efforts in the future.

Summarizing what I have said, we believe that the program of actions of the authorities of Moldova will ensure a break from past policies and will begin to reorient the economy toward market principles. The main risks and uncertainties are concentrated in the domestic front. The scope of the envisaged improvement in the public finances might be insufficient to provide support for the national currency, when it is finally introduced, and for the creation of the general economic conditions conducive to market transformation. Therefore, we would be doubly cautious about concluding discussions on a stand-by arrangement before the full successful implementation of the STF program. Let me express the hope of my authorities that the program supported by the STF will be successfully implemented and trigger the full pass-through of market mechanisms to the national economy. We wish the authorities well in their efforts to maintain the momentum for fundamental changes.

Mr. Wu made the following statement:

I agree with both the staff and the authorities that the current economic situation in Moldova is unsustainable and that a comprehensive stabilization and structural reform program should be introduced without delay. In this sense, the ambitious and comprehensive stabilization and reform program prepared by the Moldovan authorities is indeed welcome. It is an ambitious and challenging, but rewarding, step and a departure from the past reluctance for comprehensive reform. But given the severity of economic difficulties and uncertainties surrounding the program period, the authorities are encouraged to adhere to the program's objectives and fully implement the measures.

As I am in broad agreement with the staff appraisal, and the staff briefing at the beginning of today's meeting on the authorities' recent actions has resolved some of my concerns, I would like to make only some brief observations on the areas in which I think special caution should be applied during the period of the program, in particular up to the end of this year.

First, as reported by the staff, the decline in output has not been accompanied by corresponding rises in recorded unemployment, owing in large part to a sufficient supply of preferential credits and a lack of hard budget constraints. But this is a superficial picture and will become a more serious problem, because hidden unemployment is a more serious issue in a transition economy such as Moldova, and will be compounded by the lack of a functioning labor market and reliable employment data. Under the program, unemployment will no doubt become the prominent economic difficulty as a result of the envisaged tighter financial policies.

The program is committed to eliminating preferential credits and hardening budget constraints. One of the effects of such a policy will be that hidden unemployment will ultimately come out into the open as economic activity continues to decline. Without appropriate unemployment benefits, the unemployed will pose a new threat to social stability. The problem is that if there are insufficient unemployment benefits, enterprises facing hardened budget constraints will have no choice but to lay off workers. If open unemployment becomes so severe that it endangers social and economic stability, pressure on the Government and central bank to resume preferential credits and more subsidies will be enormous. Given past experience, it will be difficult to withhold such enormous pressure. If the Government and central bank start meeting such requirements, albeit unwillingly, this will jeopardize the program. Against such a background, I would appreciate the staff's comments on the potential effects of prospective open unemployment on the program.

Second, elimination of preferential credits and reductions in subsidies will have an immediate effect on business and consumer activities. Except for price adjustments, enterprise, tax, and trade reforms will take time to have a real effect on the economy. The authorities have expressed, and the staff recognizes, their concerns to protect the most vulnerable groups. But it is a pity that the current program does not have sufficient social reform elements to properly safeguard the groups that will be immediately hit as a result of the tighter financial policies.

Third, on monetary policy, the cash shortage emerged in early 1993 as a result of insufficient ruble bank note deliveries from Russia. But as over 80 percent of currency in circulation as of the middle of the year was in the form of coupons, this has made it possible for the Moldovan authorities to be responsible for their own monetary policy. However, the tight stance of monetary policy envisioned in the program will leave the authorities with little room to infuse more cash to settle the wage and salary payments arrears. With overdue payments compounded by the increased number of unemployed, the Government will be pressed to provide more compensation benefits, in one way or another, to the public. If this happens, other things remaining equal, the expenditure targets will be difficult to attain. In addition, the increased costs of oil imports for winter heating will put the Government in a difficult position in passing the cost through entirely to consumers. I am pleased to learn that the delay in the delivery of ruble bank notes has been resolved.

Fourth, on the financing gap, it is encouraging to learn from the staff briefing that active preparatory work is under way, but the financing gap of $140 million is not a negligible figure for a small country such as Moldova. Given the enormous difficulties facing the country and the authorities' daunting task of implementing the adjustment program, the international community is urged to make its best effort to provide adequate financial assistance in helping Moldova get through the difficult transition period.

Concerns about these difficulties and uncertainties will certainly not prevent me from supporting the proposed decision, because it bolsters the authorities' adjustment efforts toward a market-based economy.

Mr. Prader made the following statement:

Moldova is finding the transition to a market economy more difficult than most other countries of the former Soviet Union. The present economic program has had to be implemented under extremely unfavorable conditions. These include the terms of trade shock caused by the disintegration of the Soviet Union, the destruction caused by civil war, and a steep decline in agricultural production owing to the severe drought.

Under such circumstances--and despite the advantages of being a late starter, as outlined by Mrs. Kotova--it took courage for the authorities to design a program aimed at pushing Moldova into the next stage of transition. At this point, I should add that we very much appreciate the prior actions announced today by the staff, which is a very good sign of the seriousness with which the authorities are starting the program. Moldova's first priority is to establish the macroeconomic conditions needed to stabilize its economy and introduce a national currency to serve as a solid basis for economic recovery. The most urgent goals of the program are to bring down inflation and halt the decline in output by accelerating the structural reforms.

On fiscal policy, the deficit target of 6 percent of GDP will require a remarkable effort to overcome the continuing pressure of declining output. On the revenue side, the authorities plan broad measures to expand the tax base and improve the efficiency of tax collection. On the expenditure side, the staffs of the Fund and the World Bank will collaborate with the authorities toward the substantial reduction and eventual elimination of price subsidies. The planned tightening of financial policies must be supported by the prior development of an adequate social safety net system.

On the monetary side, rigorous implementation will be the key to achieving stabilization goals. We are therefore glad to see that the authorities have committed themselves to completely eliminating the preferential allocation of credit and introducing market mechanisms--for instance, in the form of central bank credit auctions--into the allocation of financial resources; the negative experience of Moldova's neighbors in Eastern European and the former Soviet Union shows how important such measures are. Equally imperative is imposing financial discipline on the state-owned enterprises by enacting a bankruptcy law and strictly enforcing bankruptcy procedures.

The program's structural reform component correctly emphasizes privatization and the liberalization of prices and trade as major preconditions for obtaining a supply response, priorities which are reflected in the decision to launch an ambitious privatization program covering, at the outset, almost half of all state-owned enterprises. Given this background, I was surprised that Mrs. Kotova seemed to think that the pace of privatization was slow. I am not sure whether, for example, the Russian privatization process is more rapid. Unless the statement by the staff that almost half of all state-owned enterprises are going to be privatized is wrong, I would maintain my observation that this is rather ambitious.

Mr. Törnqvist made the following statement:

There is no doubt that Moldova experienced a particularly difficult year in 1992, in large part the result of a pronounced summer drought and a very severe terms of trade shock. The political situation has not been less problematic.

In 1993, the economic situation has continued to deteriorate and the political situation remains difficult. The measures taken so far to come to grips with the economic problems have been too weak, as Mr. Havrylyshyn points out in his statement.

It is encouraging, however, that the difficult circumstances seem to have forged a political consensus to tackle the problems more vigorously, in the context of an STF program with the Fund. We certainly welcome this, as well as the ambitions to let this program lead to an arrangement in the upper credit tranches at a later stage.

I am in broad agreement with the staff paper and previous speakers, and would therefore like to concentrate on a few points.

In the previous discussion on Moldova, this chair encouraged the authorities to prepare for the early introduction of a national currency, in order to gain control over the full range of stabilization policies. Therefore, I welcome the intentions of the authorities to do so, as soon as it is feasible.

At the same time, I wish to underline the importance of underpinning such a measure, in terms of stabilizing the economy and building the necessary institutional framework, if the introduction of the currency is to succeed. Thus, it is crucial that, before the introduction of the leu, significant progress has been made in stabilizing the economy. In particular, inflation would have to be brought down sharply. The monetary program recently adopted by presidential decree is certainly a step in the right direction, and it is encouraging to note that some measures have already been taken according to the program. It is only to be hoped that the authorities will be able to resist the pressures to loosen monetary policy and continue the extension of preferential credits on a large scale.

In addition, as other speakers have already stressed, significant fiscal action is needed in order to build confidence and support monetary policy.

Another important precondition for introducing a national currency is a capable and strong central bank. This has been confirmed by the experience of the Baltic states. Thus, there seems to be an urgent need to strengthen the National Bank of Moldova, both as regards its independence and its technical capacity. I note that several Fund missions have already been to Moldova in order to help modernize the central bank, but I would assume that further efforts would be needed in this area before the Bank can successfully handle the introduction of a national currency. I would welcome comments from the staff on how it looks upon the present status of the central bank with respect to its independence, as well as its technical capability.

In this context, I also note that the foreign exchange reserves of the National Bank are extremely small. Even if the leu is intended to float, it is certainly necessary to build up reserves to a much higher level before the leu is introduced.

When Moldova's request for a drawing under the compensatory and contingency financing facility was discussed, several Directors, including this chair, were concerned about Moldova's ability to repay the Fund. We said then that, even if there were reasons for concern, we were willing to give Moldova the benefit of the doubt. I believe that the same can be said now. On the one hand, the authorities have adopted an ambitious program, which, if implemented vigorously, would make the prospects for timely repayment reasonably good. On the other hand, the problems and uncertainties are great, and even with good policies, the balance of payments outlook is very difficult and the need for additional external assistance is great. This underscores the importance of following the program meticulously. There is no room for slippage.

Finally, I agree with the staff and other speakers that Moldova qualifies for a STF drawing and I support the proposed decision.

Mr. Barr remarked that his attitude toward Moldova's program had become increasingly supportive as he read through the staff paper. Section II of the paper, which described recent economic developments, presented a depressing picture of policy inaction and its consequences. Section III of the paper, however, outlined the Government's ambitious attempts to address the country's problems and secure stabilization, and he could agree with the penultimate statement in the paper that the program "constitutes a real break from past policies." Nevertheless, he had a number of concerns about the prospects for achieving the objectives of the program. In particular, support for the program did not seem unanimous even among members of the Government, which made the task even more challenging than in some other states of the former Soviet Union. He would be interested in further amplification from the staff or Mr. Havrylyshyn on what the Government was doing to "market" the program and what their assessment was of the political risk.

He was particularly worried by the fact that, until at least very recently, the Government itself had been putting pressure on the National Bank of Moldova to direct credit to priority sectors at highly preferential rates, Mr. Barr commented. Thus, although no further preferential credits beyond those already committed would be provided in the context of the STF program, there would still be sizable access to the preferential credits already committed throughout the second half of 1993. As other speakers had mentioned, the elimination of such credits was essential to move the economy on to a more market-oriented course.

He was slightly less sanguine than the staff that an adjustment program that was adequate for the country excluding the Trans-Dniester region would be adequate for the country as a whole, Mr. Barr stated. The Trans-Dniester region represented a significant part of the economy, and, if none of the reforms would apply to that region, its economic prospects would almost certainly deteriorate, notwithstanding the fact that the region had traditionally generated a surplus on both the fiscal and balance of payments accounts. The uncertain economic prospects for the Trans-Dniester region reinforced the need to seek a peaceful solution to the problem as soon as possible, so as to consolidate the effects of the stabilization program.

He wondered why the program envisaged only a gradual increase in interest rates toward market levels, Mr. Barr said. Moreover, given that the monetary program had been approved by decree when the Parliament was in recess, he wondered how confident the staff was that the Government would be able to stick to the program. The program's fiscal policy was appropriately ambitious, but he wondered how realistic it was to expect a deficit of 3.7 percent of GDP for the second half of 1993, particularly given that the target included clearance of government arrears accumulated in the first half of the year. He would be interested in knowing the extent to which the program's objectives would be jeopardized if there were some further fiscal slippage. He was also concerned to learn that consumer subsidies were programmed to grow by almost 2 percent of GDP in relation to their level in 1992. Clearly, there was a need to put in place a social safety net quickly and for consumer subsidies to be eliminated.

In conclusion, Mr. Barr commented, full and resolute implementation of the program would be needed to achieve the stabilization objectives and to move forward to a second drawing under the STF and, it was hoped, a stand-by arrangement in the near future.

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

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/93/132 (9/15/93) and EBM/93/133 (9/16/93).

3. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAM/93/161 (9/14/93) is approved.

APPROVED: January 13, 1994

LEO VAN HOUTVEN
Secretary