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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 87/116

3:00 p.m., August 3, 1987

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	E. T. El Kogali
Dai Q.	
	M. K. Bush
	J. Prader
A. Donoso	
M. Finaish	M. B. Chatah, Temporary
G. Grosche	
J. E. Ismael	
	J. Hospedales
	M. Foot
M. Massé	D. McCormack
	D. Saha, Temporary
Y. A. Nimatallah	I. A. Al-Assaf
G. Ortiz	L. Filardo
	M. Fogelholm
	G. Pineau, Temporary
G. A. Posthumus	
	F. E. R. Alfiler, Temporary
	S. Rouai, Temporary
	B. Tamami, Temporary
	A. Vasudevan, Temporary
K. Yamazaki	M. Sugita
	R. Manfredi Selvaggi, Temporary

L. Van Houtven, Secretary and Counsellor
J. K. Bungay, Assistant

Also Present

IBRD: L. Y. L. Yap, Europe, Middle East and North Africa Regional Office. African Department: A. D. Ouattara, Counsellor and Director; G. E. Gondwe, Deputy Director; D. T. S. Ballali, C. V. Callender, T. K. Morrison, T. R. Muzondo. Exchange and Trade Relations Department: J. Hicklin, S. Kanesa-Thasan. External Relations Department: A. F. Mohammed, Director. Legal Department: J. M. Ogoola, J. K. Oh. Middle Eastern Department: P. Chabrier, Deputy Director; E. J. Bell, S. H. Hitti, M. D. Knight, H. E. Jakubiak. Secretary's Department: J. W. Lang, Jr., Deputy Secretary. Treasurer's Department: T. Leddy, Deputy Treasurer; J. E. Blalock, P. J. Bradley, J. C. Corr. Advisor to Executive Director: A. Ouanes. Assistants to Executive Directors: N. Adachi, M. Arif, O. S.-M. Bethel, H. S. Binay, R. Comotto, E. C. Demaestri, S. Guribye, J. M. Jones, K.-H. Kleine, V. K. Malhotra, T. Morita, J. A. K. Munthali, L. M. Piantini, A. Rieffel, S. Rouai, H. van der Burg.

1. PAKISTAN - 1987 ARTICLE IV CONSULTATION

The Executive Directors resumed from the previous meeting (EBM/87/115, 8/3/87) their consideration of the staff report for the 1987 Article IV consultation with Pakistan (SM/87/137, 6/22/87; Sup. 1, 7/22/87). They also had before them a background paper on recent economic developments in Pakistan (SM/87/152, 7/9/87).

Ms. Bush remarked that the Government of Pakistan had taken measures in recent years that had contributed to relatively strong growth and a moderate rate of inflation. Significant gains had been made in agricultural output and in oil production, and reforms had begun to increase the efficiency of the public sector enterprises and to stimulate private sector investment. In particular, the authorities merited commendation for steps taken to enhance producer prices, for their recent deregulation actions, and for the decision to abolish the wheat rationing system. It was also noteworthy that the authorities had ended the government monopoly for the import of edible oils and had allowed the private sector to import all fertilizers free of duties. Those measures should help to create an environment that was suitable for further expansion. Nevertheless, the remaining significant problems needed to be addressed if Pakistan was to achieve adequate economic growth in the context of a sustainable balance of payments position. Gross fixed investment remained low, and both domestic savings and gross national savings had declined in recent years. The overall fiscal deficit, already considered too large in 1984/85, had grown larger, and there was a troubling possibility that that deficit would reach 12 percent of GDP in 1987/88.

The authorities had adopted as an objective for 1987/88 a deficit-to-GDP ratio below the one estimated for 1986/87, Ms. Bush noted. She agreed with the staff's judgment that the policies needed to achieve that objective were not yet in place. It was particularly crucial for the authorities to commit themselves to controlling expenditures. For example, it was disturbing to find that a significant amount of maneuvering room afforded by falling oil prices had been consumed by new subsidies for cotton exports and steel production, and by arrangements to benefit the sugar trade. Moreover, a special effort needed to be made to reduce the burden that the public sector enterprises represented in the budget, and an accelerated pace of divestiture would certainly help to accomplish that goal. She was reassured to learn that the authorities were committed to implementing the recommendations of the National Taxation Reform Commission.

With respect to the external sector, she agreed with the staff that there was too much reliance on workers' remittances and agricultural exports, Ms. Bush continued. She was concerned that the balance of payments position could become unmanageable unless measures were taken to bolster the growth of nontraditional exports, to bring imports into better balance with exports, and to build international reserves. The staff's first medium-term scenario illustrated vividly the implications for Pakistan's debt service ratio if current policies were maintained. The alternative scenario was obviously preferable, and she wondered whether Mr. Finaish had any comment on factors that might stand in the way of realizing the second scenario. Finally, while the balance of payments situation was much better than it would have been in the absence of the previous year's devaluation, she was persuaded that the authorities should be pursuing a more active exchange rate policy.

Pakistan had achieved enviable rates of economic growth and inflation over the past year, Ms. Bush remarked. However, the recent growth had benefited from short-term factors such as declining oil prices and good harvests. The staff had noted in the background paper the extensive influence of the Government over prices, which suggested that the underlying rate of inflation might be considerably higher than the recorded rate. It was essential to remember the risks associated with rising fiscal deficits and borrowing to maintain growth; it was more appropriate for growth to be fueled by higher levels of domestic savings and investment.

Pakistan's economy appeared to have much potential that was thwarted to some extent by government controls, Ms. Bush considered. The authorities had cited vested interests as a major obstacle to the removal of government controls, but the perpetuation of those controls strengthened those interests. Moreover, Pakistan was fortunate in having an extensive, experienced private sector that could quickly take advantage of measures such as the earlier decision to liberalize the procedures for approving private investment in industrial projects. She was thus troubled by the impression that the most recent initiatives continued to entail intervention mechanisms that limited the involvement of the private sector. She hoped that the authorities would create an environment that would permit the private sector to flourish, without intervention mechanisms. She looked forward to an improved outlook for the economy at the next Article IV consultation; such an improvement could certainly occur if the authorities intensified their efforts to address Pakistan's structural problems and fiscal imbalances.

Mr. Yamazaki made the following statement:

As is pointed out in the staff report, Pakistan's growth and inflation performance in recent years has been commendable; therefore, I will limit my remarks to specific policy areas that merit particular attention.

Although I appreciate Mr. Finaish's opening remarks, it seems to me that fiscal policy is the area where the utmost effort for adjustment and rectification is urgently called for. The overall fiscal deficit, which is estimated to be quite high in relation to GDP, and even higher according to certain assumptions of the staff analysis, is not at all sustainable, and urgent policy efforts should be directed at curtailing it.

Problems exist on both sides--expenditure and revenue--and accordingly, remedies must also come from both sides. I fully endorse the staff's cautious advice that the authorities should make further cuts in budget expenditures, including subsidies, as it is indeed important not to approve additional expenditures before the expected increase in revenue materializes. In any attempt to consolidate the fiscal deficit, vigorous expenditure cuts should come first.

Revenue is the other side of the coin. A fiscal deficit of this magnitude naturally requires a strong push in tax increase measures, and the recommendations of the National Taxation Reform Commission, particularly the implementation of the across-the-board single-rate sales tax measure, seem to be exactly in the right direction. It is advisable to implement the measures recommended by the Commission as early as possible.

On the external policy front, Pakistan's overall balance of payments position seems to be manageable in the short run. The medium-term prospects, however, are less encouraging, in view of the weaknesses and the vulnerability of the balance of payments structure, caused mainly by too heavy a reliance on workers' remittances and agricultural and cotton-based manufactured exports. Given those weaknesses and the rapidly deteriorating trend in the external debt service payments position, further determined efforts on the part of the authorities toward structural adjustment measures are called for.

Diversification and widening of the export base, and improvements in debt-management policies need to be pursued, together with structural reforms in the real sector and a tightening of the fiscal and credit policy stance. Further efforts also are required in liberalizing investment policies, as well as tariff and trade reforms.

All in all, I fully trust that the authorities will redouble their good intentions of pursuing these policy efforts, which should help them toward successful management of Pakistan's economy. I endorse the proposed decision.

Mr. Tamami made the following statement:

Despite the prolonged stagnation in gross domestic investment and the unfavorable external conditions, Pakistan's economy continued to register impressive economic growth with a low rate of inflation in 1985/86 and 1986/87. However, taking into account the effect of the relatively high rate of population growth, the increase in Pakistan's per capita income was moderate.

On the supply side, after the 9 percent increase recorded in 1984/85, GDP grew by 7.3 percent in 1985/86 and by an estimated 7 percent in 1986/87, owing mainly to the favorable weather and a wide range of adjustment policies. The authorities are to be commended for their timely implementation of corrective measures including in particular deregulation, price incentives, and flexible exchange rates. The implementation of these measures, which helped to facilitate the availability of improved input and to rationalize prices, made a considerable contribution to the rise in agricultural production and manufacturing output. In this regard, I am pleased to note a tripling of domestic oil output, which now accounts for one fourth of domestic consumption; the 20 percent rise in wheat production owing mainly to the use of a new high-yielding variety; and the 20 percent increase in cotton production in 1985/86 after it had doubled in 1984/85. The rate of inflation declined for the third consecutive year and was at the comfortable level of 4.6 percent in 1985/86.

On the financial side, the overall fiscal deficit, which had deteriorated over a number of years, registered a moderate improvement in 1985/86 because of the slower growth of government expenditures resulting partly from the fall in prices of petroleum, edible oils, and fertilizers. The level of the fiscal deficit, however, remains unsustainable and is an area of concern. In 1986/87, the fiscal deficit is estimated to have increased by 1.1 percentage point to a record 8.8 percent of GDP. This development calls for the implementation of further corrective measures that will give rise to revenues and contain expenditures. I welcome the authorities' acknowledgment of the need for a major correction in the structure of public finances and their intention to take measures to strengthen fiscal performance in connection with the 1987/88 budget. The measures indicated in Mr. Finaish's opening statement appear to be steps in the right direction. However, they are not sufficient to address fully the financial difficulties. In this respect, while I share the staff's concern about the persistent fiscal deficit, the required domestic and external financing, and the adverse consequences for inflation and the external position of the economy, it appears that the staff is less optimistic than the authorities about the possibilities for curtailing the overall fiscal deficit/GDP ratio to 7.6 percent in 1987/88. The staff is of the opinion that the revenue and expenditure targets will be difficult to achieve, and that in the circumstances it does not appear likely that the targeted improvement in fiscal performance will materialize. It would be helpful to have further comments from Mr. Finaish or the staff on the effectiveness of the envisaged measures under the approved revised budget.

In 1985/86 the increase in the overall fiscal deficit was fully financed by external resources. The authorities' determination to contain the growth of domestic liquidity in line with that of GDP led to a considerable reduction in the recourse to domestic bank borrowing in 1985/86--one third of the amount in the previous year--while domestic nonbank borrowings almost doubled. There were overruns in commercial bank credit to the private sector and public enterprises, resulting in a 15 percent increase in total domestic credit. These developments suggest that the expanded recourse to external and domestic nonbank financing, together with the likely increase in total bank credit, will make the country's already high debt service ratio even worse, weaken the external position that had reached a manageable level, and give rise to inflationary pressures. To maintain the momentum of adjustment, the authorities should pursue a more cautious approach to fiscal policy, and should contain the growth of government expenditures if slippages occur on the revenue side. As the staff has rightly pointed out, it is important not to approve additional expenditures unless there are clear indications that the expected increase in revenue is in fact materializing. Finally, there have been further welcome improvements in the implementation of an Islamic banking system, resulting in deregulation and the introduction of greater flexibility in the structure of deposit and financing rates.

On the external side, the current account deficit/GDP ratio improved by 1.5 percentage points to 3.5 percent in 1985/86, owing to the sharp rise in exports, the unexpected increase in workers' remittances, and the leveling of the current payments. This improvement, along with higher capital inflows, resulted in a substantial reduction in the overall balance of payments deficit. The current account and the overall balance of payments positions for 1986/87 are estimated to have improved further. However, the prospects for 1987/88 and beyond are uncertain, given the expectations of lower external demand, a decline in workers' remittances, and increased protectionism. The staff's scenarios indicate that the current account is unlikely to improve over a number of years ahead. In this regard I wonder how and to what extent the removal of existing bilateral agreements suggested by the staff would help sustain the momentum of export growth, particularly cotton-based manufactures, when major industrial countries have imposed restrictions on textile exports.

In concluding, I welcome the authorities' intentions to pursue a cautious external debt policy. Measures to limit commercial bank borrowing are steps in the right direction.

The staff representative from the Middle Eastern Department recalled that Directors' comments had focused essentially on the low savings and investment ratios and what could be done to raise them; the fiscal situation, particularly as it pertained to the 1987/88 budget and the possibilities of tax reform; and the external sector and exchange rates.

To improve the savings and investment ratios in the economy, the authorities needed to accord urgent priority to redressing the public sector situation. In the 1987/88 budget, the overall deficit was greater than public sector investment, which indicated that Pakistan would be borrowing to finance current expenditures. Moreover, the financing of such a sizable deficit was claiming a large proportion of private savings that would otherwise be available for private investments. Thus, the savings and investment performance of the economy was tied closely to the fiscal situation.

A number of factors had given rise to the staff's doubts that the projected improvement in the overall fiscal situation in 1987/88 would materialize fully, the staff representative explained. The staff had observed that one half of the projected growth in revenue was predicated on better tax measures and improved tax collection. While such measures had yielded additional revenues in the past, they tended to have diminishing returns; there was a limit to the yields stemming from improved tax collection. Thus, the predicted growth in revenue could be viewed as an optimistic assumption. Similarly, the decisions taken on the expenditure side had been more in the context of targets for cuts than proposals to cut specific expenditures. Finally, Pakistan's recent fiscal performance itself had given rise to the staff's doubts about the attainability of its budgetary goals; only one year earlier, the fiscal deficit had been projected at 7.5 percent of GDP, and in fact it was nearing 9 percent of GDP.

It was true that a more thorough analysis in terms of the elasticity of the taxation system would be helpful, the staff representative commented. There was prima facie evidence that in the 1980s, despite substantial discretionary tax measures in the earlier years, the tax elasticity had been below unity. In addition, since the effectiveness of the discretionary measures had weakened after 1984/85 and expenditures had continued to grow as well during the same period, the size of the overall deficit had grown at a rather rapid pace.

The National Taxation Reform Commission had examined with some thoroughness the possibility of agricultural taxation, the staff representative indicated. The decision after that review had been that constitutionally, such taxation was a matter to be left to the provinces, and that it would not be approached at the national level.

He wished to clarify a possible misunderstanding concerning the 9 percent premium on the foreign exchange bearer certificates, which the staff report had cited because of their multiple currency characteristics, the staff representative mentioned. The staff had not wished to imply that the premium on the certificates represented an overvaluation of the currency. In fact, the premium would disappear if the multiple currency practice were eliminated.

Although some Directors had doubted that a more active exchange rate policy was needed with regard to exports, it was useful to disaggregate exports and then to examine the performance of specific types of exports, the staff representative suggested. Such an examination revealed that some exports with a potential for growth--not the main agricultural exports or cotton-based manufactures that were subject to limitations in foreign exchange markets--had not grown rapidly or had even stagnated. In fact, the actions of the authorities substantiated such a conclusion: they had found it necessary to give tax concessions and other inducements, including tied loans, to move exports. This was an indication of a price problem that might be corrected by means of exchange rate action. In addition, the exchange rate issue ought to be viewed within the context of the broader external position. Imports were subject to detailed restrictions, and a 10 percent surcharge was being added to tariffs that were already high. A more realistic exchange rate would facilitate necessary reforms of both the tariff system and the import regime.

As for the feasibility of the external balance of payments scenarios, Mr. Finaish had rightly stated that they were illustrative examples, especially the one based on the assumption that current policies would continue, the staff representative from the Middle Eastern Department observed. It was not clear whether those illustrative examples should be extended to 1992/93 if the situation was projected to become unviable well before then. The second example in the staff report was an adjustment scenario that was supported by a wide-ranging set of measures and policies.

The staff representative from the Exchange and Trade Relations Department commented that Pakistan's bilateral payments arrangements involved restrictions under Article VIII. The objection to such arrangements was based on their potential for giving rise to inefficient allocation of resources. Moreover, Pakistan had had increasing balances over the years with respect to such arrangements; according to Table 24 in SM/87/152, those balances had increased steadily from $25 million in 1981/82 to $146 million in 1985/86.

Mr. Finaish said that it was clear from the discussion that the authorities had made considerable progress in certain areas--growth, inflation, financial sector reform, exchange rate management--and that they had introduced a number of structural reform measures. At the same time, of course, the discussion had underlined the need for increasing savings and investment and strengthening the fiscal position. In evaluating the performance of the authorities and in recommending certain measures and directions for the future, one needed to be mindful of the existing constraints and exogenous factors. The general constraints included lower prices for commodities, relatively low growth in the world economy, and protectionism; beyond that, an important constraint specific to Pakistan was the refugee problem. Pakistan was the host country for the world's largest concentration of refugees--more than three million--with all the attendant implications--political, economic, financial, and security. It was useful to remember that Pakistan's refugee situation affected not only the budget, but also the climate for investment and many other aspects of the economy.

The authorities had taken measures to reduce the budget deficit, but some of the problems were structural in nature and their solution would require time, Mr. Finaish stated. Defense, social services, and interest payments accounted for a significant proportion of current expenditures. It was difficult to determine how to cut expenditures for social services in the light of the Government's stated commitments, particularly in a country in which the per capita income was quite low and in which special attention had to be directed toward equity and regional balance in income distribution. Accordingly, there were many claims on the budget, and economic policy was being shaped within the context of the Government's basic social philosophy, with special emphasis on improving the social and economic conditions of the lower income groups and supporting small business and agriculture.

The authorities had in fact made considerable progress in restraining the growth of cash subsidies, which had declined by about PRs 1 billion in the past year, including those for fertilizers and petroleum, Mr. Finaish added. Although wheat subsidies were large, the authorities had changed arrangements for domestic wheat pricing and trade in April 1987. The wheat rationing system had been abolished, and domestic wheat prices and trade had been decontrolled. The aim was to limit wheat subsidies and to target better the assistance to the lower income groups, given the inefficiencies in the ration card system.

In addition to reducing current expenditures, revenue had been increased, Mr. Finaish went on. The authorities agreed that the revenue-enhancing measures should place less reliance on foreign trade and more on income derived from domestic activities. While the authorities intended to keep those issues under review, they could not ignore completely the social and political implications of budgetary actions.

The authorities agreed that savings and investment were low by international standards, Mr. Finaish indicated. They had taken certain measures to foster increased savings, and both domestic and national savings had increased significantly in 1986/87, with the ratio of domestic savings to GNP having risen by almost 3 percentage points. By keeping the growth in domestic liquidity broadly in line with that of nominal GDP and keeping inflation under control, the authorities had been able to provide an adequate rate of return on financial assets. For example, the rate of return on deposits in profit- and loss-sharing accounts, which constituted about 60 percent of the demand deposits, averaged between 9 percent and 14 percent. The rate of inflation was about 5 percent, and thus the rate of return was attractive. Investments by banks under the profit-and-loss sharing system were subject to the State Bank's credit ceilings and targets, but the changeover had resulted in financial deregulation and greater flexibility in the structure of the rates for financing and deposits. Banks had been free to act individually, and deposit rates might vary according to individual banks' profitability and types of deposits.

Measures had also been taken to increase private investment, including deregulation, increased incentives, liberalizing the import regime, and adopting a policy of delegating responsibility in manufacturing investment to the private sector, Mr. Finaish added. Special attention had been given to promoting small-scale investment, which represented a basic change for Pakistan. The ratio of gross domestic investment to GNP had also increased in 1986/87, and with the expected improvement in the fiscal position, the authorities were expecting a stronger increase over the medium term. The authorities intended to continue their efforts in promoting private sector investment in general, whether in textiles or in other sectors, but the problem was not necessarily the availability of resources, as adequate funds had been available to the private sector.

The authorities had placed increased emphasis on policies for improving efficiency through greater flexibility in pricing and reduction in regulatory constraints, Mr. Finaish continued. Toward that end, further steps were to be taken to strengthen the country's infrastructure and production base, encourage private enterprises, and promote exports. Access by industry, especially export-oriented industries, to imported inputs, spare parts, and capital equipment had been enhanced by the liberal trade policy for 1987/88-1989/90. The investment limit below which an industrial license was not required had been substantially increased. Those measures to improve the international competitiveness by reducing input costs had been supplemented by measures aimed at enhancing quality control and marketing. A difficulty that the authorities had to contend with in implementing policies of import liberalization was the widespread knowledge within the country of the protectionism Pakistan faced in marketing its products in major export markets. Whereas Pakistan had taken measures to liberalize the trade regime, the trend in the industrial countries had been in the opposite direction.

To strengthen the balance of payments, the authorities had followed a flexible exchange rate policy, Mr. Finaish said. In January 1982, to improve external competitiveness, the rupee had been delinked from the U.S. dollar, and a managed floating rate system had been introduced; the authorities' calculations indicated that from then until February 1987, the real effective exchange rate index based on 36 export partners had declined by 33 percent. Similar indices, based on 14 trading partners and 6 industrial countries, had declined over the same period by 35 percent and 43 percent, respectively. Under the circumstances, the authorities were of the view that the rupee had depreciated sufficiently in recent years, and that its current rate in terms of the U.S. dollar was appropriate and provided adequate returns to exporters. The problems faced by Pakistan in expanding its exports, particularly nontraditional exports, could not be tackled by exchange rate action alone but required industry-specific measures intended to remove barriers holding back the growth of particular exports. The other main hurdle in expanding Pakistan's exports was the growing protectionism in industrial countries.

The main objective in introducing the foreign exchange bearer certificates had been to develop a new source of foreign exchange receipts at a time when remittances from Pakistani workers abroad were likely to begin tapering off, Mr. Finaish noted. Those certificates had been introduced in 1985, and permission had been granted in 1986 for authorized dealers to issue travelers checks against encashment of them to conduct external transactions, which had effectively resulted in the liberalization of access to foreign exchange for both current and capital transactions.

The staff scenario based on maintenance of current policies did not represent the implications of certain broadly plausible assumptions for the major variables in the economy, Mr. Finaish pointed out. The scenario was set out for six years ahead, but government policy was not going to be left unchanged for six years. Indeed, since the issuance of the staff report, the authorities had implemented measures in both the government budget and the new trade policy, which should promote exports and contain the current account deficit. The medium-term scenarios were highly sensitive to any deviation of exports and imports from their predicted patterns, and any small negative deviation of exports from their projected growth rate could result in very substantial figures in the debt outstanding and the debt service after several years. Those simple exercises in calculation should not be used as predictions of difficult debt situations in the years ahead. The Pakistani authorities had traditionally pursued a cautious external borrowing policy and were determined to contain short-term commercial borrowing, which was viewed only as a transitional measure, and to keep debt-service payments within manageable levels.

Pakistan's economy had proved to be one of the more robust in the current period of sluggish growth, despite adverse external conditions, such as the lower than expected pickup in the world economy, declining commodity prices, increased protectionism, and reduced workers' remittances, Mr. Finaish concluded. However, that robustness was no reason for complacency, and the authorities were fully aware that they had to pursue an export-oriented growth strategy and increase domestic saving and investment. The authorities intended to pursue the policies that would reduce dependence on primary commodity exports and workers' remittances, thereby overcoming the protracted nature of the balance of payments problems. They recognized that the success of their adjustment would depend in great measure on improving trends in the public sector, both with respect to reducing its borrowing requirements and making structural changes in the public enterprise sector.

The Acting Chairman made the following summing up:

Executive Directors commended Pakistan's growth and inflation performance in the past several years and noted with approval the recent deregulation actions and the policy of enhancing producer prices. They observed that, partly in response to the latter measures, production of petroleum and the major agricultural crops reached high levels in 1986/87. Directors welcomed Pakistan's policy of removing impediments to the efficient functioning of the economy, including the recent liberalization of procedures for sanctioning investment and the decision to discontinue the wheat rationing system. Directors also noted the considerable reduction in the external current account/GNP ratio since 1984/85, which reflected both record cotton crops and lower world prices for major commodity imports, particularly petroleum and petroleum derivatives. Directors observed, however, that those favorable developments could be transient, since Pakistan's fiscal performance had continued to deteriorate and the domestic savings and investment rates had remained unduly low. In that context, Directors expressed concern over both the absence of significant resource mobilization efforts and the rapid growth of current government spending in the past three years. Directors regretted that the initial proposals to bring about a very substantial increase in revenues in the 1987/88 budget had not been carried through. They expressed concern about whether the approved budget for 1987/88 would be able to achieve the declared objective of reducing the fiscal deficit substantially, particularly in the light of the experience in the previous year. Directors also shared the staff's concern over the rapid accumulation of domestic and external debt, and debt-servicing obligations, as well as the continued overruns in credit to the nongovernment sectors.

Directors stressed that policy measures--including in particular the across-the-board single-rate sales tax and other revenue-generating measures recommended by the National Taxation Reform Commission--should be implemented as soon as possible to strengthen the resource mobilization effort. In order to achieve the needed fiscal improvement, the revenue effort would have to be supplemented by specific measures such as price adjustments and cuts in subsidies to limit the growth in current expenditures, Directors considered. There was thus a broad consensus among speakers that more forceful action was urgently called for both on the revenue and on the expenditure side in order to bring the deficit/GDP ratio down to manageable levels. An early and considerable correction of the fiscal position was deemed necessary to enhance domestic savings and investment levels, to give more room to the development of the private sector, and to foster sustained economic growth over the medium term.

Directors commented that the reduction in the external current account deficit/GNP ratio notwithstanding, the underlying structure of the balance of payments had changed little in recent years and remained vulnerable. The export performance of nontraditional and noncotton-based manufactures continued to be of particular concern, especially given the prospect for rising imports, declining workers' remittances, and high external debt servicing in the current fiscal year and over the medium term. While commending the authorities for their flexible exchange rate management in recent months and their effort to rationalize the trade system, Directors encouraged them to continue their flexible exchange rate policy. In order to foster economic development and reorient the economy toward export-led growth, more policies aimed at structural reform, investment liberalization, and meaningful deregulation--particularly economic pricing policies and comprehensive reform of the trade system--were needed, Directors said. Those policies would also help to contain the growth of external indebtedness and to reduce the vulnerability of gross official reserves, which were matched by short-term commercial borrowing. Finally, in their remarks on the external sector, several Directors deplored the increased protectionism in Pakistan's export markets.

In sum, Directors were of the view that a substantial correction of the fiscal situation and a strengthening of the external current account position were needed to sustain economic growth and to promote social and economic development over the medium term. They also noted that achievement of those objectives would be facilitated by comprehensive structural reforms in the real sector, a tightened credit policy stance, appropriate external policies, and improved external debt management.

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

The Executive Board then took the following decision:

1. The Fund takes this decision relating to Pakistan's exchange measures subject to Article VIII, Sections 2 and 3, and in concluding the 1987 Article XIV consultation with Pakistan, in the light of the 1987 Article IV consultation with Pakistan conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. Pakistan maintains restrictions on payments and transfers for current international transactions, including those maintained under the transitional arrangements of Article XIV, as described in SM/87/152, and bilateral payments arrangements with four Fund members. The introduction of the foreign exchange bearer certificates, while having the indirect effect of easing the restrictions on current payments, has given rise to a multiple currency practice. The Fund urges the authorities to eliminate the bilateral payments arrangements with Fund members and the multiple currency practices as soon as possible, and to take appropriate steps toward early removal of the remaining restrictions on the making of payments and transfers for current international transactions.

Decision No. 8669-(87/116), adopted
August 3, 1987

2. ZAMBIA - OVERDUE FINANCIAL OBLIGATIONS - REPORT AND COMPLAINT UNDER RULE S-1, AND NOTICE OF FAILURE TO SETTLE TRUST FUND OBLIGATIONS

The Executive Directors gave consideration to the Managing Director's report and complaint under Rule S-1 relating to Zambia's overdue financial obligations in the SDR Department and to the notice of Zambia's failure to settle Trust Fund obligations (EBS/87/172, 7/30/87).

The staff representative from the Treasurer's Department noted that EBS/87/172 and the proposed draft decision had been prepared in the expectation that the Board's earlier decision on the declaration of Zambia's ineligibility to use the general resources of the Fund would take effect on July 31, 1987. However, the Board had agreed at EBM/87/114 (7/31/87) to delay the effective date of ineligibility until September 30, 1987. The proposed decision on the complaint under Rule S-1, as originally drafted, similar to a decision in the General Department to declare a member ineligible to use the general resources of the Fund, would require a further decision of the Board to reinstate Zambia's right to use SDRs. However, the Board might wish to consider amending the decision, in the light of the decision taken at EBM/87/114, to provide for automatic reinstatement of Zambia's right to use SDRs when it became current in the SDR Department, an option comparable to the one relating to a decision to limit a member's use of resources in the General Department. There was no legal link, however, between ineligibility in the General Department and the form of suspension of the right to use SDRs in the SDR Department, and Directors could opt either to make the two decisions parallel, or to leave the decision concerning the overdue obligations in the SDR Department as it had been proposed originally.

Mr. El Kogali remarked that the situation with respect to Zambia's overdue obligations was all too familiar, particularly because Executive Directors had had a lengthy, difficult discussion on the matter only a few days earlier. The Board had been magnanimous and had demonstrated the spirit of cooperation that characterized the membership of the Fund, in arriving at its decision at EBM/87/114. He was hopeful that that decision would enhance the authorities' efforts to adopt a comprehensive adjustment program that, among other things, would address the underlying problem of external indebtedness, including the overdue obligations to the Fund. The Board's decision had sent a clear, positive message to Zambia, a message that the country had not been forsaken, and that encouraged Zambia to put its house in order so that the Fund could feel confident about providing the necessary assistance. He had no specific problem with the proposed decision so long as it was parallel with the decision taken at EBM/87/114.

Mr. Nimatallah asked the staff how its suggested amendment to the original wording of the proposed decision would read.

The staff representative from the Treasurer's Department indicated that the amendment would consist of an addition to Paragraph 2(b) of the draft decision reading "until such time as Zambia has become current in its obligation to which that provision applies." That language had been used previously in analogous situations.

Mr. Foot indicated that he could accept the proposed amendment. The magnitude of Zambia's arrears--SDR 260 million compared with net SDR charges of about SDR 1 million--made it unlikely that the specific wording of the decision would pose difficulties. The reinstatement of the right to use SDRs would probably take place as part of a broader package, with the full clearance of all arrears to the Fund.

Mr. Massé said that he had no problem with the proposed amendment.

Ms. Bush said that she regretted the events that had required the Board to hold a further discussion on the matter of Zambia's overdue obligations in the SDR Department. She wished to re-emphasize Mr. Dallara's comments at EBM/87/114, namely, that the most important priority was the formulation of a sound program that could be agreed to by the Fund and could catalyze donor cooperation. She understood that the authorities were working toward that end and she urged them to come forward with proposals as soon as possible. It was also quite important for the authorities to make some payments on the arrears until such time that the program was fully developed and the arrears were cleared. She had no problem with the staff's amendment to the proposed decision.

Mr. Grosche stated that he did have some problems with the amended decision. He believed that by treating the decisions relating to Rule K-1 and Rule S-1 in parallel fashion, the Board would not be paying sufficient attention to the worsening situation with respect to Zambia's arrears. Previously, the country had tried to remain current in the SDR Department and Trust Fund, but was overdue in those departments as well as in the General Resources Account, demonstrating a certain lack of cooperation on the part of Zambia. Accordingly, as long as there was no legal obligation for parallelism in the two decisions, he preferred to retain the original draft decision.

Mr. Ortiz said that he wished to associate himself with the comments made by Ms. Bush.

Mr. Posthumus commented that he did not wish to choose between the original and amended decisions on the basis either of technical efficiency or easing the work of the Board, or of an automatic extension of a solution that had been adopted at EBM/87/114 for the complaint under Rule K-1. Moreover, his position would be the same regardless of the country under discussion. What was at issue was the way in which the Board and the Fund operated. It was surely no accident that the Articles of Agreement provided two options for the Fund when a member had had its right to use SDRs suspended because it was not current in its obligations to the SDR Department--to terminate the suspension by a further decision of the Executive Board--with or without special limitations or conditions--or automatic termination when the member became current. He supported the decision as originally proposed in the staff paper.

Mr. Nimatallah said that as he understood it, under the General Resources Account, a new decision to reverse the limitation was not required, a procedure that resulted in less work for the Board. He asked whether the same procedure was applicable to the suspension of the right to use SDRs in the SDR Department.

The staff representative from the Treasurer's Department said that in the General Resources Account, a decision on limitation did not require additional action by the Board to reverse it, because it was terminated automatically when the country became current in its obligations. The suggested amendment to the original decision in EBS/87/172 was structurally identical to the procedure in the General Department. However, the Board might elect to retain the original wording of the decision, which did not have the automaticity feature. In that case, an additional decision by the Board would be required to re-establish Zambia's right to use SDRs after Zambia had become current in the SDR Department.

Mr. Sugita recalled that a declaration of ineligibility brought with it the automatic disclosure of that declaration. If the original text of the decision in EBS/87/172 involved comparable treatment with ineligibility in the General Department, then he wondered whether comparable publicity would be required for the decision in the SDR Department.

The staff representative from the Treasurer's Department replied that it was his recollection that the automatic publicity applied only to ineligibility in the General Department, and not to the SDR Department. Therefore, irrespective of the decision taken, there would be no publicity.

Mr. El Kogali explained that when he had referred to parallelism between the two decisions, he had been referring to publicity. Harmful misunderstandings might arise if a decision with regard to Zambia's overdue obligations in the SDR Department was publicized, giving the impression that it contradicted the Board's decision taken three days earlier on Zambia's overdue obligations in the General Department. The technical aspects of the Board's decisions--such as the distinction between the automaticity or nonautomaticity of a decision on limitation--were not always easy for the public to grasp and it would be helpful not to publicize the decision.

The staff representative from the Legal Department confirmed that there was no publicity involved in decisions taken with respect to overdue obligations in the SDR Department.

The staff representative from the Treasurer's Department recalled that a similar issue had arisen with respect to Sudan when, after having been declared ineligible to use the Fund's general resources, Sudan had incurred overdue obligations in the SDR Department as well. The staff had proposed a decision with respect to the S-1 complaint that was parallel in structure to the ineligibility decision in the General Department, even though there had not been an earlier decision in the SDR Department comparable to the limitation decision in the General Department. The staff had sought the Board's endorsement of that approach both then and afterward in the context of the next six-monthly report on overdue financial obligations to the Fund. The proposals of the staff and the actions of the Board had implied a certain amount of parallelism in the treatment of a member country that had overdue obligations in both departments. However, that precedent did not preclude the Board from retaining the original text of the proposed decision in EBS/87/172, even though it was not parallel to the decision taken by the Board at EBM/87/114.

Mr. Nimatallah said that for the sake of consistency, he could go along with the proposed amendment to the decision. At the same time, he wanted to urge the authorities to take the opportunity provided to construct an adjustment program and to talk in specific terms to the Fund. It was important for the authorities to be aware of the efforts of the Managing Director and of other countries that were trying to provide additional assistance, for Africa in particular, and in general for all the eligible countries under the structural adjustment facility. No one was helped if Zambia had overdue obligations in both the General and SDR Departments, and he hoped that the authorities would understand the need for them to accelerate their efforts.

Mr. Prader said that he shared the concerns of Mr. Grosche and Mr. Posthumus. In accordance with his chair's position at EBM/87/114, he did not wish to accept the proposed amendment to the original text of the decision.

Ms. Bush said that after further reflection, and having heard from the staff that no publicity would be associated with the decision on the complaint under Rule S-1, she no longer saw a compelling reason for amending the original text of the proposed decision.

Mr. Dai, Mr. Donoso, Mr. Ismael, Mr. Ortiz, Mr. Fogelholm, Mr. Hospedales, Mr. Sugita, Mr. Chatah, Mr. Pineau, Mr. Rouai, and Mr. Vasudevan said that they could go along with the amended proposed decision.

The Executive Board then took the following decision:

1. On July 2, 1987, the Managing Director submitted a report and complaint to the Executive Board (EBS/87/146), under Rule S-1 of the Fund's Rules and Regulations, setting out the basis on which it appeared to him at that time that Zambia was not fulfilling its obligation under the Articles of Agreement to pay net charges in the SDR Department. In addition, the Managing Director issued a notice of the facts on the basis of which it appeared to him that as of July 2, 1987, Zambia was not fulfilling its obligations under Decision No. 5069-(76/72) with regard to the Trust Fund to repay disbursements and to pay interest under its Trust Fund loans, and pursuant to Decision No. 8165-(85/189) to pay special charges that are overdue to the Trust Fund. These

facts and the complaint under Rule S-1 and notice with respect to the Trust Fund were communicated to the authorities of Zambia on July 8, 1987.

2. The Fund regrets the nonobservance by Zambia of its obligations, urges Zambia to resume their observance forthwith, and decides: (a) pursuant to Article XXIII, Section 2(b) of the Articles of Agreement, to suspend the right of Zambia to use SDRs it acquires after the suspension, other than for settlement of financial obligations to the Fund, until such time as Zambia has become current in its obligations to which that provision applies, and (b) if Zambia were otherwise eligible to make use of the general resources of the Fund, to take account of the existence of any overdue obligation to the Trust Fund in considering any request by Zambia for the use of the general resources.

Decision No. 8670-(87/116), adopted
August 3, 1987

APPROVED: March 2, 1988

LEO VAN HOUTVEN
Secretary