FOR AGENDA

EBS/93/140
Supplement 2

CONFIDENTIAL

September 13, 1993

To: Members of the Executive Board

From: The Secretary

Subject: Pakistan - Request for Stand-By Arrangement

The attached supplement to the staff report on Pakistan's request for a stand-by arrangement (EBS/93/140, Supplement 1, 8/25/93) has been prepared on the basis of additional information. Revised draft decisions appear on page 6.

Mr. El-Erian (ext. 37357) or Mr. Furtado (ext. 38423) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Unless the Documents Preparation Section (ext. 36760) is otherwise notified, the document will be transmitted, in accordance with the procedures approved by the Executive Board and with the appropriate deletions, to the Asian Development Bank (AsDB), following its consideration by the Executive Board.

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PAKISTAN

Staff Report for Request for Stand-By Arrangement Supplementary Information

Prepared by the Middle Eastern Department and the Policy Development and Review Department

Approved by Paul Chabrier and Anoop Singh

September 10, 1993

This report provides supplementary information on developments in Pakistan, focusing on the implementation of prior actions under the program for 1993/94 described in EBS/93/140 (8/20/93) and Supplement 1 (8/25/93).

I. Policy Implementation

1. Fiscal policy

The program incorporated the following fiscal prior actions that still needed to be implemented in end-August/early September: budgetary measures resulting in net revenue mobilization of PRs 6 billion (in addition to the measures implemented in the context of the 1993/94 budget); and extension of the direct tax net to agriculture through the wealth tax.

The incremental fiscal package was announced on August 19. Measures were taken to raise an additional PRs 10.5 billion for the remainder of 1993/94 through increases in petroleum, gas, and edible oil prices. 1/ As envisaged under the program, the direct tax net was extended to agriculture through the imposition of a wealth tax with a larger "Produce Index Unit" (PIU) valuation than initially envisaged--thereby resulting in a wider

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1/ The 10 percent increase in petroleum prices (further to the adjustment implemented in June 1993) is estimated to yield PRs 6.9 billion. The average 19 percent increase in gas tariffs would yield an estimated PRs 1.6 billion. The higher edible oil duties would yield an estimated PRs 2.0 billion.

coverage. Progress in this policy area was also greater than programmed as steps taken to impose a federal wealth tax were supplemented by a provincial income tax. 1/ The authorities also announced the intensification of tax audits and better enforcement of the self-assessment scheme.

The 19 percent increase in electricity prices implemented in mid-August would result in estimated receipts for the Water and Power Development Authority (WAPDA) of PRs 6.8 billion, thereby strengthening the prospects for its projected transfers to the budget in the form of dividends, profits, and repayments. This is to be accompanied by stronger sanctions in the event of nonpayment of bills. Finally, provincial receipts are being supplemented by all provinces increasing irrigation water rates by 25 percent--thereby providing for larger coverage of expenditure by self-generated revenues.

To mitigate the impact of higher prices on the more vulnerable segments of the population, the authorities have now granted a fixed wage increase of PRs 100 per month to public sector employees in the lower grades (effective in September)--the associated wage increases are in the range of 3-8 percent. The minimum wage was increased by the same amount and the duty on sugar was reduced. The cost to the budget in 1993/94 of the "relief measures" is estimated at some PRs 3 billion. Consequently, on a net basis, the package would yield, ceteris paribus, additional budgetary revenues of PRs 7.5 billion or PRs 1.5 billion above the level specified in the program. The authorities view this latter amount as providing a cushion against unanticipated adverse developments during the year.

2. Monetary policy

The upfront increases in rates of return envisaged to be taken by August 31 were implemented on August 16. As noted in EBS/93/140, Supplement 1, the State Bank of Pakistan (SBP) increased by 2 percentage points the discount rate, repo rates (for short-term and long-term securities), and the maximum lending rate. Rates on all concessional credit schemes were increased to 11 percent. Consistent with these adjustments, the maximum accepted bid rate at treasury bill auctions rose from 12.7 percent in July to 14.5 percent in the auction which was settled on August 26--this in the context of adherence to the announced minimum borrowing requirement. The effective yields at auctions of the longer term securities (Federal Investment Bonds) have also risen.

1/ The wealth tax is based on a PIU valuation of PRs 200 (compared with the initial value of PRs 100) and the general exemption level of PRs 1 million. The income tax is based on PRs 2 per PIU subject to a threshold of 4,000 PIUs. Given uncertainties about yields in the first year, the incremental fiscal package is so designed as to generate the required revenue without dependence on these taxes.

As noted in the staff report, there was considerable bank financing of the budget in July (now estimated at PRs 20 billion, compared with a programmed PRs 20 billion for the year as a whole). 1/ Outstanding credit was reduced to PRs 18 billion as of end-August. The authorities have indicated that, given the impact of the revenue measures and the availability of external financing from the World Bank and the Asian Development Bank, they are confident that the end-September performance criterion of PRs 10.3 billion will be met. 2/ They have also stated that available monetary indicators point to Pakistan being in a position to observe other performance criteria and indicative targets for end-September 1993.

3. External sector

The program's prior actions in the external sector include: (i) removal of restrictions maintained under Article XIV relating to travel allowances, remittances by foreigners for living expenses, and allowances for professional training abroad; (ii) removal of specified items from the negative list of imports; and (iii) elimination of the restricted list of imports. Circulars removing the payments restrictions were issued on August 30 and September 7. Actions relating to the restricted and negative lists were adopted on September 7. The slippage from the August 31 implementation date reflected administrative delays. The implemented measures relating to the payments restrictions and negative list correspond to those specified in the Memorandum on Economic Policies (EBS/93/140). As regards the restricted list, the authorities indicated that steps were taken as specified in the Memorandum except that it was decided for security reasons not to remove the two groups related to T.V. transmission antenna systems, field pick-up units et al, and aircraft and spacecraft; consequently the restricted list is still in place. The staff supports altering the prior actions accordingly pending further discussions on this issue.

Gross official reserves have registered further gains, increasing to US$507 million as of the last week of August (2.6 weeks of imports), compared with US$185 million in mid-July and US$330 million in the second week of August. Consistent with the implementation of policies, indications are that these gains reflect primarily higher export receipts, a slowdown in

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1/ The authorities have provided the staff with revised monetary stock numbers incorporating a lower base for June 1992. As a result, domestic liquidity growth is now estimated at 24.6 percent in 1991/92 (compared with 28.1 percent cited in EBS/93/140, Supplement 1) and 17.5 percent in 1992/93 (compared with 16.6 percent). Money supply at current exchange rates for June 1993 amounts to PRs 554.1 billion compared with the earlier estimate of PRs 565.8 billion. The performance criteria under the program are not affected since these are defined in flow terms.

2/ As described in Table 1 of EBS/93/140, the program provides for the end-September ceilings to be adjusted upward for shortfalls in foreign financing from these sources.

imports, and increased private capital inflows. Gross reserves are to be bolstered further in the coming weeks by the availability of quick disbursing assistance from the World Bank and the Asian Development Bank, and the first purchase under the proposed stand-by arrangement. With the strengthening of the reserve position, the authorities removed on August 29 the margin requirement for opening of letters of credit for imports. This requirement, which was to be removed under the program by end-December 1993, gave rise to restrictions subject to Fund approval under Article VIII. The proposed decision relating to the exchange system contained in EBS/93/140, Supplement 1 has been modified to reflect the early elimination of the restrictions (see Section III).

4. Other

The economic package announced by the Prime Minister included additional structural reform measures. The domestic deregulation and privatization program is to be strengthened, inter alia, through enlarging private sector participation in the areas of utilities, insurance, investment and commercial banking, roads, railways, ports, and airline operations. A committee has been set up to analyze in detail the impact on industry and trade of further tariff reform consistent with the broad parameters specified in the Policy Framework Paper; a World Bank technical assistance mission is currently in Pakistan to assist in this process. Steps have also been taken to liberalize the marketing of fertilizers. A taskforce has been set up to develop action plans to strengthen social safety net provisions, in coordination with the implementation of the Social Action Program. The Government also announced its intention to increase the independence of the SBP. Finally, and in addition to the reform of the civil service, the Government is taking steps to establish strict and transparent rules for the public sector's acquisition and disposal of land.

The migration of large locust swarms from North Africa and the Middle East to Pakistan's south-eastern border areas in Punjab and Sind constitutes a threat to certain agricultural crops. The authorities have launched--in collaboration with donor agencies, the United Nations, and India--an effort to prevent the maturing of swarms including through ground and aerial spraying.

The staff will be following up on these issues in the context of the next round of policy discussions to be held shortly.

II. Staff Appraisal

The staff welcomes the authorities' implementation of prior actions which---other than the reconsideration of the removal of some items from the restricted list of imports--has been in line with expectations. Indeed, in some cases (including net budgetary revenue mobilization, agricultural taxation, and payments restrictions), implementation has gone beyond that specified in the program. The measures serve to intensify and broaden Pakistan's adjustment and reform policies.

The authorities' determined policy implementation under the 1993/94 program has already contributed to a recovery of gross official reserves from the very low levels recorded in July. Specifically, fiscal and monetary policies have been tightened, supplementing the impact of the exchange rate adjustment. The authorities have also strengthened structural reforms aimed at placing the economy on the path of sustained high economic growth. They have indicated that they are confident that the end-September quantitative performance criteria will be met. In all, and while the external financial situation remains vulnerable, indications point to encouraging economic and financial developments that are in line with the program to be supported by the proposed stand-by arrangement and provide for continued gains in the context of sustained and timely policy implementation.

III. Proposed Decisions

The following modified draft decisions are proposed for adoption by the Executive Board:

A. Pakistan: Stand-By Arrangement

1. The Government of Pakistan has requested a stand-by arrangement for a period of 12 months from September __, 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 1.

B. 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 (SBP), 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.